Determining the Value of a Property

Cap Rate, GRM, and Cash-on-Cash Demystified

1031
Knowledge

Investment property owners use commonly accepted formulas to analyze new purchases and arrive at appropriate prices for the sale and purchase of investment properties. A few commonly used methods to determine the value of an investment property are the Income Capitalization Rate (Cap Rate), the Gross Rent Multiplier (GRM) approach and the cash-on-cash rate of return.

Capitalization Rate (Cap Rate): The cap rate is the ratio between the first year Net Operating Income (NOI) and the purchase price of the property. The cap rate formula below can be used to arrive at the value of an investment property, when the cap rate and the net operating income are known. Another variation of the cap rate formula is to determine the cap rate of an investment property when the NOI is known and the price is fixed.

$$\frac{\text{NOI}}{\text{Cap Rate}} = \text{Investment Value} \qquad \frac{\text{NOI}}{\text{Purchase Price}} = \text{Cap Rate}$$

Once the NOI for an investment property has been determined, the following assumptions can be made: the lower the cap rate, the higher the sales price; the higher the cap rate, the lower the sales price; sellers want buyers to accept the lowest possible cap rate; from the buyer's point of view, the higher the cap rate, the more advantageous the purchase.

Pros: The main advantage of using a cap rate is its simplicity. It also accounts for vacancy and operating expenses.

Cons: The reliability of using a cap rate is limited because it only looks at a one-year forecast and does not take into consideration any financing or tax implications.

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Gross Rent Multiplier (GRM): The value of an investment property is calculated using the Gross Scheduled Income (GSI = the maximum amount of annual rent received if the property was 100% occupied) for year one, multiplied by the GRM.

First Year GSI x GRM = Investment Value

If a taxpayer wants to calculate the GRM for a potential investment, they should divide the asking price by the first year GSI. The higher the asking price, the higher the GRM. Sellers generally try to sell their properties at the highest possible GRM. Buyers typically try to purchase investment properties at the lowest possible GRM. The lower the GRM, the more attractive the investment becomes to the buyer.

Pros: The GRM is a convenient tool because of its simplicity.

Cons: The usefulness of the GRM is limited by the fact that it does not take into account vacancy and uncollected rent, operating expenses, debt service, tax impact or income past the first year.

Cash-on-Cash: Another measurement of investment performance is called the cash-on-cash rate of return. This involves comparing a taxpayer's initial investment to the potential before-tax cash flow that the investment property is likely to produce.

$$\frac{\text{Before-Tax Cash Flow}}{\text{Initial Investment}} = \%\ \text{Return}$$

Pros: Cash-on-cash takes into consideration vacancy and uncollected rent, operating expenses, and debt service.

Cons: Cash-on-cash does not take into consideration anything past a first-year forecast and does not take into account tax considerations.

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