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| Income Capitalization Approach |

Methodology

The market valuation of the subject property is summarized in this section via the **Direct Capitalization Method** of the Income Approach. In applying the Direct Capitalization Method, two components are necessary in arriving at an estimate of net operating income: potential revenues and projected operating expenses; with the difference resulting in net operating income. Value is then derived by dividing stabilized year's income by a market derived capitalization rate. Therefore, it is important to analyze both income and expenses for the subject property in terms of reasonability and their relative relationship to similar properties in the marketplace.

Potential Gross Rental Income

The first step in the Income Approach is to estimate the subject's potential gross income, which reflects its market rent if currently leased in the marketplace. The analysis is conducted on the basis of a monthly dollar per square foot rental, which is then applied to the gross leasable area (GLA) of the property. Hence, we have anticipated that all future rent for the subject would be payable on this basis.

A review of current subject market trends indicates that typical multi-tenant industrial leases for newer industrial properties in the subject market area are written on an **absolute triple net** rental basis. Such triple net tenant rents include not only the net base rent, with the tenant typically also responsible for all building operating expenses ((including management fees and reserves for capital expenditures). Hence, we have anticipated that all future rent for the subject would be payable on this basis.

Comparable Rent Analysis

In order to estimate the current market rent for the subject industrial property, we conducted a survey of reasonably comparable tenant leases of industrial buildings located in the immediate to expanded market area. The result of this survey is summarized on the following pages, along with a location map and photographs of the buildings relating to each lease comparable.

Rental Adjustments

Depending on market conditions, free rent, or other incentives are used to attract tenants. When applicable, the comparable rents are adjusted to reflect current market terms with an effective rent to the property owner.





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| **Rent Comparable Location Map** |
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Merge & Insert Rent Comp Photos or Write-ups

Comparable Rent Analysis

Industrial lease rates in the area are typically segmented between rents for the building shell and a surcharge for the interior office build-out, which together, form a blended or effective rental rate. For ease of comparison, our analysis of the subject will be segmented between analyses of the shell and office surcharge rent for each area. An analysis of the office build-out surcharge rent will follow the shell rent analysis.

From our rental survey we selected leases of industrial building space most similar to the subject property. The leases commenced between \_\_\_\_\_\_\_ 2018 and an \_\_\_\_\_\_\_\_\_\_\_\_\_ 2020. The comparables provide a reasonable basis for concluding a market rent for the subject property. The leased space ranges from \_\_\_\_\_\_\_\_\_\_\_ SF to \_\_\_\_\_\_\_\_\_\_\_ SF and have rental shell rates ranging from $\_\_\_\_\_ to $\_\_\_\_\_ per SF NNN with industrial building lease rates in the area typically quoted on a monthly rental rate basis. The following analysis is presented.

Merge & Insert Rent Comp Data Analysis Output

Additional Quantitative Analysis

A comparable adjustment grid for the rents is provided as additional analysis in a preceding chart. The comparables indicate an adjusted shell rental range of between $0.\_\_\_\_\_ and $0.\_\_\_\_\_ per SF GLA with an average shell rent of $0.\_\_\_\_\_ per SF and median shell rent of $0.\_\_\_\_\_per SF. Note that a 3.0% per year market conditions adjustment was applied in this analysis. The adjusted rental range provides additional support for the following final market shell rent conclusion.

Recent Subject Leasing Activity

With regard to leasing activity at the subject, the 2009 building forming the north space of the subject property (20,400 SF GLA; 5,882 SF of office, 28.8%) was leased to Farmer Bros. Co. (dba West Coast Coffee). Note that this tenant’s lease indicates a GLA of 20,500 SF. However, this space (the original building portion built in 2009) measures 170’ x 120’, which is equal to 20,400 SF which is used in our analysis. The lease commenced for a 3-year term in February 2017, as part of the sale of the business to Farmer Bros. Co., with the business owners retaining ownership of the property. The current monthly contract rent is $16,400 per month or $0.804 per SF, NNN and escalates on February 7, 2021 at 2.5% annually over the current 3-year option period. Applying a reasonable office surcharge of $0.850 / SF infers a contract shell rate of $0.561 per SF over the next 12-month period.

