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Commercial real estate property comparables: The wise appraiser will compare apples to apples

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Commercial appraisers have to examine many types of market evidence in the course of investigating a particular market and property. Commercial appraisers observe and analyze sales and rentals, market trends, activity and non-activity, listings, offerings, and rumors, and, hints of rumors. Further, we have to worry about not only what has happened and try to understand it in the context of what we think is going on now and what may happen. Or what may not happen. This is true in active markets with a reasonable volume of transactions. It is also true for markets where there is less velocity.

For many property types, comparables not only give us that all important (perhaps too important) sales price per square foot. The sales price per square foot tells us many things about a property and that's why it is used so widely. Do we always understand, however, what the market is telling us?

In considering income property, its income producing characteristics are critical. The price per square foot is often an extremely telling indicator as to how a typical investor views the property's income producing characteristics. Appraisers typically make adjustments for things like location, condition, and size, for example, and consideration of these adjustments is perfectly reasonable. However, many times, the price paid reflects strongly the direction, duration, durability, and attractiveness of the income and the price per square foot functions as a proxy for otherwise undiscovered or undisclosed income. It seems many commercial appraisers don't entirely grasp that and treat some of these properties as if they were single family residences, and end up putting peaches and apples in the same bin.

Clearly, in owner markets, this kind of "amenity" approach to value is reasonable. It also pertains to certain specialty property types.

However, let's concentrate on investor property, those that typically transfer as "leased fee" interests. For these markets, income is king. The appropriate indicators might be the "cap rate" or it might be Net Operating Income (NOI) / unit, or some other income related unit of comparison.

That cap rate expresses any number of possible relationships between income and the price paid. Here are three examples.

If the income is stable and predictable, the cap rate will express the classic relationship of NOI to the sales price, i.e., $100,000 (NOI) / $1,000,000 (SP) = 10%, for a hypothetical Class B office in a modest location, which is financed conventionally. For a stable tenant and a long term lease, this is a very comforting relationship uncovered by the appraiser.

In another example, if a similar building with the same NOI sells for $1,200,000, a cap rate of 8.3% results. Financing is the same, but the tenants are superior and lease terms and rollovers are more favorable.

In a third example, an office property transfers for $2,000,000 at a 5% "cap" from which NOI of $100,000 can be calculated. This transaction was all cash, purchased by a long term investor, say, an REIT, for a building with national long term signings.

Why the differences? Some commercial appraisers might well grab the cap rate in C and apply it to B. Even with adjustment, there is some caution to be exercised. Example C is a cash buyer and that in itself distorts the rate since the rate does not take into account the effects of financing. Nor does it take into account risk. These all cash cap rates are typically expressed in surveys like the PWC/Korpacz Investor Survey and the survey results should be used with great caution when making comparisons with more ordinary, leveraged properties. Surveys, tables, and nicely packaged up statistical data is useful as a general guide but is often prone to misinterpretation and misapplications, so it should be handled carefully.

Risk premiums abound in today's market. The CRE market is not all blue skies and wispy white clouds. The wise appraiser will take care to make comparisons of apples to apples and peaches to peaches or at least make the appropriate adjustments when there is no alternatives to comparing apples and peaches! And there is a relationship between price per square foot and the "cap rate!" It's a matter of digging enough to find out what it is.

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