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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 subject has a commercial component and an apartment component. The commercial analysis is conducted on the basis of an annual dollar per square foot rental, which is then applied to the gross leasable area (GLA) of the commercial space. The apartment analysis is conducted by projecting the total monthly market rent for the apartment units.

A review of current subject market trends indicates that typical tenant leases in the subject market area are written on a **triple net** rental basis for commercial space and **modified gross** rents for apartment rentals. Triple net tenant rents include only the net base rent, with the tenant typically responsible for all building operating expenses. Regarding modified gross rents, the tenant’s rent includes water, sewer, gas, garbage and trash (tenant pays own interior electric and gas utilities). Generally excluded are allocations for management fees and reserves for the replacement of capital items. Hence, we have anticipated that all future rent for the subject would be payable on this basis. Note that the subject apartment tenant spaces are leased on a gross basis and it is reasonable to assume that the subject will continue to operate in this manner.

Comparable Rent Analysis

In order to estimate the current market rents for the subject apartment units and retail space, we conducted a survey of reasonably comparable apartment units and commercial space leases located in the immediate to expanded market area. Our analysis begins with the results of our comparable apartment unit survey, which is then followed by our comparable commercial space rent analysis. The results of these surveys are summarized in the following charts, along with a location map and photographs of the rent comparables. Historic income and expenses were also provided for the subject and we have further relied on the expense comparables.

Rental Adjustments

Depending on market conditions, free rent, above market build-out 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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| **Apartment Rent Comparable Location Map** |
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Merge & Insert Rent Comp Photos or Write-ups

Comparable Apartment Rent Analysis

The following analysis compares the subject property’s different unit types with similar apartments in the immediate area. It is noted that the qualitative adjustments presented on the prior page are expressed as numeric adjustments and are presented for informational purposes only and are intended to allow the reader to understand the though process of the appraiser, when arriving at a concluded market rent estimate. A matched-pairs analysis, while acceptable in theory, is highly limited due to the fact that no two properties are exactly alike.

2.0 Bed / 1.0 Bath Units



Analysis of Comparable Properties

Our analysis of the comparable properties in the subject property’s immediate area considers the following elements of comparison:

Location: All of the projects are in the same general area as the subject and no adjustments have been applied for location.

Quality/Age/Condition: Most of the comparables are considered similar to the subject and no adjustments have been applied. However, Comparable 1 was considered to be to be of superior age/condition.

Appeal:Each comparable property has various physical traits that determine its appeal. All were similar to the subject.

Unit Design / Layout: Each comparable property has various unit features, design and layout project amenities that determine its appeal. On the previous chart the comparable properties’ unit features and project amenities were subjectively adjusted compared to the subject property.

Recreation Amenities: Most of the comparables are considered similar to the subject and no adjustments have been applied. However, Comparable 4 was considered to have superior amenities compared to the subject.

The adjusted rental range for 2.0 bedroom / 1.0 bath units is $1,050 to $1,415 per month for the rent comparables with an average rent of $1,176. We noted that the subject units are currently renting between $900 and $1,099 or an average of $996. The subject units will potentially see some units turnover, but it is likely the tenants will stay as the new rental rate is in-line with competing project and the included rent comparables. Considering recent rental activity, location, unit size, the appraiser has concluded to an average rent of $1,050 per month per unit for the 2.0 bedroom / 1.0 bath units. Note the 2.0 bedroom / 1.0 bath units are slightly smaller at 936 SF and both rent for $950. A market rent of $975 is anticipated for the subject’s 2.0 bedroom / 1.0 bath units.

Studio Units



Analysis of Comparable Properties

Our analysis of the comparable properties in the subject property’s immediate area considers the following elements of comparison:

Location: All of the projects are in the same general area as the subject and no adjustments have been applied for location.

Quality/Age/Condition: Most of the comparables are considered similar to the subject and no adjustments have been applied. However, Comparables 1 and 5 were considered to be to be of superior age/condition.

Appeal:Each comparable property has various physical traits that determine its appeal. All were similar to the subject.

Unit Design / Layout: Each comparable property has various unit features, design and layout project amenities that determine its appeal. On the previous chart the comparable properties’ unit features and project amenities were subjectively adjusted compared to the subject property.

Recreation Amenities: Most of the comparables are considered similar to the subject and no adjustments have been applied. However, Comparable 4 was considered to have superior amenities compared to the subject.

