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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 market trends indicates that typical leases in the subject market area for retail space are written on a **triple net** rental basis. Triple net rents include only the net base rent, with the tenant typically responsible for all building operating expenses. Generally excluded are allocations for management fees and reserves for the replacement of capital items. Therefore, we have anticipated that all future rent for the subject retail space would be payable on a triple net basis.

A review of current market trends indicates that typical leases in the subject market area for office space are written on a **full service** rental basis. Full service rents, also referred to as gross rents, include only the net base rent, with the tenant typically responsible for no other charges other than their telecommunications expenses. All building operating expenses are the responsibility of the landlord. Therefore, we have anticipated that all future rent for the subject office space would be payable on a full service basis.

Comparable Rent Analysis

In order to estimate the current market rents for the subject retail and office space, we conducted a survey of reasonably comparable space leases located in the immediate to expanded market area. Our analysis begins with the results of our comparable retail rents, which is then followed by our comparable office 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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| **Retail Rent Comparable Location Map** |
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|  |

Merge & Insert Rent Comp Photos or Write-ups





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| --- |
| **Office 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 - Retail

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 Retail 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**.

Comparable Office Rent Analysis

From our rental survey we selected leases of office 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 full service leases ranging from $17.21 to $27.55 per SF NRA. Overall, the market has remained stable to improving for office 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 - Office

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 NRA 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 Office Leasing Activity

The subject is 43.5% occupied by entities related to the owners, along with 9 tenants. Counting the owner-occupied space, the leases average $22.99 per SF, full service. A rent roll for the subject property is provided on preceding page.

The most recent lease is to TVFR who is leasing 2,930 SF on a 5-year term which will start in March 2020 at $26.00 per SF, which escalates 3% annually. This tenant received a $40 per SF TI allowance, but the space had never been occupied since the building was built and was in shell condition. The tenant has no extension options. The tenant also pays $400 per month for the right to construct a garage building for service vehicles on the site.

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 OfficeRent 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 NRA**.

Potential Gross Rental Income

Applying the subject’s estimated market rents to the subject retail space and the subject office space results in annual potential gross rental income for the subject of **$\_\_\_\_\_\_\_\_\_** ($\_\_\_\_\_\_\_ per SF GLA / NRA). This amount is indicated in the following stabilized income and expense statement for the subject property.

Reimbursable Expenses

The stabilized income for the subject is based on office leases written on full service basis with the tenant responsible only for their base rent, and their individualized telecommunications costs, and the retail leases written on a triple net basis with the tenants responsible for paying all operating expenses including: real estate taxes, building (fire and flood) insurance, utilities and common area maintenance (CAM) expenses. Under this rent structure, the landlord is responsible for management and reserves. The reimbursement income for the subject consists of a portion of the fixed expenses (real estate tax, insurance, and CAM reimbursements) received from the retail tenants only, presented as an income item. As the stabilized rent structure is based on full service leasing of the office space, only a portion of the fixed expenses are received as income.

Based on the preceding, **reimbursed expenses for the retail space** are concluded at **$\_\_\_\_\_\_ per SF** for the subject’s \_\_\_\_\_\_\_ SF of retail space, or an annual total of **$\_\_\_\_\_\_\_\_**. This equates to $\_\_\_\_\_\_ per SF for the building’s full gross leasable / net rentable areas. The annual **stabilized expense reimbursements** of **$\_\_\_\_\_\_\_\_** are fully discussed in the following expense analysis. The preceding assumes a 100% recovery ratio for the subject retail space. Expense comparables surveyed in the Portland metro area indicate recoverable expenses widely ranging from $2.50 to $7.00 per SF, depending on age and location. The high end is indicative of newer, anchored centers which are successfully passing all reimbursable expenses, while the lower end is applicable to older properties, usually with higher site coverage and minimal or no on-site parking. The impact on income and value relates only to the vacant space expenses of the retail space for which the owner would be responsible.

Potential Gross Income

Adding together potential gross rental income with the reimbursed expenses results in **potential gross income** for the subject property estimated at **$\_\_\_\_\_\_\_\_** ($\_\_\_\_\_ per SF GLA / NRA), 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

The appraiser used **CoStar** to produce a search of the subject’s expanded and competing Mall 205 / Gateway / Clackamas-Milwaukie submarket for **retail properties**. As of May 2019, report indicates an extremely low total sit-down restaurant / bar vacancy of 0.7% (7,732 SF out of 1,141,797 SF; 288 properties), with a 5-year average vacancy only a bit higher at 1.9%, but still indicating long-term tight market conditions. In tandem with strengthening market conditions, average asking rental rates for restaurants have exhibited an upward trend over the past 5 years. No new construction of retail properties is underway, nor has any new inventory been completed in the past 12 months. The current surveyed average retail rent is $23.19 per SF, up from the 5-year average of $20.30 per SF per year NNN. However, these statistics can be sharply skewed by the available inventory at any given time, and may be fully reflective of the market as a whole.

