Commercial classroom: Back to basics investment properties - by Edward Smith

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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.

One method by which investment properties are evaluated is known as the Income Approach to valuation. Banks typically use this method when they appraise investment properties. This direct return method of valuation focuses on the cash flow produced. The annual cash flow results from subtracting the owner's operating expenses from the gross operating income and is referred to as the Net Operating Income or NOI. Buyers use the NOI of a property in developing their purchase offers.

Gross Operating Income has several components. Potential Rental Income (a/k/a Rent Roll) consists of actual and projected income for all rentable spaces. Additional rent charged by the landlord must also be included, such as utility pass throughs, CAM (common area maintenance) charges or real estate taxes.

This income is adjusted for a vacancy contingency, initially in percentage terms, based on the possibility that part or all of the space may be vacant for a certain period of time. In calculating potential lost revenue from vacancy consideration is also given to the number of units in the building, available space in competing properties and overall market conditions. Then this data is converted to dollars and subtracted from the Gross Operating Income.

Other income to the building, aside from the tenants, is also accounted for, i.e. income from advertising billboards or antennas on the roof. Added into the Performa this creates the Gross Operating Income of the property.

Next is the calculation of the Operating Expenses. This category includes all operating expenses paid by the owner except annual debt service (mortgage expenses). Debt service is not an expense of the building, rather it's an expense of the owner if they choose to finance their purchase.

Depending on the size of the building Property Management expenses may be included, which are usually calculated as a percentage of the Rent Roll. A contingency fund for Repair and Maintenance expenses (unexpected major problems – not routine maintenance) is also considered as an expense if actually used. How much money should be included in this category is primarily based on the age and condition of the building. Subtracting the Total Operating Expenses from the Gross Operating Income equals the Net Operating Income (NOI).

A CAP Rate (Capitalization Rate) may be practically thought of as a desired profit percentage of an investor. It is based on the concept that a correlation exists between the income a property produces and its market value. Value may be determined using this formula:

Net Operating Income (NOI) ÷ Capitalization Rate (CAP) = Market Value

For example: If a building had a NOI of $100,000 and the current CAP Rate was 10%, the building would have a value of $1,000,000. ($100,000 ÷.10% = $1,000,000). Note this is based only on the current year's performance; some investors project future performance in determining value.

In addition, two other methods of valuation should be considered. The Comparable Method (comps), looking at actual previous sales and what "competition" is currently on the market in the area. The Cost Approach is used with some Industrial buildings and "Green" buildings looking at the construction costs to replicate this building with the same features. These methods of valuation give an agent the ability to answer the question, "What is my property worth?"

Another way to look at the CAP rate is as the Return on Investment (ROI). If they purchased the property for all cash one can divide the current annual cash flow, the NOI, by the purchase price and determine the percentage return on the investment for the current year. For example: Purchase Price $500,000, current NOI (cash flow) $60,000, Return on Investment 12% ($60,000 ÷ $500,000 = .12%).

However, in most cases when a property is purchased it is leveraged, bought in part using borrowed funds, other people's money. Most commonly the structure involves a down payment, Initial Investment, paid by the purchaser and a mortgage loan from a bank. The total amount repaid on the loan each year, including principal and interest, is called the Annual Debt Service. If the question is again posed "what return is the investor getting on their investment?" Two formulas are needed to determine the Cash on Cash Return. When properties are financed the Return on Investment is called the Cash on Cash Return.

Net Operating Income (NOI) – Annual Debt Service = Cash Flow Before Taxes (CFBT)

Cash Flow Before Taxes (CFBT) ÷ Initial Investment (II) = Cash on Cash Return (CoC)

The "Taxes" referred to in these formulas are the Income Taxes the owner may have to pay on this building this year.

For example: A property is purchased for $1,000,000 with a 30% down payment (typical in today's market) $300,000. A mortgage is obtained for $700,000 with a 20-year term and 7.5% interest rate. The annual debt service is calculated to be $67,670. Assume a NOI (annual cash flow) of $100,000. The Cash on Cash Return is 10.78%.

$100,000 (NOI) – $67,670 (Annual Debt Service) = $32,330 (CFBT)

$32,330 (CFBT) ÷ $300,000 (II) = .1078 Cash on Cash Return of 10.78%

It is important to realize this reflects the current return of the current owner on this investment, or how the property performed financially this year, based on a purchase price and down payment that may have been made several years ago.

A buyer is usually not concerned with the owner's Cash on Cash return on their investment. The return would only be significant to the buyer if they were assuming the current mortgage – which is rare in commercial transactions.

Usually, the current sales price reflects an appreciation in value that would require a higher down payment. Loan terms and interest rate will also vary. Some owners desire to hold paper or give a purchaser a mortgage themselves to gain the benefit of the interest on the loan and for other tax advantages.

Buyer's focus on the current and/or future cash flow(s), using the Net Operating Income to determine their purchase offers.

The real value of the property has a few other steps, Once the Cash Flow Before Taxes has been calculated, the owners Income Taxes for this year, on this property, can be calculated and paid, with the After Tax Cash Flow remaining. By dividing the After Tax Cash Flow by the Initial Investment (down payment) the real Cash on Cash return can be calculated. This will generally increase over time, reflecting the current equity the owner has in this property

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