CE class

Small Mixed Use and Residential Investment Appraisal Appeal
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Introduction

Small Mixed Use and Residential Investment Properties
- 1 – 4 units
- Financing – residential loan – including FHA and VA
- Commercial loan – 5 or more units
  - Higher down payment than residential loan
  - Higher interest rate than residential loan
  - Possibly a shorter loan term than residential loan

Mixed Use

Mixed Use Investment Properties
- Typically, commercial use on lower floor(s) and residential on upper floors
- For example, retail use on first and two apartments on 2nd and 3rd floors
- Definitions will vary depending on your jurisdiction
- For example, in Philadelphia a mixed use property is up to 4 commercial units and up to 4 residential units - for a possible total of 8 units.

Other combinations

Mixed Use Investment Properties
- Can also be a combination of commercial uses
- Industrial / Office
- Retail / Office
- Retail / Industrial
- Retail / Office / Apartments

Income Approach

Potential Gross Income (PGI)
- Market (Economic) Rent
- 100% Occupied
- Annual Basis

Subtract Vacancy and Collection Loss
Add Miscellaneous Income
Effective Gross Income (EGI)
Subtract Operating Expenses
Net Operating Income (NOI)
Divide NOI by capitalization rate to estimate value
PAV, p.318

Income Approach

Potential Gross Income (PGI)
4 units x $1,000/mo. = $4,000 x $12,000 = $48,000
Subtract Vacancy & Collection Loss $48,000 x 5% = $2,400
$48,000 - $2,400 = $45,600
Add Miscellaneous Income $45,600 + $1,200 = $46,800
Effective Gross Income (EGI)
Subtract Operating Expenses $46,800 X 30% = $14,040
$46,800 - $14,040 = $32,760
Net Operating Income
Divide NOI by capitalization rate to estimate value
$32,760 / 9% = $364,000

Important consideration

An important consideration is looking at the real estate through the eyes of an investor.

Look at what factors are important to an investor when they are looking at purchasing real estate.

Investment considerations

Safety
Liquidity
Size of investment
Use as collateral
Time
Management
Appreciation
Income Tax Advantages
Leverage
PAV, p. 304 - 305

Why invest in real estate?

Pros
- Make money – income and appreciation
- Tax benefits – depreciation, capital tax gain, Section 1031 exchange
- Leverage
- Inflation hedge

Cons
- Risk
- Management
- Upkeep
- Liquidity

Investor Yield Requirements

Safe rate – with the most safety and least risk
Risk rate – the risk assumed by the investor
Rate for liquidity – real estate is an illiquid asset
Rate for management of the investment – compensate for time and cost involved
PAV, p. 305 - 306

Investor Goals

Normal goals of an investor
- A return on the investment
- A return of the investment

When looking at income, consider the
- Quantity
- Quality
- Duration
- of the income stream

PAV p. 339

Types of Leases

Month-to-month
Short term lease – usually for a period of less than 5 years
Long term lease – more than 5 years
Percentage lease – minimum base rent plus an overage rental amount
Graduated lease – Stated rent with rent change during the lease
- $1,000 per month increasing $25 each year

Index lease – annual rent increase or decrease tied to
- Consumer Price Index (CPI) or another economic indicator

Renewal lease – provides for one or more extensions – 5 year
- lease with single or multiple 5 year renewal options

PAV p. 320

Comparing Lease Factors

Effective date of lease
Location of property
Physical characteristics of property
Terms of the lease
These will help determine the comparability of the rental properties.
PAV p. 320

Comparison Guidelines 1

Date of lease
Name of Owner (Landlord or Lessor)
Name of Tenant (Lessee)
Reference
Legal Description
Lease Term
Amount of Rent
Owner's Responsibility
Tenant's Responsibility
PAV, p. 320 - 322

Comparison Guidelines 2

Taxes
Right to Sublease or Assign
Option to Renew
Tenant Improvements
Security
Termination
Special Provisions
PAV, p. 320 - 322

Lease types

Gross lease – residential lease – tenant pays one amount to landlord, landlord pays all maintenance, utilities, insurance, and taxes
Net lease – tenant pays rent and property taxes
Net, net lease – tenant pays rent, property taxes, and insurance
Net, net, net (NNN) or triple net lease or absolute net– tenant pays rent and all property expenses except debt service
PAV, p. 322

Sales Comparison Approach

Also known as site market approach
Define the appraisal problem
Collect and analyze the data
Select appropriate units of comparison
Make reasonable adjustments based on the market
Apply the data to the subject of the appraisal
PAV, p. 203 - 204