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 retail space**. The concluded rate is equivalent to 6 months of rent loss every 10 years.

Copy this paragraph directly from Market Analysis

The appraiser used **CoStar** to produce a search of the subject’s immediate to expanded Beaverton / 217Corridor/ Tigard submarkets for **office properties**. As of March 2020, **Costar** indicates current vacancy at 10.4% (803,081 SF out of 7,704,170 SF, 470 properties surveyed) with negative absorption of -45,141 SF over the past 12 months. This vacancy is also lower than the 5-year average of 11.9%, with only 33,704 SF delivered on average over the 5-year period. Currently, there is no new office under construction within the defined submarket area and no new space delivered over the past 12 months. The current average asking rate for office space in the immediate area is $22.44per SF (primarily quoted as full-service basis), which is above the 5-year average of $20.33 per SF.

Though the market research indicates relative strength in both the retail and office sectors, circumstances specific to the subject property would indicate a higher vacancy rate applicable to the property, as only 14.7% of the GLA / NRA is secured by substantial lease terms. Thus, the risk of further vacancy is increased.

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 office 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 / NRA).

Projected Operating Expenses

The appraiser received summary income / expense statements for the subject pertaining to years 2018, 2019 and through June 2020. It is noted that the statements do not separate rental income from expense reimbursements. Or 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 compared the subject’s actual reported expenses with report expenses of similar commercial properties in the Portland metro area in order to derive a reasonable estimate of stabilized operating expenses for the subject property.

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 have relied upon our expense comparables that are similar to the subject property.





Reimbursable Expenses

Special Note: The following reimbursable expense analysis is segmented into three categories which are analyzed as follows. First, the CAM expenses are estimated, but are only applicable to the retail square footage. Next, property taxes and insurance are analyzed in total, as they represent a combination of reimbursable (retail) and non-reimbursable (office) expenses. Based on these totals, an allocation to the retail portion of the project is made which facilitated the preceding estimate of reimbursable income. Finally the non-reimbursable expenses are estimated which are applicable to the entire property.

Common Area Expenses: Common area expenses for multi-tenant retail properties typically include utilities (water, sewer, common area electricity), trash removal, security, landscaping, and building and grounds maintenance, and repairs. CAM expenses for similar multi-tenant retail properties in the Portland metropolitan area generally range from $1.00 to $3.00 per SF. Therefore, a market stabilized CAM expense of $2.00 per square foot has been estimated. This is only applied to the retail area of \_\_\_\_\_\_\_ SF.

Real Estate Taxes: Previously in the Tax Information section of this report the stabilized tax liability was estimated at $\_\_\_\_\_\_\_\_. We have divided the taxes by use with $\_\_\_\_\_\_ applying to the retail area (\_\_\_\_%) and $\_\_\_\_\_\_\_ applying to the office area (\_\_\_\_\_%). Only the retail taxes of $\_\_\_\_\_\_ are reimbursable.

- Or for Historic Buildings -

The subject has a little over a year left on a 15-year historic property tax freeze. Due to the 15-year tax freeze, this real estate tax liability is atypically low. Therefore, the present value of the tax savings (due to the freeze) will be added as a line item addition at the end of the Reconciliation of Value. Previously in the Tax Information section of this report the stabilized tax liability was estimated at $\_\_\_\_\_\_\_\_. We have divided the taxes by use with $\_\_\_\_\_\_ applying to the retail area (\_\_\_\_%) and $\_\_\_\_\_\_\_ applying to the office area (\_\_\_\_\_%). Only the retail taxes of $\_\_\_\_\_\_ are reimbursable.

Insurance: Building insurance for similar office and retail properties in the Portland metropolitan area generally range from $0.15 to $0.30 per SF. In the last 18 months of operations, the subject has a cost of $0.42 to $0.44 per SF. Thus, a property insurance expense of $0.\_\_\_\_ per SF is estimated. We have divided the insurance expense by use with $\_\_\_\_\_\_\_ applying to the retail area and $\_\_\_\_\_\_\_ applying to the office area. Only the retail insurance expense of **$\_\_\_\_\_\_\_** is reimbursable.