The 2017 building addition (15,000 SF GLA; 1,988 SF of office, 13.3%) forming the south space of the subject property is leased to Thermo Fisher Scientific. The lease commenced for a 7-year and 2-month term in December 2018. The current monthly rate is $10,444 per month or $0.696 per SF, NNN with 3.0% annual escalations and 2 months free rent (already incurred in 2019). Applying a reasonable office surcharge of $0.850 / SF infers a contract shell rate of $0.595 per SF over the next 12-month period.

The current subject rent roll is provided on the following page, while copies of the tenant leases are contained on file in our office.



Based on the preceding, the tenants’ contract rent is considered below market with a measurable positive leasehold interest noted. Therefore, the value of fee simple interest is less than the leased fee interest. A valuation of the subject positive leasehold interest is provided at the end of the Reconciliation section.

Market Rent Conclusion

The rent comparables provide a range of **market shell rate** indicators from $0.\_\_\_\_ to $0.\_\_\_\_ per SF per month NNN. Based on the following reasoning \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_, it is the appraiser’s opinion that the comparables provide support for a shell rate of **$0.\_\_\_\_\_\_ per SF**. The rate is well supported just above the average adjusted shell rental rate of $0.\_\_\_\_ per SF and median of $0.\_\_\_\_\_ per SF.

Regarding the **office build-out** premium, the subject has office space that is well maintained and in average condition. The comparables indicate an office of surcharges from $0.\_\_\_\_ to $0.\_\_\_\_ per SF. Given the higher than typical percentage of office build-out ratio of \_\_\_\_% and generally average quality, a mid-range **market office surcharge** of **$0.\_\_\_\_ per SF** is considered applicable in this analysis.

Combined, the shell and office rents result in a **blended monthly rate** of **$0.\_\_\_\_ per SF GLA** which, as the Market Analysis section suggests, is reasonable and well bracketed by the lease comparables.

Potential Gross Rental Income

Applying the market rent estimates results in an annual potential gross rental income of **$\_\_\_\_\_\_\_\_\_\_** ($\_\_\_\_\_ per SF GLA),as indicated in the following stabilized income and expense statement for the subject property (at the end of this section).

Reimbursable Expenses

For purposes of this cash flow projection, and consistent with the subject leases in place, we have assumed the subject leases will continue to be payable on an absolute triple net expenses basis. Consistent with the most common market expense terms for newer multi-tenant industrial in the subject marketplace, the tenants are assumed responsible for paying all operating expenses including real estate taxes, building (fire and flood) insurance, and common area maintenance (CAM) expenses. Also generally included are management fees and reserves for capital expenditures. This reimbursement income is presented as an income item which is offset by a like operating expense amount. The actual expense to the ownership position relates to operating expense associated with vacant space, which is treated by applying vacancy and credit loss to the expense reimbursement income.

The client has provided historical operating expenses for 2018 and 2019, as well as CAM budget for YTD 2020, with these documents considered in this analysis (see Addenda). In addition, we relied up our interviews with the market participants, as well as general market analysis to determine a reasonable level of reimbursable income for the subject property. Since our recoverable expense analysis assumes nearly 100% expense recovery, which is a reasonable assumption for the subject property, we have projected such **reimbursable income** for the subject project at **$\_\_\_\_\_\_\_\_**, or $\_\_\_\_\_\_\_ per SF GLA ($0.0\_\_ / SF / mo.). Note that this falls near the low end of typical expense reimbursements for in-house rent comparables, as well as the surveyed rent comps, of between $0.15 and $0.27 per SF. Overall, our projection of reimbursable income appears to be reasonable.