Sales Comparison Approach

Sequence of adjustments
- Financing
- Changing market conditions
- Location
- Physical characteristics

PAV, p. 212 - 213

Cost Approach

Estimate the land (site) value as if vacant and available for development to its highest and best use

Estimate the total cost new of the improvements as of the appraisal date

Estimate the total amount of depreciation from all causes

- Physical depreciation
- Functional obsolescence
- External (economic) obsolescence

Subject depreciation from total cost new to arrive at depreciated cost of improvements

Add site value to the depreciated cost of the primary improvements to arrive at estimate/opinion of value

PAV, p. 230

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Effective Gross Income (EGI)

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PAV, p.318

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IRV

Income = Value x Rate $364,000 x 9% = $32,760

Rate = Income / Value $32,760 / $364,000 = 9% or .09

Value = Income / Rate $32,760 / 9% or .09 = $364,000

Income

Rate | Value

If you change rate...

Value = Income / Rate $32,760 / 9% or .09 = $364,000

Increase rate to 10% $32,760 / 10% or .10 = $327,600

If you increase the capitalization rate, the value will decrease.

Decrease rate to 8% $32,760 / 8% or .08 = $409,500

If you decrease the capitalization rate, the value will increase.

Income

Rate | Value

VIF

Value = Income x Factor $100,000 x 10 = $1,000,000

Income = Value / Factor $1,000,000 / 10 = $100,000

Factor = Value / Income $1,000,000 / $100,000 = 10

Value

Income | Factor

Income Approach

The fundamental principle on which the income approach is based is the principle of anticipation.
This looks at the present worth of the future benefit of owning this property.
What is an investor willing to pay today for the benefits (income) they will receive in the future?
An investor is looking for a return on and a return of their money.
PAV, p.303,339

Additional Principles of Value

Substitution
Competition
Balance
Supply and Demand
Change
PAV, p. 34 - 40

LTV

LTV is the loan to value ratio.
LTV = Loan Amount divided by the purchase price or appraisal value, whichever is less.
Example - $80,000 loan with a market value of $100,000
$80,000 / $100,000 = 80%
PAV, p. 34 - 40

Debt Service

Mortgage Payment
The amount of money to pay back the borrowed capital (the money the bank lent you) and interest (what the bank charges you for the use of the money).

GRM and GIM

Gross Rent Multiplier (GRM)
- Residential
- Sale Price / Gross Monthly Rent = Gross Rent Multiplier
- $200,000 / $1,400 = 142.86
- Gross Rent Monthly Multiplier (GRMM)

Gross Income Multiplier (GIM)
- Commercial
- Sales Price / Gross Annual Rent = Gross Income Multiplier
- $1,000,000 / $100,000 = 10
- Gross Rent Multiplier (GRM)

PAV, p.323

GRM and GIM examples

1. If the sales price of a residential property is $150,000, and the monthly rent is $1,200, what is the Gross Rent Multiplier (GRM)?

Sales Price / Monthly Rent = Gross Rent Multiplier

$150,000 / $1,200 = 125 GRM

GRM and GIM examples

2. If the sales price of a commercial property is $800,000, and the annual rent is $96,000, what is the Gross Income Multiplier (GIM)?

Sales Price / Annual Rent = Gross Income Multiplier

$800,000 / $96,000 = 8.33 GIM

Percentage Rent example

A retail store leases a 50,000 sf location for $15/sf. The lease states that the overage rent is 1% of any sales over $3,000,000. The store had $4,000,000 is sales last year. What is the total rent?

Percentage Rent example

Base Rent + Overage Rent = Total Rent
Base Rent = 50,000 sf x $15/sf = $750,000
Amount of sales over threshold amount
$4,000,000 - $3,000,000 = $1,000,000
Overage Rent
$1,000,000 x 1% or .01 = $10,000
Base Rent + Overage Rent = Total Rent
$750,000 + $1,000 = $751,000

Percentage Rent Problem 1

A retail store leases a 15,000 sf location for $8/sf. The lease states that the overage rent is 2% of any sales over $1,000,000. The store had $3,000,000 is sales last year. What is the total rent? Including the overage rent, what is the rent per sf?

