HOW TO DETERMINE VALUE
IN COMMERCIAL REAL ESTATE

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> *"Price is what you pay, Value is what you get."*
> **Warren Buffet**

[Please note … this report is only an introduction to the basics of Commercial Property Valuation. Mastering the concepts presented here will give you the ability to understand the components of Value in a specific property and speak with comprehension to Brokers, Sellers, Lenders and other investors. The art and science of complete property analysis is taught in additional courses available at our website www.investortours.com]

If you are new to Commercial Real Estate one of the most important concepts to learn is how to determine the value of a commercial property. Just like Warren Buffet's quote above there is often a large difference between price and value in Commercial Property. Your goal is to always pay a price that is reasonable for the amount of value in the property you acquire.

If you are experienced in Residential Real Estate, it's time to start over...

If you are an experienced Residential Real Estate Investor, you simply have to forget what you know about determining property values and prices when you move up to commercial. **Here's why...**

Commercial Real Estate values have nothing to do with appraisals and little to do with comparables or "comps" in the traditional "residential real estate sense". Commercial Real Estate value is determined much more clinically and that is what makes it so much easier to understand.

Much of the value of Residential Real Estate is determined by the emotions of the buyer, the supply and demand of that type of home and the desirability of the neighborhood. These are all very subjective ... so looking at comparable sales – that is, what similar houses in similar neighborhoods have recently sold for – is a time honored way to learn what you will likely pay for that Residential Property. And when you do get an appraisal they will use "comps" as one of the methods of determining value.

Once you have purchased a Residential Property, your job is very simple ... keep it rented and hold on and hope for general market appreciation. From 2002 to 2005 that was a great way to make money in most every market in the USA. Not so ever since.

How is Commercial different ...

You will find that Commercial Real Estate value is based on numbers and calculations you will learn in this article. Commercial Property values are much less subjective and much more focused on the Income the property will produce and the cost you will have to pay to keep that income stream coming. Before we get to the numbers, please remember this ...

You are Buying a Business

With Commercial Real Estate, you aren't buying a property so much as buying an actual business. You are buying both the physical property AND the income stream associated with the building. The income stream is a result the desirability of the product and/or service that is housed in the property.

In order to profit in Commercial Real Estate, you have to purchase the physical property at a reasonable price AND manage the business effectively.

In Multifamily Property:

The business you are buying is the provision of affordable, safe, clean housing reasonably close to jobs, schools and shopping with a responsive staff of management and maintenance people. Once you purchase the property, if your Multifamily Property cannot continue to provide that product/service at competitive rates, you have to question its value.

In Retail Property:

You are actually buying two layers of business. YOUR business is providing visible, attractive, well maintained space for retail tenants. And the profitability of your business is also dependent on your tenant's business strength.

EXAMPLE: Compare two retail strips in the same town. They are identical in size and both listed by Commercial Real Estate Brokers at the same time.

The tenants in strip #1 are “Happy Nail Salon”, a massage therapist, a dog grooming business and a Subway store. All but the Subway store are on one year leases.

The tenants in strip #2 are Starbucks, a Verizon store, a title company and a Chiropractor. Starbucks and Verizon are on 10 year leases and the remaining tenants on five year leases.

You can immediately see the difference in value between the two properties. Both are Retail investment properties; however the difference in value is in the quality of the Tenant’s Businesses and the length of the leases.

In Office Property:

Your business is providing well located, clean office space with up-to-date amenities and services – such as onsite generators, or phone and computer network cabling. Value is also dependent on your tenant’s business strength.

In Industrial Property:

Your business is providing a building that meets the industrial requirements of your tenant(s). Value is also dependent on your tenant’s business strength.

Now that you can see the dual nature of a Commercial Property purchase – the physical buildings and the business inherent to them, we can start to get down to cold hard numbers. The most important number to understand is the income the property produces.

In Commercial Real Estate, VALUE and PRICE are closely tied to INCOME no matter what property type you are looking for. There are other factors to take into account, which we go in to later in this report, and Income is a key determinant of value.

