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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 Class C, multi-tenant office tenant leases in the subject market area are written on a **modified gross** rental basis. While there may be some variability between properties (and landlords) in how the specific expense terms are applied or negotiated, modified gross tenant rents at the subject project typically include all operating expenses, except that interior electrical utilities and janitorial is paid directly by the tenants. Otherwise, property taxes, insurance, landscape maintenance, general repairs, and trash removal are included in the subject base rent 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 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 adjusted annual modified gross rents 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

According to rent roll information provided by the owner (see Addenda), the subject is currently occupied by (3) office tenants. Two of the tenants, Sports & Spine Clinic and Living Wholehearted, each occupy multiple office suites while the third tenant, Cooney Cooney & Madigan occupies one suite on the second floor. One space (Suite 202 – 689 SF NRA) is currently vacant. The lease for Sports and Spine Clinic (Suites 101 and 103 – 2,296 SF NRA); will terminate in May 2020. The two suite leases for Living Wholehearted (1,016 SF NRA) extend through April 2023, while the lease to Cooney Cooney & Madigan (1,305 SF NRA) extend through March 2024. After closing, the buyer intends to partially owner-occupy the building on two levels (Suites 101, 103 and 202 – NRA = 2,985 SF NRA) with a related party business – Capital Hill Mortgage. Provided following page is our reconstructed Tenant Rent Roll, with copies of the lease agreements for the two remaining tenants provided in the Addenda of this report.



After the closing of the pending sale, there will be only (2) third party tenants occupying space within the subject building, and these are detailed as follows:

Living Wholehearted occupies Suites 102 and 203 (1,016 SF), plus Suite 204 (486 SF) on two separate 5-year leases which began July 2018. The current contract rates for each of these leases over the next 12-month period is $20.22 per SF and $19.98 per SF NRA. Both are considered reasonably close to market with very little measurable leasehold interest applicable in this analysis.

Cooney Cooney & Madigan occupies Suite 201 (1,305 SF), is in the midst of a 5-year lease which began April 2019. The current contract rates for each of these leases over the next 12-month period is $18.97 per SF NRA. This rate is considered slightly below market, and based on our internal calculations, amounts to roughly a $2,600 positive leasehold interest, which is insignificant and would not have a material impact on the final valuation conclusion.

Based on the preceding, the tenant’s contract rent is considered at market with no measurable leasehold interest noted. Therefore, the value of fee simple interest is equal to 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 modified gross basis (tenants only pay their own interior electrical utilities and janitorial), with all other 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. Please note that no historical income / expenses were provided for review by the appraiser, though operating expense projection for the subject were provided within the listing broker’s pro forma / marketing flyer in the Addenda of this report.

Real Estate Taxes: The subject is currently responsible for real estate taxes of $10,594 for the 2019-2020 tax year, the current tax year for the subject property. As these taxes were just recently paid this tax amount plus 3%, less a 3% discount for on time payment will be used in this analysis, or **$\_\_\_\_\_\_\_\_**.

Insurance: Building insurance for similar office properties in the Portland metropolitan area generally range from $0.20 to $0.50 per SF. The marketing flyer projects insurance costs at $1,117 ($0.193 per SF NRA) which appears near reasonable for this property type. Therefore, an expense at the lower end of the comparable range of **$0.20 per SF** has been applied.

Utilities (Excluding Interior Electricity): The marketing flyer projects utility / landscaping expenses at $10,413 ($1.80 per SF NRA). However, this figure includes landscaping / grounds maintenance which we estimated in the next paragraph at $0.61 per SF. Deducting this from the total equates to a unit cost projection just for utilities of $1.19 per SF NRA which appears very high considering it excludes interior electricity for the individual office suites. Overall, total utility expenses for most suburban Class C offices typically range from $1.00 to $2.00 per SF (including interior electricity). Excluding interior electricity would lower this range to $0.50 to $1.50 per SF. Therefore, a mid-range, modified gross utility expense of **$1.00** **per SF** is reasonable.

Grounds Maintenance / Security: The client provided the appraiser with the landscape contract for the subject which is quoted at $295 per month, or annual unit cost of $0.61 per SF. This expense typically ranges from $0.25 to $0.75 per SF. Given the subject’s significant degree of relatively good quality landscaping, a similar mid-range landscaping expense of **$0.61** **per SF** is reasonable.

Janitorial: No historical or pro form janitorial expenses were provided for our review. This expense typically ranges from $0.75 to $1.50 per SF. Considering the preceding, as well as a typical once a week janitorial service common for Class C office properties, a stabilized expense of **$1.00 per SF**, is deemed reasonable.

Repairs and Maintenance: The pro forma repairs and maintenance for the subject which is estimated by the broker at $3,100 per month, or annual unit cost of $0.535 per SF. This expense typically ranges from $0.50 to $2.00 per SF. Considering the subject’s newer age and average, adequately maintained condition (assuming the curing of the noted items of deferred maintenance), a stabilized maintenance and repair expense of **$0.55 per SF**, is concluded as 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, overall condition and amount of site improvements, an allocation of **3.0% 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 4.0% of effective gross income depending on the property's size, lease structure, and rent levels. The subject pro form estimates a management fee of 4.0% which appears within market standard. Considering the subject's moderate size, quality, condition, multi-tenant occupancy and modified gross lease structure, a management fee of **4.0% 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. It must be noted that this expense amount is on the high side, primarily due to the taxes which are very high at $\_\_\_\_\_ per SF.

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.

