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The commercial classroom: Valuing investment props. today

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This column is offered to help educate agents new to commercial and investment brokerage and serve as a review of basics for existing practitioners.

Prior to the economic crash in 2008 investment properties were primarily valued based upon the income approach to valuation. In this method an operation statement of the property is forecast. Considered are: the potential rental income (as if totally rented), an adjustment for the possibility of vacancy, adding in non-tenant income to the building and subtracting the owner's operating expenses including a reserve for unexpected repairs, resulting in the building Net Operating Income (NOI). Then using a capitalization rate (simply put, a percentage of return on investment acceptable to investors in that market place at that point in time) a value of the property is calculated. This would be a reflection of only the current year's financial analysis. To properly appraise the property value other things would also be considered, but this is the basic structure of the approach.

Today the method may also be used, but it now requires additional considerations. In most market areas commercial property values have dropped 25%, 30% or more. The investment property may still have basically the same NOI as it did two or three years ago, but what will the NOI be in the future? As property values have dropped so have the rental rates. A property that was renting for $25 per s/f several years ago may only be able to get $20 per s/f today. As the leases written before the downturn start to expire, replacement tenants will pay less. Landlords who want to keep existing tenants may have to renew at lower rents or even make rent adjustments before the lease concludes.

In valuing these properties, a realistic projection of future rent possibilities must be made. Now a spread sheet must be developed showing the projected operating statements for the next five years. Take into account expiring leases during that period, realistic expectations of replacement rents, factor in increased vacancy adjustments (as vacancy rates have also increased during this period of economic turmoil), and anticipated increases in operating expenses. This will undoubtedly show a decrease in NOI for the immediate future. Using CAP rate methodology a value can be determined for future years which may be more realistic than just using the current year's operating statement.

To get a true picture of value today other methods of valuation must also be considered. Traditionally the comparable approach is also used: comparing this property to recent sales. This is fine, but there have not been many commercial sales in the last few years. One can modify this to examining the current competition on the market. What is the price per s/f of similar properties for sale? Another approach is the cost approach. What would it cost to replicate the subject property? This is especially important in valuing green buildings or properties that have has significant energy related improvements.

Valuation of investment properties or any commercial property today is not easy. Careful consideration must given to setting the right price.

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