Problem 1

Base Rent + Overage Rent = Total Rent
Base Rent = 15,000 sf x $8/sf = $120,000
Amount of sales over threshold amount
$3,000,000 - $1,000,000 = $2,000,000
Overage Rent
$2,000,000 x 2% or .02 = $40,000
Base Rent + Overage Rent = Total Rent
$120,000 + $40,000 = $160,000
Including the overage rent, the rent per sf is:
$160,000 / 15,000 sf = $10.67/sf

Percentage Rent Problem 2

A hardware store leases a 50,000 sf location for $4/sf. The lease states that the overage rent is 2% of any sales over $1,000,000. The store had $4,200,000 is sales last year. What is the total rent? Including the overage rent, what is the rent per sf?

Problem 2

Base Rent + Overage Rent = Total Rent
Base Rent = 50,000 sf x $4/sf = $200,000
Amount of sales over threshold amount
$4,200,000 - $1,000,000 = $3,200,000
Overage Rent
$3,200,000 x 2% or .02 = $64,000
Base Rent + Overage Rent = Total Rent
$200,000 + $64,000 = $264,000
Including the overage rent, the rent per sf is:
$264,000 / 50,000 sf = $5.28/sf

Percentage Rent Problem 3

A hardware store leases a 70,000 sf location for $4/sf. The lease states that the overage rent is 1% of any sales over $1,000,000. The total rent paid last year was $300,000. What were the total sales?

Problem 3

Base Rent + Overage Rent = Total Rent
Base Rent = 70,000 sf x $4/sf = $280,000
Total Rent – Base Rent = Overage Rent
$300,000 - $280,000 = $20,000
Overage Rent / Overage Percentage = Amount of Overage Sales
$20,000 / 1% or 0.01 = $2,000,000
Threshold Amount + Overage Sales = Total Sales
$1,000,000 + $2,000,000 = $3,000,000

Expenses

Fixed
- Owner has no control over expenses
- Insurance and real estate taxes

Operating
- Expenses on the property that are not paid for by the tenant
- Can include management, major maintenance and personal liability insurance

Reserves for replacement
- Short lived components of the property that require replacement
- Roof, appliances, carpeting, painting, air conditioning units, heating units, hot water heaters and others

Improper Expenses

Real estate taxes
Depreciation
Mortgage payments
Mortgage interest
Income taxes (payroll taxes are allowed)
Capital improvements
Owners business expense

The IRV Equation

Income = Rate x Value

Rate = Income / Value

Value = Income / Rate

Selection of Rates

A small change in the capitalization rate can cause a large change in thousands of dollars in the value estimate

If the capitalization rate is increased, the value will decrease

If the capitalization rate is decreased, the value will increase

Income

A property is valued at $800,000, and the capitalization rate is 8%, what is the income for the property?

Income = Rate x Value

Income = 8% or .08 x $800,000 = $64,000

Rate

A property has a net operating income of $60,000, and the value is $800,000, what is the capitalization rate?

Rate = Income / Value

Rate = $60,000 / $800,000 = 7.5% or .075

Value

A property has a net operating income of $63,000 with a capitalization rate of 9%, what is the value?

Value = Income / Rate

Value = $63,000 / 9% or .09 = $700,000

Income Approach Methods

Some of the methods used in the income appraoch

- Comparable Properties
- Mortgage Equity Band of Investment
- Building and Land Band of Investment
- Gross Rent Multiplier
- Discounted Cash Flow
- Net Income Ratio
- Debt Coverage Ratio
- PAV, p. 347

Comparable Properties

Compare properties with similar characteristics

- Land to Building Ratio
- Operating Expense Ratio
- Remaining Economic Life

Rental Units of Comparison

These will vary based on the property type

- Rent per unit
- Rent per room
- Rent per space
- Rent per square foot

For example, apartments could be based on per unit, per room, or per square foot

GLA and NLA

Gross Leasable Area

- Incudes all of the leasable space including hallways, lobby, and elevators (common areas) of the building

Net Leasable Area

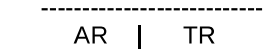
- For example, in an office building, this would include the space leased just for the individual office, and would not include any of the common areas

Effective Tax Rate - ETR

Effective Tax Rate (ETR) = Assessment Rate x Tax Rate

Assessment Rate (AR) = Effective Tax Rate / Tax Rate

Tax Rate (TR) = Effective Tax Rate / Assessment Rate



Tax Rate

1 mill = $0.001
30 mills = $0.030
If Bucks County tax rate is 29.65 mills, Lower Makefield Township is 24.993 mills, and Pennsbury School District is 204.003 mills, the total tax rate is:
29.65 + 24.993 + 204.003 = 258.646 mills or
$0.02965 + $0.024993 + $0.204003 = $0.258646
If the CLR (common level ratio) is 5.86%, the ETR is:
ETR = AR x TR = 0.0586 x $0.258646 = 0.0151567 or 1.51567%

Using ETR

If you have a property with a market value of $200,000, and an effective tax rate (ETR) of 0.015, what are the annual taxes?