The adjusted rental range for studio units is $1,100 to $1,550 per month for the rent comparables with an average rent of $1,338. We noted that the subject units are currently renting between $1,025 and $1,350 or an average of $1,179. The subject units will potentially see some units turnover, but it is likely the tenants will stay as the new rental rate is in-line with competing project and the included rent comparables. Considering recent rental activity, location, unit size, the appraiser has concluded to an average rent of $1,150 per month per unit for the studio units. Note the studio units are slightly larger at 1,295 SF and both rent between $950 and $1,125. A market rent of $1,125 is anticipated for the subject’s studio units.

Potential Apartment Gross Rent

Applying the subject’s estimated market rent, to each of the subject units or $\_\_\_\_\_\_\_\_\_ per month. This equates to a total annual gross rent of $\_\_\_\_\_\_\_\_\_\_ for the subject property. Note “x” marked interior inspected units were inspected during the ${inspect\_date} inspection.



Other Income

This category accounts for all non-rental associated income for the subject property. Other income sources are late fees or non-sufficient fund fees. Most of the other items are offset by their actual costs, and are therefore not considered real estate income. However, some of the security deposits are typically forfeited upon turnover. The subject’s operation statement does not show complete expenses and limited income information. The appraiser has anticipated **$100 per unit** or a total of $\_\_\_\_\_\_\_\_ annually.

Utility Reimbursement Income (RUBS)

The subject is charging the tenants for utility usage on a monthly basis in addition to base rent. Based on the rent survey data, most competing properties are passing utility expenses onto the tenants in the form of RUBS, with a $30 to 75 per month indicated. The subject is currently obtained a monthly utility reimbursement of $40 to 60 per unit per month, which falls in the range of the market averages. The appraiser has anticipated an average of $50 per month per unit, or **$\_\_\_\_\_\_\_\_\_**, is used in this income analysis.





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

Comparable Retail Rent Analysis

From our rental survey we selected leases of retail space most similar to the subject property. Overall, the comparables provide a reasonable basis for concluding a market rent for the subject property, and indicates adjusted annual triple net leases ranging from $17.21 to $27.55 per SF GLA. Overall, the market has remained stable to improving for retail properties, and therefore, the selected rent comparables were considered to be reasonable for use in comparison to the subject.

Merge & Insert Rent Comp Data Analysis Output

Additional Quantitative Analysis

As supplemental support, an adjustment grid for the comparable rents is provided as additional analysis following the summary chart. The comparables indicate an adjusted rents per square foot between $20.53 and $23.47 per SF GLA with an average rent of $22.01 per SF and median rent of $21.93 per SF. Note that a market conditions adjustment of 3.0% per year was applied in this analysis. The adjusted comparable rent range provides additional support for the following final market rent conclusion.

Subject Leasing Activity

None.

Or here is an example:

The subject commercial space consists of (4) commercial tenants that are further described below with a Tenant Rent Roll is included following. Each tenant rents roughly 2,000 SF of area on a triple net expense basis. What A Deal, a second hand story, has the end unit and signed a 1 year lease in May of 2013 after which are on a month to month basis. Berland Vapor Supply, an e-cigarette shop, signed a lease in July 2014 for 1 year after which are on a month to month rent basis. Both of these tenants pay $8.70 annual PSF. Lombard Tattoo, a tattoo parlor, signed a 3 year lease in August 2014 and pay $8.70 annual PSF with annual rent increases of $50 per year. Nightingales Elements of Health, a multi-discipline health clinic, signed a 3 year lease in April 2013 and expire April 2016, which they renewed at $9.45 annually PSF, with annual rent increases on $75 per year.



Based on the preceding, the tenant’s 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 Retail Rent Conclusion

Based on the preceding discussions, it is concluded that the market rent for the subject property is reasonably supported near the lower end to mid-range values indicated by Rent Comps 1, 2 and 3 ($19.83, $19.67, and $25.48 per SF). Additional secondary consideration given to the adjusted average and median rent indicators ($22.01 and $21.93 per SF). Based on the preceding, we have **concluded to a market rent** for the subject property of **$\_\_\_\_\_\_ per SF GLA**.

Potential Gross Rental Income

Applying the subject’s estimated market rents to the subject apartment units and the subject general commercial space, and adding the additional income described above, results in annual potential gross rental income for the subject of **$\_\_\_\_\_\_\_\_\_** ($\_\_\_\_\_\_\_ per unit). This amount is indicated in the following stabilized income and expense statement for the subject property.