Potential Gross Income

Combining the projected market / contract rents with the forecast expense reimbursements indicates a total **potential gross income** for the subject property of **$\_\_\_\_\_\_\_\_\_** ($\_\_\_\_\_\_\_ per SF GLA). This amount is indicated in the following stabilized income and expense statement for the subject property, presented at the end of this section.

Vacancy and Credit Loss

This expense category accounts for the time period between tenants, as well as possible prolonged vacancies under slow market conditions. The assignment will reflect the probable vacancy during the economic life of the property.

Copy this paragraph directly from Market Analysis

The appraiser used **CoStar** to produce a search of the subject’s immediate / competing Clackamas / Milwaukie -Industrial Market. As of the beginning of June 2019, the search shows a current **industrial vacancy** of 2.5% (598,476 SF out of 23,774,295 SF; 617 properties surveyed). The trend has been on a bell-shaped curve in 2018 with the beginning and ending the year rate around 2% and peaking at just over 4% in the first quarter. The rate is still below the 5-year average of 3.9%. Absorption was somewhat mixed with the previous 12 months indicating a positive net absorption of 581,077 SF, above the 5-year average of 209,086 SF. In addition, 12-month total leasing was reported at 1,735,363 SF, above the 5-year average of 1,409,368 SF.

Based on the subject's good industrial location, as well as prevalent long-term market expectations, a **stabilized vacancy and credit loss** of **5.0%** is considered applicable for the subject property. The concluded rate is equivalent to 6 months of rent loss every 10 years.

Effective Gross Income

Based on the preceding, **effective gross rental income** for the subject property is estimated at **$\_\_\_\_\_\_\_\_\_\_** ($\_\_\_\_\_ per SF GLA).

Projected Operating Expenses

The market rent conclusion has been based on a typical triple net lease for industrial properties similar in age to the subject, in which only a reserve allowance for the replacement of capital items are paid by the landlord. To estimate expenses applicable to the subject property on a stabilized basis, local suppliers have been contacted, and comparable properties have been analyzed.

Reimbursable Expenses

The market rent conclusions have been based on an absolulte triple net lease structure, in which most operating expenses for the subject (with the exception of minor administrative costs) would be reimbursed by the tenants to the landlord. Note that historical expenses for 2018 and 2019, as well as a limited forecast operating budget for 2020, was provided by the owner and is included within the Addenda of this report.

Real Estate Taxes: The subject’s real estate taxes for this current fiscal year were recent set and paid at $\_\_\_\_\_\_\_\_\_ (before the 3.0% discount allowed by the county for payment in full). Assuming continued 3.0% inflation in property taxes (the max allowable), less the 3.0% discount for full payment, this results in similar stabilized property taxes continuing at **$\_\_\_\_\_\_\_\_\_\_** ($\_\_\_\_\_\_ per SF) for the subject property.

Insurance: Building insurance for similar industrial properties in the subject market area generally range from $0.20 to $0.50 per square foot, with the upper end indicative of properties impacted by flood plain insurance. Without these special coverages, insurance rates generally range from $0.15 to $0.25 per SF. The subject’s 2019 operating information indicates an insurance premium at $\_\_\_\_\_\_ or $0.\_\_\_\_\_ per SF which is reasonable relative to the market expense data. Hence, for purposes of this analysis, we have assumed a stabilized property insurance expense of **$0.\_\_\_\_ per SF**.

Common Area Maintenance (CAM): Common area expenses for multi-tenant properties typically include utilities (common area water, sewer, electricity), trash removal, landscaping, building and grounds maintenance, and repairs. CAM expenses for similar multi-tenant properties in the subject market area generally range from $0.50 to $1.00 per square foot. The historical expenses for 2019 report reimbursable CAM income of $13,552 or $0.382 per SF. In contrast, the CAM budget for 2020 was quoted by the owner indicates a monthly rate of $3,175.56, or a much higher, annual expense of $37,881 or $1.07 per SF. Given the newer age of the building, a similar mid-range CAM expense of **$0.\_\_\_ per SF** is considered reasonable for use in this analysis.

