

HOW TO CALCULATE CAP RATE

Let's do some math! Don't worry, it doesn't require an advanced degree. 😊

Remember, cap rate isn't the *only* equation that exists when determining whether a rental property is a good investment, but it's a big consideration!

As a refresher, the cap rate measures your cash flow, relative to property value.

CAP RATE FORMULA

$$\text{Cap rate} = \text{Annual Net Operating Income} / \text{Acquisition Price}$$

LET'S CALCULATE CAP RATE STEP-BY-STEP!

Step 1: Calculate the potential gross rent of your investment property. (Tip: grab your "How to Estimate Rent" worksheet and use one of the properties from there!).

Remember, Potential Gross Rent is calculated annually, so multiply the monthly rent by 12 and enter the answer below.

Monthly rent x 12 = Potential Gross Rent: _____

Step 2: Calculate the vacancy. Let's use five percent for this example. Calculate 5% (or .05) of your Potential Gross Rent:

Potential Gross Rent _____ **x .05 = Vacancy:** _____

Step 3: Calculate the Effective Gross Rent by subtracting vacancies from the Potential Gross Rent.

Potential Gross Rent: _____

Less Vacancies: _____

Effective Gross Rent: _____

Step 4: Add any other income sources associated with the property, such as pet fees or coin-operated laundry income. Add this to the Effective Gross Rent – the result is the Gross Operating Income.

Effective Gross Rent: _____

+ Other Income: _____

Gross Operating Income: _____

Step 5: Calculate the *annual* operating overhead. These are the expenses associated with running the property, such as utilities, water, trash, repairs, management and maintenance. It *doesn't* include the principal and interest on your mortgage, but it does include your insurance and property taxes.

Property tax (For this exercise, you can look the taxes up on websites, such as Zillow. But remember, when calculating the cap rate on a real investment property, go to the county assessor's office so you know you're getting the accurate taxes. Also, be sure to check to see if there are *both* county and city taxes.): _____

Insurance (again, you can use the suggested amount from Zillow, but be sure to call an actual agent when calculating the cap rate in real life!): _____

Utilities: _____

Maintenance and Repairs (for the sake of simplicity, let's use 1% of the purchase price for this exercise.): _____

Capital Expenditures (or Cap Ex) (again, for simplicity, use 10% of potential gross rent): _____

Management (10% of potential gross rent): _____

Now add them all up!

Grand Total of Operating Expenses: _____

Step 6: Calculate the Net Operating Income.

Gross Operating Income: _____

Less operating overhead: _____

Net Operating Income (NOI): _____

Step 7: To find the cap rate, divide your NOI by the total acquisition price of the house (The total acquisition price of the house includes the price, any up-front renovations to get it rent ready, and the closing costs. You can use online calculators for the closing costs).

NOI/total acquisition price = _____

Step 8: Multiply the result by 100 to convert it into a percentage. The result is X% cash flow return on your property value – your cap rate.

_____ x 100 = _____%

Step 9: Celebrate! Because you now know how to calculate cap rate! Woo hoo!