Before we dive into the hard numbers of property valuation there are some terms, abbreviations and simple formulas to learn. No heavy lifting here. Fortunately you learned all the math you need for Commercial Real Estate Investing in Grade School.

Commercial Real Estate Valuation Terms and Formulas

"Net Operating Income" - N.O.I.

The Net Operating Income is all of the income from the property minus all of the expenses EXCEPT FOR the payment of the mortgage(s) or loan(s) on the property and non-recurring Capital Expenses and Reserves. NOI is typically an annual figure. Because the loan payment is not subtracted, you may hear the Net Operating Income referred to as the "*Net Before Debt*"

"Capitalization Rate" – CAP Rate

CAP Rate is a measurement of the profitability of a property. It is defined by the following formula

CAP Rate = NOI / Price

EXAMPLES:
1) A property which produces $100,000 Net Operating Income which is priced at $1,000,000 would have a CAP Rate of $100,000 / $1,000,000 = 10%.

2) If you paid $1,500,000 for the same property producing the same $100,000 in annual NOI the CAP Rate would $100,000 / $1,500,000 = 6.6%

AS YOU CAN SEE, THE MORE YOU PAY FOR A GIVEN INCOME STREAM, THE LOWER THE PROPERTY'S CAP RATE FALLS. For this reason CAP Rates are usually lower and Prices usually higher for properties perceived as higher quality or safety.

A brand new fully rented up property in a nice part of a growing town would command the highest price for each dollar of income produced and therefore, the lowest CAP Rate.

NOTE:
The CAP Rate Formula can be rearranged to produce any one of the three variables if you know the other two. Like this…

Price = NOI / CAP Rate

NOI = (CAP Rate) X (Price)

A Market CAP Rate is an average Cap Rate for a group of similar properties recently sold in this Market.

Market Cap Rates can be used to compare the property you are evaluating to others that have recently sold in your market. This is the closest you will get to a "Comp" in Commercial Property. Remember the "Average CAP Rate" you are given by the broker must be for properties that are actually comparable to the one you are evaluating.

In Commercial Real Estate, finding legitimately comparable properties is much more difficult than in Residential Real Estate … so be sure to take a close look at any property used as a comparable to the one you are evaluating.

> **EXAMPLE:**
> If you are looking at a "B" Class Retail Strip of 25,000 sq ft on the south side of town you would want to find the average CAP Rate for ""B" Class Retail Strips of 25,000 sq ft on the south side of town" or as close as possible.

The market CAP will help give you an approximate value for the property you are buying based on its NOI.

"Cash on Cash Return"

Cash on Cash Return is one of many measures of Return on Investment (ROI).

It is the annual return you would receive on the actual Cash invested in a property. It also has a simple formula.

Cash on Cash Return (%)
= (Annual Profit Realized / Total Cash Invested) X 100

Notice here we are talking about Profit, not Net Operating Income.

PROFIT IS THE DISTRIBUTABLE INCOME REMAINING AFTER ALL EXPENSES OF THE PROPERTY ARE PAID INCLUDING THE MORTGAGE(S) AND LOAN(S).

A large NOI is a good thing, however if it does not translate into a good Cash on Cash Return, the investment does not make sense.

NOTE:
In Commercial Properties the cash required to close a purchase is often significantly larger than just the down payment and closing costs. It will include Loan Broker's Fees, Initial Reserves, Equity Formation Fees (if you are bringing in investors), any money for Rehabilitation and Capital Upgrades, fees for Entity Formation and potentially several more cash expense items.

THINKING TIP:
Think about this … CAP Rate is actually the Cash on Cash Return on your property if you paid All Cash. Most investors do not pay all cash for their property, choosing to finance the majority of the purchase price. This "Leverage" allows them to put down less Cash at the close and - in most cases - drives the Cash on Cash return higher than the actual CAP Rate.

"Pro Forma"

This is an incredibly important term to recognize and understand when researching properties. Here is its definition:

"Description of financial statements that have one or more assumptions or hypothetical conditions built into the data"

As you can see above the Net Operating Income is the single most important number in determining property value. It is actually the result of a rather detailed calculation.