Management Fees

A professional management fee is typically incurred to provide for periodic contact with the tenants, collection of rents, and supervision of required maintenance and replacement items. Conversations with representatives of property management companies in the market area indicate a range for professional management for industrial properties of 2.0% to 3.0% of effective gross income depending on the property's size, lease structure, and rent levels. Considering the subject's size, quality, condition, two-tenant status, and triple net lease structure, a management fee of **3.0% of effective gross income** is considered reasonable for use in this analysis.

Reserves for Replacement

Reserves are not typical annual cash expenditures, but rather, the annualized cost of major expense items in the future, such as repair or replacement of the heating and air-conditioning system, landscaping, paving, and roof cover. A reserve allowance must be established for the replacement of these components, which the owner may be responsible for replacing during the economic life of the building. The probable future cost of replacing and repairing these items is converted into an annual figure. The analysis estimates the amount of money which must be set aside on an annual basis in an interest-bearing account to have adequate funds to repair or replace the item at the end of its economic life. This reflects typical investor behavior as it accounts for the cost which owners incur or the discount from the market's perspective for the deficiency.

Analysis of the market indicates that investors are allocating a reserve equal to 1.0% to 4.0% of effective gross income depending on the property age, size, condition, quality of construction, and value. Considering the subject's age and overall good condition, an allocation of **2.0% of effective gross income** is conservatively made for reserves for replacement items for the subject property.

Total Reimbursable Expenses

In total, **potential reimbursable expenses** were estimated at **$\_\_\_\_\_\_\_**, or $\_\_\_\_\_ per SF ($0.\_\_\_\_ per SF monthly) for the subject property.

Non-Reimbursable Expenses

Miscellaneous Expenses

The market rent conclusion has been based on a typical absolute triple net lease for newer, multi-tenant industrial properties similar to the subject, in which both professional management fees and a reserve allowance for the replacement of capital items are reimbursed by the tenant. Therefore, just a minor deduction is applied for miscellaneous landlord expenses (non-reimbursable administrative costs mostly).

Overall, the ownership is likely to incur minor administrative expenses associated with the property ownership which would not be considered reimbursable by the tenant(s). Considering the subject's moderate size, quality, condition, and absolute triple net lease structure, a miscellaneous expense of **1.0% of effective gross income** is considered reasonable for use in this analysis.

Total Non-Reimbursable Expenses

Based on the preceding, **total non-reimbursable expenses** for the subject property of **$\_\_\_\_\_\_\_\_** ($0.\_\_\_ per SF GLA) were considered reasonably supported in this analysis.

Total Operating Expenses

Combining reimbursable and non-reimbursable expenses, **total stabilized operating expenses** for the subject property of **$\_\_\_\_\_\_\_\_\_\_** ($\_\_\_\_\_\_ per SF GLA) were considered reasonably supported in this analysis.

Net Operating Income

Deducting projected annual operating expenses from the annual effective gross income results in a projected **net operating income** for the subject property of **$\_\_\_\_\_\_\_\_\_** ($\_\_\_\_\_\_ per SF GLA) as is summarized on a following page. It is at this time that net income can be capitalized into a value estimate.

Overall Capitalization Rate

Direct Comparison Analysis

The final step of the Income Capitalization Approach is to capitalize the estimated net operating income by an appropriate rate. The capitalization rate is estimated using the market sales method. The overall capitalization rate of each sale is market derived by dividing its net operating income by its cash equivalent sale price. This technique illustrates what purchasers are willing to pay for the net operating income available from competitive investment properties. This method best approximates the decision-making processes of the typical investor.

The primary factors influencing capitalization rates are: 1) The quality and certainty of the net operating income stream; 2) risk factors; 3) physical and locational characteristics of the property; 4) the competitive market position of the property and 5) the potential for future appreciation. The following chart summarizes the data used to estimate the market capitalization rate applicable to the subject property.

