Cap Rate Conundrum

Cap Rate Evaluations

Someone recently approached me asking a question about Cap Rate Evaluations. In evaluating hundreds of cap rates, I have noticed the following well-known areas where I believe people "fudge" in order to "polish the cap rates," and areas I believe deserve a little more scrutiny when looking at a Leased Investment. Here goes:

- **"Pro-forma Income":** One of my pet peeves because they are calculating income that is not there yet. Obviously Upside is important, but so is a clear reflection on what it is you are buying.
- **Property Tax Re-calculation:** Why repeat a number that will be re-adjusted after a sale? It's easy enough to estimate a new tax assessment, and not considering a new calculation for the property located in California is not helpful to a new investor's bottom line…
- **Vacancy Rate/Reserves:** Most standard Income and Expense Statements allow for both a reserve factor and one for vacancy. It is an accepted prudent guideline when planning an annual budget, and they are often ignored in an income and expense statement.
- **Repairs and Maintenance:** These may be issues but if they are non-recurring; where do they fit in? Are they accurate? What deferred maintenance issues are not mentioned and may need to be accounted for? Can you pass any of them on to the tenant?
- **Management Fees:** Can vary depending on the owner's interest and geographic proximity to the investment. An investor buying out of state to achieve a better return

will no doubt need a bigger factor set aside for both management and the costs to travel periodically? I have seen this variable grossly under-estimated for a new manager.