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The commercial classroom: Pricing for sale challenges

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This column is offered to help educate agents new to commercial and investment brokerage and serve as a review of basics for existing practitioners.

What is the correct price of a building or space? The academic answer is whatever the buyer (tenant) is willing to pay; whatever the market will bear. But, as real estate agents we are looked upon to guide our clients to a realistic price. Sale pricing is determined by several methods, the income approach, gross rent multiplier, comparable method, and the cost approach. Historically, the income approach has been predominately used, but today all methods will be considered in determining sale value. Comparing values for leasing space is less defined and more difficult.

The income approach to valuation considers the building potential income, calculated with an adjustment for possible vacancy. The owners operating expenses are then subtracted, including a contingent fund for possible unexpected repairs and maintenance. Expenses do not include debt service - the buyer could pay all cash. What remains is the net operating income. Based on a local capitalization rate, which can be thought of as a desired profit percentage of local investors at this time, a value can be determined.

__NOI__

Cap-rate = Market Value

An issue with this method today is the fact that the rental income may have declined. Tenants are now paying rents based on leases created 5-10 years ago; but when vacated the landlord may have to rent for lower rates. To adjust for this, projections have to be made on expected lower future NOI, which reduces current value.

The gross rent multiplier compares the gross rent buildings produce to the sale prices of those buildings. A building with a price of $1 million with a gross rent of $100,000 would be selling for 10 times the rent roll. If we then have a similar building with a gross rent roll of $80,000, by multiplying that by the GRM 10 X; the value would be estimated at $800,000. The danger in using the gross rent multiplier is that the condition, expenses and vacancies of the buildings are not considered.

Buyers who wish to occupy a building for their own business are more likely to be focused on what other similar buildings recently sold for, known as the comparable method of valuation. But all buildings are not always the "same," and adjustments to compare them may be required. Regarding size alone, the buyer may want an office building and recent sales are of different size buildings. To compare, values must be calculated to a cost per s/f. (Price divided by the size of the building.) The average cost per s/f value can then be multiplied by the size of the subject property to determine market value.

Recent Sales

$1 million ÷ 7,800 s/f = $128 per s/f;

$785,999 ÷ 6,390 s/f = $123 per s/f;

$625,000 ÷ 5,000 s/f = $125 per s/f.

Subject Property: Comparable Average per s/f $125

Market value: 7,000 s/f building 7,000 x $125 = $875,000

With a lack of commercial sales over recent years, comparisons are also made based upon the competition currently on the market, also using the cost per ft.

For certain properties a buyer will compare the cost of buying land and constructing a new building to the cost of buying an existing building.

Agents today must be familiar with financial analysis and the inventory (sold and available) in their market area to advise and guide their clients in proper pricing of their buildings.

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