NOI = (All Income) **–** (All Expenses except Mortgage and non-recurring capital expenses and reserves)

The biggest question in figuring the price of any property is this,

"Are the numbers used to calculate the Net Operating Income based on Actual Data or are they PRO FORMA?"

As you project the future performance of properties you are researching you will need to make your own assumptions and hypotheses based on Actual Data you get from your seller. This is an Investor's Pro Forma. You are trying to be as accurate as possible to make a purchase decision.

Watch Out…
Be very cautious about any Pro Forma put together by any Commercial Real Estate Broker representing the property. Better yet, COMPLETELY IGNORE ANY BROKER'S PRO FORMA AND ASSUME ALL OF THEIR NUMBERS ARE TRASH BASED ON WHAT THE INVESTMENT WOULD LOOK LIKE IN AN UNOBTAINABLE PERFECT WORLD. Broker's numbers are not based on actual data and your numbers have to be.

Make sure that any time you are projecting future performance of a property you are using realistic assumptions based on ACTUAL data from the seller.

> **NOTE:**
> The term Pro Forma is also used to describe a spreadsheet of projections. As in, "Here is the Pro Forma."

Points to Remember …

Investors make property purchase decisions based on Return On Investment (ROI), not NOI or CAP Rates. Always calculate your ROI … Cash on Cash return is a good method to use.

Calculate and double check all numbers in the calculation of NOI for every property you research.

NEVER trust any number in a Broker's Proforma.

Always ask for Actual Numbers from the property. Request at least last year's and year to date profit and loss statements.

CAP Rates can be artificially depressed in an underperforming property. Don't pass on a distressed property because it is offered for sale at a low CAP Rate - believing it to be over priced. If there is a correctable reason the NOI is currently lower than expected, you can fix that problem and produce dramatic profits.

Now that you have some basic terms down….

Let’s Go a Little Deeper

Many commercial real estate investment trainers will tell you that the Net Operating Income is the ONLY factor in the value of a piece of Commercial Real Estate. Here at Investortours University our $250M in Commercial Property experience has taught us that the Net Operating Income cannot be the ONLY measure of a property's value and here is why...

Your property has an Income Stream - the Net Operating Income

AND that income stream is produced in CONTEXT or framework

The value of your property is in the NOI AND the CONTEXT where the building resides. The context is all the surrounding market forces and local influences that can affect the value of that income stream.

EXAMPLE:
Imagine two buildings, each with an annual Net Operating Income of $500,000 per year....

Building #1
is an apartment complex built in 1968 in a war zone neighborhood in Detroit. The market surrounding this complex is depressed and has been so for the last five years. However, the complex is so big that even with a 70% occupancy rate and high expense structure and significant maintenance costs it is still able to maintain a $500,000 net operating income.
This property is for sale with a CAP Rate of 11%.

Building #2
is a high-end strip retail center in a high growth area of Dallas. It was built just two years ago, fully occupied (Starbucks, Walgreens, Laser hair removal and Verizon all on long term leases) and set in an upscale neighborhood.
This property is for sale with a CAP Rate of 4.5%

Which is the better prospect?

I know it is a lot like comparing Apples and Oranges AND you get an instant appreciation for the concept that Net Operating Income is NOT the only indicator of value in Commercial Real Estate.

Building #2 has the same $500,000 per year net operating income however it sits in a completely different CONTEXT.

It's only by acknowledging this difference in CONTEXT - all of the outside influences on the true value of the property's income stream - that we can make a valid evaluation of the property's value.

These outside influences include...

- The Phase of the larger Market Cycle
- The projections of population and job growth for the area
- The physical attributes of the building
- The age of the building and its maintenance
- The quality of the tenants
- The local laws, taxes, and neighborhood conditions that are surrounding the property
- Local weather patterns and most common weather damages

It's only when we take all of these context factors into account that we can truly place a value on that income stream.

The Value of a Property is actually determined by Three Things

- **CURRENT AND FUTURE INCOME**
- **RELIABILITY OF FUTURE INCOME**
- **THE RISK ASSOCIATED WITH THE INVESTMENT**

Only current income is expressed in NOI. The Reliability of the income stream and the Risk are all associated with the Context in which we find this building.