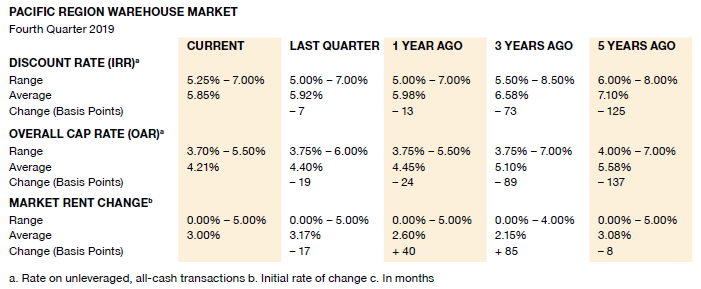
Merge cap rate comparables from CARDS and insert into here (example below)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Comp. No.** | **Property Name Address Location** | **Sale Date** | **Year Built (Renovated)** | **Rentable Area**  **(SF)** | **Cash Equivalent Sales Price** | **Cap Rate** |
| A | Western Integrated Technologies 8900 N Ramsey Blvd. Portland, OR | 11/18 | 2007 | 43,335 | $5,100,000 | 6.47 % |
| B | Allred Industrial Park 9380-9452 SW Tigard St. Tigard, OR | 09/18 | 1990 | 48,238 | $6,250,000 | 6.60 % |
| C | Ryonet Building 12303 NE 56th Street Vancouver, WA | 08/18 | 2004 | 30,000 | $4,850,000 | 5.28 % |
| D | Silver Eagle Mfg. Co. 5825 NE Skyport Way Portland, OR | 07/18 | 1979 | 77,960 | $8,300,000 | 6.50 % |
| E | None 6333 Lakeview Boulevard Lake Oswego, OR | 05/18 | 1967 & 1974 | 27,336 | $3,250,000 | 5.33 % |
| F | Pacific Industrial Commons 14511 NE 13th Avenue Vancouver, WA | 04/18 | 1985 | 44,500 | $5,325,000 | 6.54 % |

The surveyed improved sales data indicate a range of capitalization rates from \_\_\_\_\_\_% to \_\_\_\_\_\_% (average = \_\_\_\_\_\_%). Considering the subject’s average condition with some recent updating and average exposure location on a secondary commercial corridor, mid-range indicator is considered supportable.

National & Regional Surveys

Provided following is a chart excerpt from the PwC Real Estate Investor Survey for the Q-1 2020 that pertain to investors relating to the Pacific Region Warehouse Market which reports a range of 3.70% to 5.50% (average of 4.21%). Note that this survey is heavily weighted toward the Seattle – Puget Sound market which typically has lower cap rates than the Portland-Vancouver market, but is still considered to provide support for continued cap rate compression over the past several years for investment grade properties like the subject. Therefore, a cap rate in the mid to upper end of the surveyed range is considered supportable for the subject project.



Cap Rate Conclusion

Given the preceding extensive comparable local cap rate support and regional investor market survey, and given the subject’s attractive new age / condition and functional design with assumed stabilized leased status on a long-term basis, a concluded **direct capitalization rate** of **\_\_\_\_\_\_%** is used in analyzing the subject property on a stabilized basis.

Concluded Market Value Via The Income Capitalization Approach

To value the subject by Direct Capitalization, the Net Operating Income was divided by the selected overall rate yielding a **stabilized market value** of the fee simple interest in the **subject property**, via the **Income Capitalization Approach** (rounded to the nearest $5,000):

|  |  |
| --- | --- |
|  |  |
| **Concluded Market Value Via the**  **Income Capitalization Approach:** | **$\_\_\_\_\_\_\_\_\_\_\_\_** |

Our analysis of the subject property via the Income Capitalization Approach is presented on the following page.

