Income approach commonly used for valuation

Cap rate measure of investment risk

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The main difference between residential and commercial real estate is you live in the first and rent the latter.

But this simple distinction requires two very different methods for calculating value. A home is valued based on how much money a buyer is willing to pay to live in a specific home in that particular neighborhood.

Home purchases are emotional decisions. How much you desire to live in a home drives how much you are willing to pay to live there. This condition is called demand, and today's demand combined with the current level of supply determines current market value.

It does not matter what you think your home is worth. It doesn't even matter what an appraiser or a bank says your home value should be. Residential real estate value is determined by how much a buyer is willing to spend for the home. As Albert Einstein once said, "A man should look for what is, and not for what he thinks should be."

Establishing value in commercial real estate is a whole different story. Commercial property value is determined much more simply. It is based on a multiple of the net annual rent produced. This is called the "income approach" to valuation. It is the method most commonly used to establish the value for commercial income properties around the world.

The decision to buy a commercial property is based on an unemotional calculation of a simple equation called the capitalization rate or "cap rate" formula. To put it in mathematical terms, CR = NI/P where the cap rate equals net income divided by price.

A property's cap rate is a measure of its investment risk. This risk differs from property to property based on three key factors.

- **Tenant strength:** Is it Exxon or a local mom and pop business?
- **Building quality and location:** Is it a concrete and steel structure built two years ago in New York's Times Square, or a wooden-frame building constructed in 1800 on a rural farm road in Iowa?
- **Lease comprehensiveness and duration:** Is it a 100-year triple net lease where the tenant pays for CAM (i.e., real estate taxes, insurance and maintenance) in addition to base rent, or, is it a one-year gross lease where the tenant pays for only base rent while the owner pays for all other property expenses (i.e., CAM)?

Recession dents values

The recession has delivered lost jobs and lower pay for those with jobs. It has caused fear and uncertainty in the market, which in turn causes us to pull back and spend less.

People have less to spend on housing. Some people don't trust the real estate market anymore and are opting to rent instead. Lower demand coupled with increased supply has caused home values to go down.

Large banks control a shadow inventory of foreclosed homes that have not all been brought to market with realistic pricing to generate sales yet. This set of circumstances perpetuates uncertainty in the residential market.

Commercial real estate has seen higher vacancies due to over-building during the peak years combined with tenant consolidations, bankruptcies and relocations. Tenants are getting great deals now to renew their leases or are relocating to nearby buildings for much lower rents.

This market adjustment is allowing medical practices and other well-heeled commercial tenants to exploit the current downturn to lock-in low rents through the recovery. This environment has created an interesting phenomenon in the commercial real estate sales market today.

New trend

In years past, there were always two distinct segments of commercial real estate sales. Vacant buildings sold for lower prices and leased buildings sold for higher prices based on the income approach to valuation where cap rates set prices. But now, one of those segments has almost disappeared. Today we see very few commercial sales that are what is referred to as "well leased". This is the case for two reasons:

First, there are fewer well leased buildings due to the current unfavorable economic conditions. Second, the few owners that have well leased buildings tend to hold them longer to enjoy the cash flow. The outcome that we see today is most commercial building sales have higher vacancies with lower rents that produce lower sale prices per square foot.

Banks have little choice but to foreclose when their commercial mortgages default. The result is banks fuel the further deterioration in commercial prices when they foreclose on office buildings and then sell the buildings, which are usually poorly leased or they wouldn't have been foreclosed in the first place, for whatever the market will bear. I believe this missing segment of well leased commercial sales is the reason that our commercial sales market appears worse than it actually is today.

Since appraisers use recently closed sales for their comparable sales analysis, commercial appraised values are trending downward and creating problems for owners that are just now refinancing their buildings as mortgages come due.

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