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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 an annual dollar per square foot rental, which is then applied to the net rentable area (NRA) of the property.

A review of current subject market trends indicates that typical office tenant leases in multi-tenant buildings the subject market area are written on a **gross** rental basis (commonly referred to in the marketplace as “full service” rent). Full service rents are inclusive of both net base rent and all building operating expenses. Hence, we have anticipated that all future rent for the subject office space would be payable on this basis.

Comparable Rent Analysis

In order to estimate the current market rent for the subject office property, we conducted a survey of reasonably comparable tenant leases of office buildings located in the immediate to expanded market area. The result of this survey is summarized on the preceding 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

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

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 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 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 NRA**.

Potential Gross Rent

Overall, the preceding market conclusion equates to **potential gross rent** for the subject property estimated at **$\_\_\_\_\_\_\_\_** ($\_\_\_\_\_ per SF NRA).

Reimbursable Expenses

Market standards indicate that the landlord passes through expenses over the base year for each tenant. This amount varies by how recently the tenant has taken occupancy, and / or renegotiated their lease. The appraisers were provided with an annualized 11 months of income and expenses from the management company as this is as long as they have been managing the property. This report indicated that reimbursable income has been $\_\_\_\_\_\_, annualized in 2020. Thus, a conservative stabilized amount of **$\_\_\_\_\_\_\_\_\_\_**, annually for reimbursable expenses is concluded for this analysis.

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 NRA), as indicated in the following stabilized income and expense statement for the subject property (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 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.

Based on the subject's good suburban office 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 NRA).

Projected Operating Expenses

The market rent conclusion has been based on full service basis, in which all operating expenses for the subject space would be paid for 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. In addition, the following chart shows the subject expenses for the first 11 months of 2019 annualized. The subject has a new management company as of December 2019 and these were the only expenses available.



Real Estate Taxes: The subject is currently responsible for real estate taxes of $92,793 for the 2019-2020 tax year, the current tax year for the subject property. As these taxes were just recently paid this tax amount plus 3%, less a 3% discount for on time payment will be used in this analysis, or **$\_\_\_\_\_\_\_\_\_**. Note that the real property taxes were reported at $104,821 for 2020, though it appears other taxes (such as personal property) may have been loaded into this figure. Therefore, we will defer to the current real property taxes for purposes of this analysis.

Insurance: Building insurance for similar properties in the Portland metropolitan area generally range from $0.20 to $0.50 per SF. The 2020 amount was $0.117 per SF with no other expense provided and appears unreasonably low for this property type. Therefore, an expense at the lower end of the comparable range of **$0.20 per SF** has been applied.

Utilities: The subject’s historical expenses are $2.45 per SF. This expense typically ranges from $1.50 to $2.50 per SF. Placing primary emphasis on the high end of the subject's historical expenses, a utility expense of **$2.50** **per SF** is reasonable.

Grounds Maintenance / Security: The subject’s historical expenses have been $1.19 per SF for 2020. This expense typically ranges from $0.25 to $0.75 per SF. However, the subject has a large yard area needing greater maintenance. Placing primary emphasis on the subject's historical expenses, a landscaping expense of **$1.20** **per SF** is reasonable.

Janitorial: The subject’s historical expenses are $1.41 per SF for 2020. This expense typically ranges from $0.75 to $1.50 per SF. Considering the subject’s historical expenses, a stabilized expense of **$1.40 per SF**, is deemed reasonable.

Repairs and Maintenance: The subject’s historical expenses are $1.70 per SF for 2020. This expense typically ranges from $0.50 to $2.00 per SF. Considering the subject’s age and good well-maintained condition, a stabilized maintenance and repair expense of **$1.70 per SF**, is deemed reasonable.

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 3.0% of effective gross income depending on the property age, size, condition, quality of construction, and value. Considering the subject's age and overall average condition, an allocation of **2.0% of effective gross income** is made for reserves for replacement items for the subject property.

Administration / Management

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 office properties of 2.0% to 3.0% of effective gross income depending on the property's size, lease structure, and rent levels. The subject owner has reported a management fee of 5.8% which appears above market standard. Considering the subject's moderate size, quality, condition, multi-tenant occupancy and full-service lease structure, a management fee of **3.0% of effective gross income** is considered more reasonable for use in this analysis.

Total Operating Expenses

Based on the preceding, **total stabilized operating expenses** for the subject property of **$\_\_\_\_\_\_\_\_\_\_** ($\_\_\_\_\_\_ per SF NRA; \_\_\_\_.\_\_% of EGI) 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 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.

