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CANNING CONSULTANTS: THE OPAC ASSESSMENT

Professor Greg Zaric prepared this case solely to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.

In January 2001, George Canning, a real estate appraiser in London, Ontario, looked at a report by the Ontario Property Assessment Corporation (OPAC)[1] concerning the assessed value of seven properties located in downtown London. The owners of the buildings felt that OPAC had overestimated their value, and they hired Canning Consultants Inc., a London-based appraisal firm, to provide an independent assessment. Canning needed to produce an estimate before the next meeting of the Assessment Review Board hearing at the end of the month.

MARKET VALUE ASSESSMENTS

The dispute was related to the market value of seven office buildings in the downtown core area of London, Ontario (see Exhibit 1). The buildings were owned by Sifton Properties, the Royal Bank and TD Bank. The TD property was occupied by TD Bank, while the other seven properties were used for rental income.

The properties were assessed by OPAC to determine their current market value, which was then used by the City to determine property taxes. A recent sales price was considered to be the best estimate of market value. However, the properties in question had been in the possession of their current owners for a long period of time, and no recent sales prices were available. Thus, OPAC needed to estimate the current market value of the buildings.

THE OPAC ASSESSMENT

OPAC used an income approach to value each of the properties. The income approach proceeded by determining the net income generated by each property and applying a capitalization rate (cap rate) to determine the value of the property based on its income stream. Gross income was based on income from

[1] *OPAC is now known as MPAC, the Municipal Property Assessment Corporation.*

rents and leases and was easily determined by examining a building's financial records. Net income was calculated by adjusting gross income to account for expenses. The cap rate was the ratio of net operating income to the value of a property and is specific to a given market. Given a net income and a cap rate, the value of the property was estimated as the net income divided by the cap rate. Using this method, OPAC estimated that the seven buildings were worth approximately $27,700,000 (see Exhibit 1).

THE DISPUTE

The owners felt that an income approach was a reasonable way to value their buildings, but they disagreed with some of the assumptions made by OPAC. In particular, they were concerned that OPAC had not made sufficient allowances for vacant space in each of the buildings, nor had they adjusted for certain other non-recoverable expenses. They were also concerned about the 10 per cent cap rate used by OPAC. Since the market in downtown London had been weak for a few years, the owners felt that a higher cap rate should be used to account for the risk involved in that area.

APPRAISING OFFICE BUILDINGS

Real estate valuation usually relied on the income approach or on comparison with similar properties that had sold recently. In the comparison approach, an appraiser would select a comparable property (an index) that had sold recently and then adjust the price up or down to reflect differences between the subject property (the property whose value was being estimated) and the index property. For office properties, the price was frequently converted to a price per square foot to account for differences in building size. Canning felt that both methods had weaknesses: estimates derived from the income approach were very sensitive to the cap rate, and estimates from the comparison approach were sensitive to several factors, including the choice of index properties and arbitrary price adjustments made by the appraiser.

CANNING'S APPRAISAL

Canning Consultants Inc. had recently been using a direct comparison valuation technique called Quality Point to value a property using a small set of comparators. Using Quality Point, Canning would assemble a database of index properties that were suitable for comparison with the subject property. For each index property, he would calculate the adjusted sales price per square foot. The adjustments applied to the price per square foot were based on market conditions, financing terms, building size, land rights and time value of money. He would then determine a list of factors that might account for differences in the adjusted price per square foot of each index property, and that might be used by appraisers to justify a price adjustment with the comparison approach.

For example, if the method was used to evaluate residential properties, these factors might include location, lot size, quality of basement, size of garage and so on. Then each factor was rated on a seven-point scale (1 = fair, 7 = excellent) for each property. Some appraisers preferred to use a five-point scale. Others preferred to rate properties on a five- or seven-point scale and then use the square of the rating in the actual valuation. The numerical ratings could be explicitly tied to measurable aspects of the properties. For example, if a five point scale was used to quantify the characteristic "Vacancy and rental income," 5 might correspond to "Fully rented," 3 to "Partially rented," and 1 to "Vacant or minimal rental income."

Canning thought that variations in the adjusted price per square foot of each property could be explained by variations in their quality ratings. He thought that he could find out, on average, how much each factor contributed to the price of the index properties. He felt that all index properties should have approximately the same ratio of adjusted price per square foot to weighted average of quality points. Once he found the best set of weights to use for the index properties, he could use them to estimate the value of a subject property.

Canning had previously been successful in using linear regression techniques to estimate the impact of a number of factors on the price of residential real estate. However, he worried that linear regression might not work for office buildings because there were several important factors to consider but usually only a small number of suitable comparison buildings.

ASSESSING THE PROPERTIES

The index properties and factor ratings for properties comparable to 195 Dufferin Street are shown in Exhibit 2. Canning's estimates for the numerical values of each of these factors for 195 Dufferin Street are shown in Exhibit 3. Canning needed to estimate the value of the entire set of properties and prepare himself for a potential court case.

Exhibit 1

LONDON PROPERTIES AND THEIR ASSESSED VALUES

Owner	Address	OPAC Assessment
Sifton Properties	493-495 Richmond Street	$4,053,000
	200 Queen's Avenue	$3,660,000
	171 Queen's Avenue	$4,473,000
	285 King Street	$1,984,000
	195 Dufferin Street	$3,681,000
	Subtotal	**$17,851,000**
TD Bank	365 Richmond Street	$1,147,000
	Subtotal	**$1,147,000**
Royal Bank	383-391 Richmond Street	$8,734,000
	Subtotal	**$8,734,000**
	Total	**$27,732,000**

Source: Company files.

Exhibit 2

COMPARISON PROPERTIES FOR 195 DUFFERIN ST.

	Ratings of Index Properties				
Attribute	**Index 1**	**Index 2**	**Index 3**	**Index 4**	**Index 5**
Vacancy	1	1	5	1	1
Site Size	1	5	1	1	1
Age/condition	3	1	5	1	1
Parking	1	3	3	3	1
Location	5	5	5	5	3
Income Durability	1	1	5	1	5
Marketability	1	1	5	3	1
Size (ft^2)	89,140	58,899	302,280	166,494	118,021
Adjusted Sale Price / Square Foot	22.44	33.53	68.61	21.08	50.82

Source: Company files.

Exhibit 3

QUALITY POINT ESTIMATES FOR 195 DUFFERIN ST.

Attribute	Rating
Vacancy	1
Site Size	1
Age/condition	1
Parking	1
Location	3
Income Durability	1
Marketability	1
Size (ft^2)	69,364

Source: Company files.