Other Income

This category accounts for all non-rental associated income for the subject property. Other income sources are late fees or non-sufficient fund fees and laundry income. Most of the other items are offset by their actual costs, and are therefore not considered real estate income. However, some of the security deposits are typically forfeited upon turnover. The subject laundry is provided as an amenity and there is no income earned from these items. We were not provided laundry income and other income for the subject property. We have applied an anticipated **$100 per unit** or a total of **$\_\_\_\_\_\_\_\_\_** annually.

Reimbursable Expenses

All of the subject leases were read by the appraiser and all are based on a triple net expenses basis which conforms to market standard. Thus the tenants are responsible for paying all operating expenses including real estate taxes, building (fire and flood) insurance, management, utilities and common area maintenance (CAM) expenses. 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.

General market analysis will be used 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, we have projected such **reimbursable income** for the subject project at **$\_\_\_\_\_\_\_\_** or $\_\_\_\_\_\_\_ per SF GLA. Overall, our projection of reimbursable income appears to be reasonably supported by market data.

Potential Gross Income

Adding together potential gross rental income with the other income and the reimbursed expenses results in **potential gross income** for the subject property estimated at **$\_\_\_\_\_\_\_\_** ($\_\_\_\_\_ per SF GLA), as indicated in the following stabilized income and expense statement for the subject property (at the end of

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

Out of 565 units surveyed by the appraiser (including the subject property) in the immediate market, there were only 10 vacant units (1.70%). The market is strong with decreased vacancy, moderately increasing rental rates, and no concessions. In the subject’s immediate to expanded market area, the reported Fall 2020 vacancy rate of 3.35% is estimated, up slightly from 2.63% estimated in Spring 2020.

A **stabilized vacancy and credit loss** of **5.0%** is estimated for the subject apartment income based on that most apartment investors utilize a 5.0% vacancy factor over the long term.

Copy this paragraph directly from Market Analysis

With respect to the subject's North Portland / St. Johns Retail Submarket, **CoStar** market research indicates a current vacancy of 5.3% (167,074 SF out of 3,135,062 SF, 424 properties surveyed). Vacancy rates have decreased significantly since mid-2018, with the current vacancy estimated considerably lower than the 5-year average of 5.3%.

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

Based on the preceding, **an overall blended stabilized vacancy and credit loss** of **5.0%** is estimated for the subject property.

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 next step in the Income Capitalization Approach is to estimate the subject's stabilized operating expenses. The market rent conclusion has been based upon a modified gross basis. The landlord is therefore responsible for expenses including real estate taxes, insurance, property management, common area utilities, garbage, maintenance, advertising, office expenses, turnover expenses, and reserves for replacement. To estimate expenses applicable to the subject, interviews with management firms and local utilities are utilized. We were not provided historical expense data for the subject property. Or We were provided historical expense data for the subject property based on the last three years of tax returns which are somewhat lacking in detail. We have relied upon our expense comparables that are similar to the subject property.

Real Estate Taxes: Please see the Tax Information Section for the discussion on the subject’s taxes. The current tax rate for fiscal tax year 2019-2020 has been reported at $\_\_\_\_\_\_\_\_\_\_ that was billed in October 2019. Since this still current we have applied this amount in our analysis.





Insurance: The surveyed apartment complexes (See prior table) indicated a range of building insurance expenses of between $142 and $250 per unit. Giving credence to the expense comparables, a charge of **$200 per unit** is reasonable based on the subject’s age and number of units. We have also concluded a range of $0.15 to $0.40 PSF for the commercial space, based on age/condition of similar buildings. We have applied $0.25 per SF or $1,976, for a total of **$\_\_\_\_\_\_\_** ($0.\_\_\_ per SF GLA) for the subject property.

Repairs and Maintenance: This category includes ongoing routine repairs and maintenance such as water heaters, garbage disposals, etc., as well as landscaping, parking lot cleaning and general maintenance. Note that in the expense comparable chart these items include Repairs & Maintenance, Landscaping, and turnover. The expense comparables ranged from $450 to $500 per unit annually. The subject’s maintenance and repair numbers appear reasonable and associated with the expense comparables. Given the age and construction of the improvements, with consideration to the subject’s expense comparables, a maintenance and repairs expense of **$\_\_\_\_\_\_** **per unit** is projected. We have concluded a range of $0.50 to 1.00 per SF, which is typical range for commercial space, based on age/condition of similar buildings. We have applied $0.50 per SF or $3,968, for a total of **$\_\_\_\_\_\_\_\_\_** ($0.\_\_\_ per SF GLA) for the subject property.