Based on the preceding, the total reimbursable expenses, as applied to the retail area only, equate to $\_\_\_\_ per SF (CAM - $\_\_\_\_ / SF; Taxes - $\_\_\_\_ / SF; Insurance - $0.\_\_\_ / SF).

Non-Reimbursable Expenses

Real Estate Taxes: As indicated, the non-reimbursable real property taxes applicable to the office area has been previously calculated at **$\_\_\_\_\_\_\_**.

Insurance: As indicated, the non-reimbursable insurance expense applicable to the office area has been previously calculated at **$\_\_\_\_\_\_\_**.

Utilities (Water / Sewer / Gas / Electric): The subject’s historical expenses range from $1.06 to $1.71 per SF. This expense typically ranges from $1.00 to $2.00 per SF. Placing primary emphasis on the middle of the subject's historical expenses which are bracketed by the market expenses, a utility expense of **$1.50** **per SF** is reasonable. This expense applies to the office area only as the retail tenants are typically separately metered for utilities.

Grounds Maintenance / Security: This expense typically ranges from $0.25 to $0.75 per SF. Due to the subject’s lack of landscaping and secure building, no amount has been expenses for this category.

Cleaning / Janitorial / Garbage: The subject’s historical expenses range from $0.56 to $1.47 per SF. This expense typically ranges from $1.00 to $1.50 per SF. Placing primary emphasis on the market expenses, a cleaning / janitorial / garbage expense of **$1.25** **per SF** is reasonable. This expense applies to the office area only as the retail expense for this category is covered in the CAM charge.

Insurance: As indicated, the non-reimbursable insurance expense applicable to the office area has been previously calculated at **$\_\_\_\_\_\_\_**.

Repairs and Maintenance: The subject’s historical expenses range from $1.04 to $1.16 per SF. This expense typically ranges from $0.50 to $2.00 per SF. Considering the subject’s age and average condition, a stabilized maintenance and repair expense above the historical expenses of **$1.50 per SF**, is deemed reasonable. This expense applies to the office area only as the retail expense for this category is covered in the CAM charge.

Administrative / Management Fees: The subject’s historical expense for administrative / management fees range from 4.9% to 5.1%. Commercial management companies indicate a typical range of fees based on 3.0% to 5.0% of effective gross income. Based on the subject’s historical expense for this category, a fee toward the top of the range is indicated, or **5.0%**. This expense category is applied to the entire building as it is typically not billed back to the retail tenants.

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 typical term of ownership of the property. Analysis of the market indicates that investors are allocating a reserve equal to 1.0% to 3.0% of effective gross income depending on the property age, size, condition, quality of construction, and value. Considering the subject's much older age, average condition and moderate rent levels, an allocation of **2.0% of effective gross income** is made for reserves for replacement items for the subject. This expense category is applied to the entire building as it is typically not billed back to the retail tenants.

Total Operating Expenses

Based on the preceding, a total stabilized operating expense for the subject building of **$\_\_\_\_\_\_\_\_\_** ($\_\_\_\_\_\_\_ per SF GLA / NRA) which is within the range of mixed-use office / retail buildings in this market. 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 / NRA), 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 | Kids Incorporated Learning Center 18425 NW Walker Road Beaverton, OR | 03/20 (Pending) | 1984 | 6,000 | $1,385,370 | 7.05 % |
| B | None 7304 N. Leavitt Avenue Portland, OR | 01/20 (Pending) | 1924 | 5,000 | $1,150,000 | 5.88 % |
| C | Guidepost Montessori  9945 SW Beaverton Hillsdale Highway Beaverton, OR | 01/20 | 2019 | 6,074 | $3,761,000 | 5.56 % |
| D | Key Bank 11665 SW Pacific Hwy. Tigard, OR | 12/19 | 1976 | 5,472 | $2,300,000 | 4.57 % |
| E | SE 135th Comm. Building 15679 SE 135th Avenue Clackamas, OR | 12/19 | 2003 | 10,000 | $2,100,000 | 6.23 % |
| F | North Williams Chiropractic Clinic 3220 N. Williams Avenue Portland, OR | 09/19 | 1986  (2012) | 4,436 | $2,250,000 | 5.73 % |
| G | Plaza 125 Office Condo 12630 SE Stark Street Portland, OR | 11/18 | 1980  (2005) | 6,000 | $1,450,000 | 6.77 % |
| H | Sunset Crossing 16679 Boones Ferry Road Lake Oswego, OR | 10/18 | 2005 | 8,743 | $4,260,000 | 5.08 % |

Cap Rate Conclusion

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.

Based on the preceding, a mid-range **direct capitalization rate** of **\_\_\_\_\_\_\_%** is considered reasonable for 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.

