



Commercial Classroom: Pricing Challenges - by Ed Smith

July 12, 2022 - Long Island



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

Post pandemic, what is the correct price of a building or space? The academic answer is whatever the buyer (tenant) is willing to pay; whatever the market will bear. But as real estate agents we are looked upon to guide our clients as to a realistic price. Sale pricing is determined by several methods: The Income Approach, Comparable Method, and the Cost Approach. Historically, the Income Approach has been predominately used, as it is what the banks use in determining mortgage value. But today all methods need to be considered in determining sale value. Comparing values for leasing space is less defined and more difficult.

The Income Approach to valuation considers the buildings potential income, calculated with an adjustment for possible vacancy. The owners operating expenses are then subtracted, including a contingent fund for possible unexpected repairs and maintenance. Building expenses do not include debt service – that’s the responsibility of the owner who could buy all cash or finance the purchase. What remains is the Net Operating Income (NOI). Based on a local Capitalization Rate (CAP Rate), which can be thought of as a desired profit percentage of local investors at this time, a value can be determined. Using the formula: $NOI \div CAP\ Rate = Market\ Value$.

At issue with this method today is the fact that the rental income may have declined. After COVID-19 many retail and office tenants may be paying rents base on leases created 5-10 years ago; but when vacated the landlord may have to rent for lower rates. To adjust for this projections have to be made on current market rents and consequential lower NOI’s, which reduces current value. In contrast industrial building rents have increased, in valuing them we need to adjust projections higher.

Buyers who wish to occupy a building for their own business are more likely to be focused on what other similar building recently sold for, known as the Comparable Method of valuation. But all building are not always the “same,” and other adjustments to compare them may be required. Regarding size alone, the buyer may want to compare similar buildings based on recent sales or other properties currently on the market for sale. To compare, values must be calculated to a cost per square foot. (price divided by the size of the building.) The average cost per square foot value can then be multiplied by the size of the subject property to determine market value. For example:

Recent Sales or Currently on the Market

\$1,000,000 , 7,800 s/f = \$128 per s/f

\$785,999 , 6,390 s/f = \$123 per s/f

\$625,000 , 5,000 s/f = \$125 per s/f

Subject property: Comparable average per s/f \$125

Market Value: 7,000 s/f building $7,000 \times \$125 = \$875,000$

With a lack of commercial sales over pandemic years, sales comps may be old and need to be adjusted for time.

For industrial or “green” properties a buyer may use the Cost Approach of valuation. What would it cost to replicate this building today with its unique features? Taking into consideration the current rise in material costs and supply issues. Also, comparing the cost of buying land and constructing a new building verses the cost of buying an existing building.

Agents today must be familiar with financial analysis and the inventory (sold and available) in their market area to advise and guide their clients in proper pricing of their buildings.

More difficult is comparing lease values. Space is offered at \$20 per s/f to rent, but what does this include? Are there any other expenses to the tenant? What is the real cost of that space to the customer.

When lease listings are taken ask the owner what the quoted “base rent” includes and if there are any additional pass-thru’ s to the tenant. You may find the base rent is \$19.00 per s/f but the tenant also has to pay \$2.00 towards utilities and contribute \$3.00 per s/f to common area maintenance charges. The tenants real cost then is \$24.00. Most customers are not familiar with real estate terms. The best way to help them is to do the calculations for them; and quote the total monthly cost of the space. But, be sure to disclose in writing the detailed costs.

When pricing leasing space we need to have “comps,” but in this category our “comps” are primarily comparables; what is the current competition, what else is on the market now that the tenant can choose from. In developing your comparables make sure you get all the facts; determine what the real cost of the space is.

“Pricing” is an ongoing research job. You must be an expert in your market area, which means constantly updating your personal data base of “comps.” (If you don’t have one, start a series of files today by sale and lease and property type.) Know what is on the market and what has closed. Read the trade papers to find out what closed, talk to other agents to find out what things really sold or leased for. Have your facts ready for any listing opportunity.

Edward Smith, Jr., CREI, ITI, CIC, GREEN, MICP, CNE, e-PRO and CIREC program developer, is a commercial and investment real estate instructor, author, broker, speaker and a consultant to the trade.