MARKET ABSTRACTED OVERALL CAPITALIZATION RATES

Overview

Overall rates abstracted from the market have been considered the simplest and most accepted method of obtaining overall capitalization rates (OAR). It's easily explained, easily understood, and easily defended. However, there is more to the development of the OAR's other than a simple calculation of known facts. This presentation provides some issues appraisers and mass appraisers should consider.

More Than a Simple Mathematical Calculation

The format for abstracting the Overall Capitalization Rate from a market sale is as follows:

Net income ÷ Sales Price = Overall Capitalization Rate

Simple, right? The most difficult task the appraiser and mass appraiser have in the development of this method is obtaining the necessary and accurate information to do this simple calculation.

Because of the complications of the real estate fallout over the past several years, USPAP confidentiality, resistance to allow others to have such pertinent information in their files, non-disclosure letters, I don't have that information available and so on and on.

Have you ever asked a buyer if they have a copy of the income and expense statement for the property they just purchased? Believe it or not, some have said "I never got one". Or the broker who provides one and it has been so altered in format that you end up with more questions with no possible answer.

Getting information from the lender sometimes is a futile endeavor. Now it's important to know that the lender does have the financial statements for the property because its part of the risk analysis they perform in order to determine and affirm a lending rate.

National publications for OAR's such as Robert G. Watts of Realtyrates.com and Korpacz Real Estate Investor Survey as conducted by PricewaterhouseCoopers, who on a national scale obtain information by strict criteria for each sale and on a uniform basis. Since the information is available in markets throughout the country, and utilized by some of the largest financial institutions, it has become readily accepted as reliable.

Although confidentiality is foremost apparent, the lending institution feels its better to provide this information to the those who provide such service rather than the local appraiser. Now this does not mean that all appraisers have this problem, but in my experience, there are more who do.

Reliability

If the appraiser does obtain a financial statement, it should be reviewed as to the items that are included and those that are not included. Sometimes income and expense statements have categories that are collect-alls. Meaning more than one-(1) expense item is lumped into it.

A single year's statement should be used with great caution. For example, a single year's statement might include an extraordinary amount for so called maintenance when in fact it's for capital improvements. If the appraiser is unaware of this, the result will be overstated expenses, understated NOI (Net Operating Income), and too-low of a OAR.

Having a single year's income and expense statement for a sold property does not guarantee a reliable OAR. Relying on an owner's verbal statement of NOI may produce an even more skewed OAR, because the owner's idea of legitimate expenses may include items that should not be included in the valuation.

If at all possible, the appraiser should try to obtain a three-(3) year expense statement. Yes it's easier said than done. But this way the appraiser can do an audit, line by line to trend expenses. Any anomalies will be apparent. Keep in mind that the information being review will also assist in developing a expense ratio study based upon actual market information.

It does take time to systematically collect this information, however, it is also invaluable when the appraiser needs to estimate expenses for a similar property or simply report to a client what the market is doing or responding to existing economic conditions.

Elements Used in the Abstraction Method

Since the actual data needed to obtain an OAR for a sale property is not available to the appraiser for one-(1) reason or another, and time is of the essence, it may be necessary and is quite acceptable to estimate the essential elements from market data that is used to arrive at a NOI to abstract the OAR from a sale.

Under USPAP[1], the appraiser, subject to the Competency Rule, is responsible for factors that may apply to an appraiser's familiarity with a specific type of property, market, geographic area, or analytical method.

Lets say for example the appraiser has had a difficult time of obtaining a financial statement on a verified sale. Having previously researched the market for applicable data available to apply a market abstraction, the following basic elements are analytically applied to the sale property.

[1] USPAP 2014-2015, Competency Rule

Elements - Continued

Gross Income Estimate	$	-
(Market Rent - 100% Occupancy)		
Vacancy Rate (0%)	$	-
(Market Observed - Typical % Level)		
Income from other Sources	$	-
(If Applicable)		
Effective Gross Income	$	-
Operating Expenses		
(Typical for Property Type)	$	-
(Include Reserve Estimate)	$	-
(Other Applicable Expenses)	$	-
(Property Taxes at Time of Sale)	$	-
Net Operating Income	$	-

According to the principle of anticipation, market value can be viewed as the present worth of future benefits. Evan though the property's past performance can be a valuable guide, investors purchase on the basis of their expectations of the property's future performance under their management.

The competent investor's expectations are market-based and realistic. The investor expects to keep rental rates, vacancy, and expenses at about the same level as or better than those of similar competing properties.

Thus the appraiser develops an NOI for rate extraction from market-based estimates of rent, vacancy, and expense levels, applying the same rationale as a prudent, competent investor. Isn't that the goal of appraisers to emulate the actions of market participants.