Because the negative effects of the larger Context can completely eliminate your profit it is equally important to evaluate Context as it is to evaluate an individual building.

Let’s take each of the above components of Value one at a time and show why the current NOI simply cannot be the sole determinant of Value.

Current and Future Income:

Current income and expenses produce the seller’s NOI, however that is just a snapshot of the performance of the property. When you take over as the “Proud New Owner” the movie starts rolling again. Anything that affects your income or expense side of the ledger will change your NOI.

What if:
Your property is in Jacksonville, FL and a hurricane comes through
Your property is in NY and the state raises property taxes by 10%
Your property is in a smaller town and the major employer closes its doors
The new Toyota plant moves to town

Reliability of Future Income

Even if you can make a projection of future income, how reliable do you feel that projection is?

What if:
Your property is in a declining area with a long history of negative growth, such as Detroit… how reliable is your future income regardless of your current NOI?
Your property is located in a town whose employers are dominated by industries that are rapidly moving overseas because of lower costs?

The Risk Associated With the Investment

What are the risks of this particular property and the market in which it sits?
Is it an older building with foundation issues?
What is the neighborhood like? Is it declining?

As you can see, looking at the snapshot of current NOI, does not take into account all the CONTEXT factors that determine

- **Future Income**
- **Reliability of Income**
- **Risk**

You have to know the Market where the property is located to this level of detail to make an informed decision about the CONTEXT of an individual investment. A simple calculation of the current NOI is not enough.

One Last Thing….
Watch out for this common Investor Mistake.

Another type of Comp quoted by most Commercial Real Estate Brokers is based on Price Per Unit (Multifamily) or Price Per Square Foot in other Commercial Asset Types. This type of Comp is very close to the Comps you would use in Residential Property Investment.

Buyer Beware:
Brokers will try to sell you based on these Comps [price per unit (multifamily) or per square feet (other commercial)] which has NO BEARING on the property's NOI or on how it will perform as an investment.

These Comps can be a good comparison with other properties of similar quality and location. Use them ONLY to make sure you are not paying TOO MUCH for the property based on its Asset Class and quality

Here's how buying on Broker Comps can burn you…

A common investor mistake is buying a property at a "seemingly" good price for its Income, but paying too much for the quality of the buildings. If the property's income drops you will can end up owning a building that is now worth less than when you bought it.

Remember … income can fluctuate, but the physical asset itself will remain constant (unless you sink significant renovation dollars into it). A building built in 1970 will always be a building built in 1970.

When you buy you must simultaneously consider the Current Income, Future Income and its Reliability and Risk. Overpaying for an older property based on per unit or per square foot comps will dramatically increase your Risk over time.

If this all seems a little complicated … it is. Commercial Property Investment has a number of moving parts. Fortunately you don't have to be the one doing all the work here.

Commercial Real Estate is most definitely a Team Sport. You can't know everything about a particular market or property, BUT your Team of

- Real Estate Broker
- Property Manager
- Real Estate Lawyer
- Escrow/Title
- Commercial Mortgage Broker
- Field Partner

Sure can.

We are on your TEAM now too and we are here to help. We have found that picking the right Market is every bit as important as picking the right property AND when you buy the right property in the right market … watch out.

To help you pick the right markets and actually build a TEAM to invest … even if that means going out of state … we have created a detailed course on Market Cycles, local Market Research and building a quality Team to invest in the best markets nationwide.

It is actually 8 trainings in a single course we call the **"Investortours Commercial Quick Start System"**. This training is the answer to the question, "How Do I Get Started in Commercial Real Estate?"

You can learn much more here … www.investortours.com/crequickstart.php

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There you go for a start on the world of Commercial Property Valuation. Remember this is just an introduction to the topic and a basic understanding based on our experience of over $250,000,000 worth of Commercial Properties in 6 different states.

This is real world experience put into a format you can use right away.

And this is just the beginning

You can find much more information on Commercial Real Estate Acquisitions, Due Diligence, Property & Asset Management and Sales at our website www.investortours.com . Please visit often and don't forget to sign up for our ITU Newsletter and Commercial Power Hour Teleclasses.

To your investing success,

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