

2022 Low- and Moderate-Income Housing Capitalization Rate

NOTICE

In accordance to House Bill 3546, the Appraisal District shall give Public Notice, including posting on the District's website, the capitalization rate to be used that year to appraise property under this section. Pursuant to Section 11.1825 (r), Texas Property Tax Code, the Runnels Central Appraisal District gives notice of the capitalization rate to be used for the 2022 tax year to value properties under this section. The Chief appraiser must appraise these properties using the income method; consider the restrictions on who may rent the property and the rent rate. Also, Low Income Housing contains a high-risk cash flow, property upkeep materials, maintenance, security, and taxes. These can influence the valuation of the property. An overall capitalization rate between 4% and 10% will be used to appraise these properties. Properties can be reviewed on an individual basis and other adjustments will be made when necessary according to information provided to the Runnels Central Appraisal District and its Chief Appraiser. Most cap rates of high-risk real estate typically exceed 7%. As of January 31, of each year the district must give public notice of the cap rate to be used on all qualified low-income housing properties. This year's capitalization rate for the tax year 2022 is 6.185%

What is the Capitalization Rate?

The capitalization rate (also known as cap rate) is used in commercial real estate to indicate the rate of return that is expected to be generated on a real estate investment property.

Understanding the Capitalization Rate

The cap rate is the most popular measure through which real estate investments are assessed for their profitability and return potential. The cap rate simply represents the yield of a property over a one-year time horizon assuming the property is purchased on cash and not on a loan. The capitalization rate indicates their property's intrinsic, natural, an un-levered rate of return.

Limitations of the Cap Rate

Although capitalization rate can be useful metric for properties stable income, it is less reliable if a property has irregular or inconsistent cash flow. In these circumstances, a discounted cash flow model might be a better way to measure the returns from an investment property.

The capitalization rate is only useful to the extent that a property's income will remain stable over the long term. It does not take into account of future risks, such as depreciation, or structural changes in the rental market that could cause income fluctuations.

What is a Good Cap Rate?

There is no single value for what makes an "ideal" capitalization rate, and investors should consider their own risk when evaluating a property.

Generally, a high capitalization rate will indicate a higher level of risk, while a lower capitalization rate indicates lower returns but lower risk.

Formula for the Capitalization Rate

Several versions exist for the computation of the capitalization rate. The most popular formula, the capitalization rate of a real estate investment is calculated by dividing the property's net operating income (NOI) by the current market value. Mathematically,

$$\begin{aligned}\text{Capitalization Rate} &= \text{Net Operating Income} / \text{Current Market Value} \\ &\text{or} \\ \text{Capitalization Rate} &= \text{Net Operating Income} / \text{Purchase Price}\end{aligned}$$

where, the net operating income is the (expected) annual income generated by the property (like rentals) and is arrived at by deducting all the expenses incurred for managing the property. These expenses include the cost paid towards the regular upkeep of the facility as well as the property taxes.

The current market value of the asset is the present-day value of the property as per the prevailing market rates.

Interpreting the Capitalization Rate

Since cap rates are based on the projected estimates of the future income, they are subject to high variance. It then becomes important to understand what constitutes a good cap rate for an investment property.

Different cap rates among different properties, or different cap rates across different time horizons on the same property, represent different levels of risk.

A look at the formula indicates that the cap rate value will be higher for properties that generate higher net operating income and have a lower valuation, and vice versa.

Important: There are no clear ranges for a good or bad cap rate, and they largely depend on the context of the property and the market.

What Should My Capitalization Rate Be?

The capitalization rate for an investment property should be between 4% and 10%. The exact number will depend on the location of the property as well as the rate of return required to make the investment worthwhile.

Is a Higher or Lower Capitalization Rate Better?

Generally, the capitalization rate can be viewed as a measure of risk. So determining whether a higher or lower cap rate is better will depend on the investor and their risk profile. A higher cap rate means that the investment holds more risk whereas a lower cap rate means an investment holds less risk.

What Is the Difference Between the Capitalization Rate and Return on Investment?

Return on investment indicates what the potential return on an investment could be over a specific time horizon. The capitalization rate will tell you what the return of an investment is currently or what it should actually be.

The Bottom Line

The capitalization rate is used to measure the profitability of commercial rental properties. A high cap rate indicates a relatively high income, relative to the size of the initial investment. However, there are also other factors to consider, such as risk and local market dynamics. Investors should be careful to consider a wide range of metrics in addition to the capitalization rate.