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The Commercial Classroom: Determining tomorrow's property value

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Determining what a property is worth is a major challenge today.

With investment property, historically the income approach is used. Basically the properties rental income, less the owners operating expenses provides the Net Operating Income (NOI). Dividing the NOI by the prevailing Capitalization Rate (CAP Rate) gives a market value.

Leases were written five years ago or longer (before the economic crash) at high rental rates. With these tenants still in the building the current year's finanutUT, going into the next two years some of these leases may expire.

In most areas of the Northeast rental values over the last five years have declined 25% to 30%. If the tenants renew the lease or new tenants replace them, today's rental rates are considerably lower.

If we project an income analysis for the next year or two, due to the anticipated lower rental income, the NOI is less; as would be the market value. Owners must understand a buyer will look at this before making an offer. We as, real estate professionals, need to do a five year projection (or longer), a spreadsheet of the properties future financial performance to show the real future value. We may see a projected reduction in value over the next two years, but then toward the end of the cycle we may be able to show a gain in value.

Another basis of comparison that is used today is comparing costs per square foot. Historically, this compares the subject property to the recent similar sales. But we literally had no sales in 2009 and 2010, as financing was not available. Since 2011 we have seen increasing (but slow) sales activity. Comparisons of sales are now looking at what is the competition on the market. To equalize different sizes of similar buildings the asking price is broken down to a cost per s/f. Trends become apparent, if there are three other office building for sale in the area averaging a cost of $100 per s/f, the probabilities of a buyer paying much more is slight.

With the cost of rental space being lower, the focus on rental value is now largely also based on the local competition. If the competitions property is averaging an asking price of $15 per s/f, it would be difficult to rent space for $25 per s/f.

Owners may not like the current value realities, but buyers and tenants will not pay more. In listing presentations it is essential to prove to the owners the current values. Go into the presentation armed with future value projections, know the competition and their asking cost per square foot or in the case of rentals what the competition is asking.

Edward Smith, Jr., is a NYS licensed real estate broker, specializing in commercial and investment real estate, with over 39 years of brokerage experience. He previously had his own brokerage firm and then served as a "consultant to the trade."

Smith has been writing and teaching commercial continuing education courses for over twelve years. He has authored seven commercial continuing education courses. He has written three textbooks on commercial and investment real estate with instructor training materials used to teach commercial courses throughout the United States. He has also written "The Commercial Classroom: Lessons in Commercial and Investment Brokerage," and most recently, "Buy the Numbers: Investing in Real Estate."

He is a director and past president of the New York State Commercial Association of Realtors, the Metro-Long Island Chapter of NYSCAR, and the Long Island Commercial Network (LICN). He has previously served as a Director of the Long Island Board of Realtors, a director of the Commercial Industrial Brokers Society (CIBS) and as a director of the Real Estate Practitioners Institute at Long Island University.

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