Utilities: This category includes common area electricity, water, sewer, and garbage expense. The comparables range from $682 to $1,381 per unit for the combined utility expenses annually. The appraiser has given credence to the expense comparables. An applied utility expense of **$\_\_\_\_\_\_\_\_** annually is estimated ($\_\_\_\_\_\_ per unit**)** for the residential use. We have concluded a range of $1.00 to 1.50 per SF, which is typical range for commercial space, based on age/condition of similar buildings. We have applied $\_\_\_\_\_\_\_ per SF or $\_\_\_\_\_\_\_\_\_, for a total of **$\_\_\_\_\_\_\_\_\_** ($0.\_\_\_ per SF GLA) for the subject property.

Advertising: Given the subject’s size, an annual advertising budget is not considered typical. Given the prevalence of Craigslist (free), few small apartment complexes are utilizing the newspaper or rental guides any longer. A minimal advertising expense of **$20 per unit** annually is anticipated.

Professional Management: This estimate is based upon a comparison with several similar contracts for other complexes, as well as discussions with professional management firms. Typically, professional management fees range between 3.0% and 8.0%, depending on the size and quality of the project. Smaller projects typically require a higher fee on a percentage basis. Contracts on large projects or multiple projects can run as low as 3.0%. Given the subject’s project size and lack of on-site manager and commercial space, a high end of the range management fee of **7.0%** **of effective gross income**, is reasonable.

Reserves for Replacement: Reserves for replacement are not a typical annual cash expenditure, but rather the annualized costs of major expenses to be incurred in the future such as repair of roofing, replacement of carpeting, appliances, and repair or replacement of parking areas and window coverings. Typically, in the local market, reserve allocations are approximately 2.0% to 3.0% of the effective gross annual income for a multi-family and commercial properties. A **2.5%** reserves factor is allocated based on the subject’s average quality construction.

Total Operating Expenses

Based on the preceding, total stabilized operating expenses for the subject property of **$\_\_\_\_\_\_\_\_\_** (\_\_\_\_.\_\_% of EGI) were considered reasonably supported in this analysis. As a comparison, the expense comparables ranged between \_\_\_\_\_% and \_\_\_\_\_% of effective gross income. The subject’s projected expenses are reasonably supported by the comparables.

Net Operating Income

Deducting projected annual operating expenses from effective annual gross income results in total 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)** | **Building Area (GBA)** | **Cash Equivalent Sales Price** | **Cap Rate** |
| 1 | Pacific Village Apartments 9655 SW McKenzie Street  Tigard, OR | 8/17 | 1968 | 26,512 | $4,225,000 | 6.67 % |
| 2 | Aloha West Apartments 18633-35 SW Blanton St. Beaverton, OR | 2/17 | 1970 | 11,500 | $1,575,000 | 6.85 % |
| 3 | Village Victorian Apts. 16290 SW Shaw Street  Beaverton, OR | 1/17 | 1960 | 40,500 | $5,725,000 | 6.32 % |
| 4 | Icon Beaverton Apts. 14620 SW Farmington Rd  Beaverton, OR | 10/16 | 1968 | 45,780 | $6,500,000 | 6.37 % |
| 5 | None 6770 SW King Boulevard  Beaverton, OR | 10/16 | 1959 | 17,119 | $2,675,000 | 6.34 % |
| A | Portland Collective 2073 SW Park Avenue Portland, OR | 3/17 | 1945 | 36,671 | $10,650,000 | 5.98 % |
| B | Village 185 18380 NW Heritage Pky. Beaverton, OR | 3/16 | 1979 | 80,575 | $13,100,000 | 6.10 % |

The surveyed capitalization rate sales data indicate a range of capitalization rates from 5.98% to 6.85% (average = 6.25%). The comparables show a relatively small range and are considered to be fair indicators of a market capitalization rate and all of them have been weighed on our conclusion. Since our rental rate conclusion takes into consideration some existing tenants are paying below market and less likely to move, the income stream is considered less risky. Based on the subject’s age / condition and unit mix, a capitalization rate toward the middle of the range is considered reasonable.

Cap Rate Conclusion

Based on the preceding, we have concluded a **direct capitalization rate** of **\_\_\_\_\_\_%** as reasonable for use 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.

