Commercial Review

In the Field...

Using Your Knowledge

Definitions for Commercial Review Scenario

Livable Community

The definition of ***Livable Communities*** is an evolving one as communities strive to address transportation problems, conserve natural resources and provide for an aging population. Ideally neighborhoods should be designed for people of all ages to live there. Various elements are essential to these communities such as:

- Higher Density land usage
- Mixed-used Developments as opposed to separate developments for each use (instead of retail centers, subdivisions and office parks)
- Public transportation and Pedestrian-friendly streets
- Accessible and varied shopping
- Nearby Medical Services
- Job Opportunities for a variety of skill sets
- Various forms of Recreation to meet a wide range of activity levels

Livable communities provide an alternative to suburban commuters as well as an easier, more efficient lifestyle than traditional housing for seniors. No doubt the design of such centers will become more efficient and creative as more of the population ages and returns to urban areas. (Consider the information regarding the Aging Population on the following page.)

HABU

HABU is an acronym for "Highest and Best Use". Although this term is used as a critical concept in appraisal analysis, it is also used as a layman's term in the real estate brokerage industry. At the time the evaluation is done, HABU is the reasonable use of the property that will most likely bring the highest market value, whether it is vacant or improved. Market value is the most likely price a property should bring in a competitive and fair market. When marketing a listing, first determine its HABU!

Net

Lease rates and structures vary by property, usage, and negotiation. When a Net Lease is quoted the Tenant is expected to pay those expenses generally associated with ownership of the property:

(1) Taxes
(2) Insurance
(3) Maintenance (including repairs, utilities, etc.)

The lease may be referred to as **Triple Net** or **Net, Net, Net,** The rental the Landlord receives is net of those expenses. There may be variations on the items included so it is important to clarify what expenses the Tenant is responsible for paying in any lease.

Cap Rate

The ***Cap Rate*** or ***Capitalization Rate*** is used as a very basic measure of performance to quickly evaluate income properties. The Basic Cap Rate Formula gives an estimate of return:

$$\textbf{Cap Rate} = \frac{\textbf{Net Operating Income}}{\textbf{Value}}$$

1. If an investor requires a certain minimum Cap Rate, the licensee can quickly determine if a potential income property is in the client's acceptable range to merit his/her interest. Usually owners of income properties will provide basic Net Operating Income (NOI) numbers to assist in the marketing of the property. NOI is the income generated after expenses are covered. The seller of the property may require a confidentiality agreement be signed before detailed information is released. The Value should be comparable to other similar properties recently sold.
2. Knowing the required cap rate or the cap rates of similar properties can provide a quick estimate of value. $\textbf{Value} = \frac{\textbf{Net Operating Income}}{\textbf{Cap Rate}}$
3. The cap rate theory can also be used to estimate the Net Operating Income a property should generate based upon a certain cap rate and properties of comparable value and type. **Net Operating Income = Cap Rate X Value**

Remember that the cap rate is merely a snapshot in time and only reflects the value based upon the numbers provided for one period of time. Investors often perform more detailed performance analysis to determine if they are interested in purchasing a certain income property.

Acreage

An Acre is an Acre is an Acre. In the United States, the Acre is the measurement used for describing land. An acre is 43,560 square feet. In commercial real estate every square foot counts in the price paid for the land and it is often a price per square foot. A retail parcel priced at $20 per square foot equates to a price of $871,200 per acre. An acre is a tract of land which is 208.71 feet by 208.71 feet or 4,840 square yards. Whenever estimating land sizes, it is important for a licensee to acknowledge that any number he/she determines is an estimate only and is not to be used as a legal measurement, unless it has been quoted from a certified survey or recorded plat.

Explanations for Commercial Review Scenario

Consider the following scenario to refresh your basic analysis tools. Specific details have been minimized to simplify your review.

A seller-client asked a real estate licensee for an opinion as to the best method to maximize the value of the seller's property. The seller was considering leasing out the property or selling it.

The seller's property is already developed with a 4,800 square foot, 2-story building (currently vacant) with sewer, good road access, and extra land. (See drawing on page 2.)

In the initial discussion, the licensee must explain to the seller that he is not an appraiser or a builder, and his ideas represent the licensee's professional opinion and recommendations. The first thing the licensee needs to do is visit the property, and in doing so he collects the following additional information.

- It is located in a good area transitioning from single-family residential to mixed use, and becoming a **livable community**. The design of the existing building is well suited for a retail shop below, while maintaining the residential unit upstairs.
- Research shows that several building permits have been issued in the immediate area for both new and remodeled retail and office uses, including 2 story lofts.

- The building on the property is in good condition and could be used as residential or even retail. There appears to be extra land for parking. Noting comparable properties and research of the zoning codes, the licensee believes the property is compatible for street-level retail or office and residential on a second level.