Market Value X ETR = Annual Taxes
$200,000 x 0.015 or 1.5% = $3,000

MET

Mortgage Equity Band of Investment

The three bands are:
- Mortgage
- Equity
- Tax

Mortgage (M) = LTV x Mortgage Constant
Equity (E) = Down Payment % x Equity Return
Tax (T) = Assessment Rate x Tax Rate
M + E + T = Capitalization Rate

MET example 1

80% LTV, 20 year mortgage at 6%, 8% equity yield, assessment rate is 75%, and millage rate is 20 mills
Mortgage (M) = LTV x Mortgage Constant
M = .80 x .0859717 = .06878
Equity (E) = Down Payment % x Equity Return
E = .20 x .08 = .016
Tax (T) = Assessment Rate x Tax Rate
T = .75 x .020 = .015
M + E + T = Capitalization Rate
.06878 + .016 + .015 = .09978
If the net operating income is $15,260:
Value = Income / Rate = $15,260 / .09978 = $152,936 or $153,000

MET example 2

80% LTV, 25 year mortgage at 4.5%, 10% equity yield, assessment rate is 90%, and millage rate is 14.78 mills – NOI is $60,000
Mortgage (M) = LTV x Mortgage Constant
M = .80 x .0666999 = .05336
Equity (E) = Down Payment % x Equity Return
E = .20 x .10 = .02
Tax (T) = Assessment Rate x Tax Rate
T = .90 x .01478 = .0133
M + E + T = Capitalization Rate
.05336 + .02 + .0133 = .08666
If the net operating income is $60,000:
Value = Income / Rate = $60,000 / .08666 = $692,361 or $682,400

Mixed Use Example

You have a mixed use property with 1,000 sf of retail space on the first floor, 1,000 sf of office space on the second floor, a two bedroom apartment on the third floor, and a one bedroom apartment on the fourth floor.
The retail space rents for $25/sf per year, the office space rents for $15/sf per year, the two bedroom apartment rents for $1,100 per month, and the one bedroom apartment rents for $900 per month. All of the rents are market rents.

Mixed Use Example

Potential Gross Income (PGI)

Retail – 1,000 sf x $25/sf = $25,000
Office – 1,000 sf x $15/sf = $15,000
Two bedroom - $1,100 x 12 = $13,200
One bedroom - $900 x 12 = $10,800
$25,000 + $15,000 + $13,200 + $10,800 = $64,000

Mixed Use Example

Potential Gross Income (PGI)
$64,000
Subtract Vacancy and Rent (Collection) Loss
$64,000 x 5% = $3,200 $64,000 - $3,200 = $60,800
Effective Gross Income (EGI)
Subtract Operating Expenses
$60,800 x 40% = $24,320 $60,800 - $24,320 = $36,480
Net Operating Income
Divide NOI by capitalization rate to estimate value. With 10% cap:
$36,480 / 10% or .10 = $364,800

GRM example

Property	Sales Price	Monthly Rent	GRM
A	$200,000	$1,400	142.86
B	$205,000	$1,500	136.67
C	$190,000	$1,350	140.74
D	$195,000	$1,375	141.82
E	$192,500	$1,375	140

An appropriate GRM may be 140.
Subject will rent for $1,500 per month.

Monthly Rent x GRM = Estimated Value
$1,500 x 140 = $210,000

Appeals

Are your property characteristics correct?
Reconciliation
Read appraisal report (if provided)
- Comparables
- Capitalization rate – loaded or unloaded
- Interest rate
- Equity rate of return
- Subject lease information
- Calculations
- Extraordinary assumptions
- Hypothetical condition

Appeals

Preparation
- Thank the board/panel for their time
- Have your most important points ready
- Know your comparables and their characteristics
- Be prepared for questions – board/panel, attorney, appraiser, owner
- Do not be stressed out
- Check for updated information and changes
- Build relationships and ask for help on difficult properties or if you need additional comparables
- Understand what we do and our role is important

References

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Any questions?

Thank you for your time and attention today!

Enjoy the conference and safe travels home.

Happy Mother's Day, and wishing everyone a happy, healthy, safe and fun summer!