Other Important Factors to Consider

In the qualification process of a verified sale, a big question that needs to be answered. Does the sale contain a consideration for personal property? Are there any other considerations in the sales price that should be excluded? Before an OAR Market abstraction can have any meaning, the sale should be adjusted for those considerations. It does have an affect on the outcome of the calculation.

In the market abstraction technique for OAR's (and this is important), the appraiser must make certain that the net operating income of each comparable property is calculated and estimated in the same way the net operating income of the subject property is estimated.[2]

Non-market financing terms nor different market conditions should have affected the price of the comparables. The overall level of risk associated with each comparable should be similar to that of the subject. If there are differences between a comparable property and the subject that could affect the overall capitalization rate, the appraiser must account for the difference.[3]

As previously pointed out, the OAR abstraction analysis is "property specific". If the income to the property includes property taxes, then the market rent estimate will include that consideration. If a property receives an income based upon a Net-Net-Net Lease, then the inclusion of property taxes is not made.

The property taxes are paid by the Tenant and is reflected in the Lease rate per square foot. The following is a simple outline that can be adapted to all type of properties.

Market Extracted Overall Capitalization Rate (OAR)

Warehouse Valuation Data

Market Rent	$4.00 - $5.00 NNN Per Sq. Ft.
Vacancy (Observed for Market)	9.50%
Total Expenses To Owner (Observed)	9.00% Includes Reserves Estimate
Taxes Paid By Tenant	100.0% Not included in Market Rent

Technique 1

Sale #1	$686,000
Square Feet	14,000
Date of Sale	10/2014
Estimated Gross Rent	$4.50 (Per Market Comparison Method)
Potential Gross Income	$63,000
Vacancy Rate	9.50%
Effective Gross Income	$57,015
Total Expenses (9%)	$5,131
Net Operating Income	$51,884
Net Income Ratio (NIR)*	91% of Eff. Gross Inc.
OAR	$51,884 ÷ $686,000 = **7.56%**
Effective Gross Income Multiplier	12.03 ($686,000 ÷ $57,015)

[2] Appraisal Institute, Appraisal of Real Estate, 12th Edit ion, Pg 531.
[3] Appraisal Institute, Appraisal of Real Estate, 12th Edition, Pg 532.

Technique 2 – Abstraction from Multiplier

Effective Gross Income Multiplier

(NIR)* ÷ EGIM = OAR	91% ÷ 12.03 = .0756 or **7.56%**

Market Extracted Overall Capitalization Rate (OAR)

Method 1 - **Apartment Valuation Data**

Market Rent	$600 / Month 14-Units
Vacancy (Observed for Market)	8.00%
Total Expenses To Owner	55.88% Includes Reserves Estimate

Technique 1

Sale #1	$378,000
Date of Sale	October - 2014
Estimated Gross Income	$100,800 (Per Market Comparison Method)
Vacancy Rate	8.00%
Income from other Sources	$2,800
Effective Gross Income	$95,536
Expenses (excluding Taxes) (45%)	$42,991
NOI (Including Taxes)	$52,545
Estimated Taxes	$10,395 $378000 x .50 [ratio] x .055 [tax rate]
NOI After Taxes	$42,150
OAR	$42,150 ÷ $378,000 = **11.15%**
Effective Gross Income Multiplier	3.96 ($378,000 ÷ $95,536)
Net Income Ratio (NIR)*	44.12% of EGI

Technique 2 – Abstraction from Multiplier

Effective Gross Income Multiplier

(NIR)* ÷ EGIM = OAR	44.12% ÷ 3.96 = .1114 or **11.14%**

Method 2

Effective Gross Income	$95,536
Expenses (excluding Taxes) (45%)	$42,991
NOI (Including Taxes)	$52,545
Indicated OAR	13.90% ($52,545 ÷ $378,000)
Effective Tax Rate	2.75% (.50 AV Level x .055 Tax Rate)
Indicated OAR (Base Rate)	**11.15%**

Conclusion

Market-extracted OARs are not difficult to determine as long as the appraiser exercises analytical skill and judgment in the application of the market data available.

Bibliography

Select readings and information Sources

1. Appraisal of Real Estate, 12th Edition, Appraisal Institute, 2001
2. USPAP, Appraisal Foundation, 2014-2015 Edition

Biography of Author

Daniel J. Dzierbicki is an independent real estate appraiser with thirty-Nine-(39) years of experience. He specializes in industrial real estate and special purpose property. Daniel holds the Senior designation of ASA-RP with the American Society of Appraiser, also the Senior designation of IFAS with the National Associations of Real Estate Appraisers, and the RES designation with the International Association of Assessing Officers. He is a Licensed Certified General Real Estate Appraiser with the State of Michigan and a Licensed Michigan Real Estate Broker. **Contact: dzierbicki54@att.net**