The licensee presents 2 options to the seller regarding the marketing of the property for its **HABU.**

1. Market the property for its value if sold as land for redevelopment.
2. Market the building for lease as street-level retail and residential on the second floor. (The licensee will include a discussion of the pros and cons of being a landlord).

The licensee's research of rental rates indicates the following:

- Rental rates for Retail space are running a bit low at $11 per square foot **Net**.
- Rental for residential properties of comparable size and features runs $1,200 per month.

Using only the data provided, complete the missing information for his analysis.

1. What would be the monthly rental for the retail portion of the subject property? Check all the answers that apply:

- o $26,400
- o $2,200
- o (2,400 x $11)/12

Answer: The Question asks for Monthly Rental so the answer is $2,200 which is (2,400 x $11)/12 the rate is quoted as Net, which generally means that the landlord will not be responsible for the maintenance (utilities, etc.) taxes, and insurance. Those expenses will be paid by the tenant.

2. Based on an overall Cap rate of 6.5% what is the indicated value of the rental property?

Answer: Cap Rate refers to the Capitalization Rate calculated by the Annual Net Operating Income/ Value. In this case, the seller's desired Cap rate is 6.5% and we know the net rental amount. Based on these assumptions, a value can be determined. However, we must total all rentals to obtain the "Overall rate"

($26,400 + 14,400) /.065 = $40,800/.065 = $627,692 Indicated Value

3. If the licensee is to be paid a commission for negotiating the leases on the transaction, how could his/her commission is paid? Check all the answers that apply:

- o As a flat fee
- o A percentage of the monthly or total rental
- o A percentage of the total rental for the lease term and/or a flat fee
- o The first month's rental amount
- o Any clearly defined method that is agreeable between the parties and that can be calculated to a definite amount

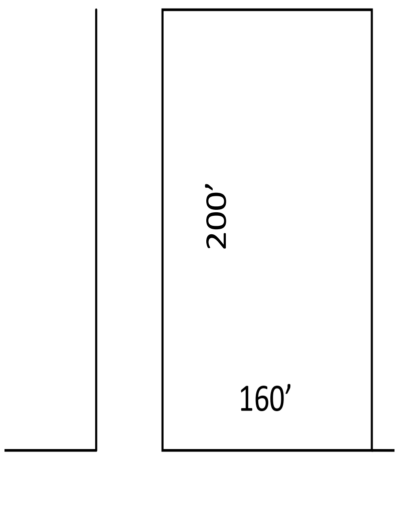
Answer: All of the listed methods are acceptable. All commissions are negotiable.

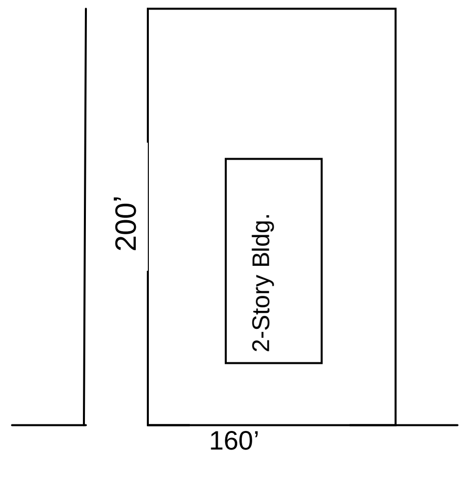
4. What is the acreage of the property?
- o (160 x 200)/44,000
- o .74 acre
- o (160 x 200)/43,560

Answer: There are 43,560 square feet in an acre. (160 x 200) /43,560 = .74 acre.

5. If recent sales indicate land values of $25 per square foot, what is a reasonable listing price for the property?
- o 32,000 x $25
- o $800,000
- o $1,000,000

Answer: 32,000 x $25 =$800,000 price. It is not appropriate to round the 43,560 acreage especially if property is selling by the square foot.





6. Based on the values of the above analysis, what use or disposition would the licensee likely recommend for marketing the subject property to obtain the highest value?

Any analysis must consider the investment objectives and personal goals of the seller. The entire analysis should be reviewed with the seller. However, based on the research and information given, analysis of the current market indicates that sale for redevelopment of the land should bring the highest value of $800,000. The cap rate valuation indicates a value of about $628,000. If the Seller were to sell the property and reinvest the proceeds of the sale, he could continue to earn income. But if he is amenable to the responsibilities of being a landlord, the annual stream of rental income ($26,400) could be realized, and he could later sell the property for its residual value. Although not considered in this scenario, there could also be expenses of preparing the property for rental. The seller’s decision will depend on the current market and his expectations of the future market. The licensee should also reiterate that he is not an appraiser or a builder, and his ideas represent the licensee’s professional opinion and recommendations.