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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.

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. Triple net tenant rents include only the net base rent, with the tenant typically responsible for all building operating expenses (including management fees for larger investment-grade properties). Generally excluded are reserves for the replacement of capital items. 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’s industrial property, we conducted a survey of reasonably comparable tenant leases of industrial buildings located in the local 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

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.

Subject Leasing Activity

None.

Or here is an example:

As indicated, the subject property is encumbered by a 5-year lease extension to Carl Zeiss Vision, Inc. which began April 1, 2016 (2 Years / 9 months remaining, as of July 1, 2019 – no options to extend). A tenant rent roll is provided below, while copies of the lease & 2nd amendment to lease are contained in the Addenda of this report. This is a triple net lease with a current contract rent payable monthly as follows: Year 1 - $11,826.46 per month ($0.597 per SF; blended), which then escalates annually by a fixed rate of +3.0% per year. The current contract rent is $12,923.09 ($0.653 per SF, blended), with then escalates to $13,310.78 per month ($0.672 per SF, blended) for final Year 5. The average rent over the next 12-month period equates to $0.658 per SF, blended. Note that applying a market office surcharge of $0.800 per SF to the office portion infers a current contract shell rate of $0.378 per SF, which is below our concluded market rent of $0.520 per SF.



Based on the preceding, the tenant’s contract rent is considered below market with a modest measurable positive leasehold interest noted. Therefore, the value of fee simple interest is slightly greater than the leased fee interest.

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),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.

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 professional management fees and 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.

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. As property management is reimbursable as an expense, **2.0% management fee** 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 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 overall age / condition, an allocation of **3.0% of effective gross income** is reasonably made for reserves for replacement items for the subject property.

Total Operating Expenses

Based on the preceding, **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. None of the sales used in the Sales Comparison Approach provided cap rate indicator. Therefore, as supplemental data, several additional sales were provided from the surrounding market and included as follows.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **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.

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:

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| --- | --- |
|  |  |
| **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.

