How to determine THE VALUE of your investment property

Do you leave the valuation of your investment property to the professionals? *Christopher Seepe* shows how investors can do the calculations

Determining the value of an investment property is likely the first thing you want to know, whether buying or selling. An income-generating property's value is driven primarily, but not exclusively, by the amount of net operating income or NOI (income after expenses and before financing) it generates.

METHODOLOGY

1 Determine the property's potential gross income. This is all the income you expect if you have no vacancy or bad debt, including unit rents, parking, laundry, storage etc.

2 You'll inevitably have vacancies and bad debts (non-payment of rent) from time-to-time. Deduct this amount from your projected income. Even if the existing owner says turnover is once every five years, Canada Housing and Mortgage Corporation (CMHC) and all financial institutions will include a vacancy rate in their assessment of

what they will lend. This is usually 2 to 4 per cent of income. You also want to be realistic and conservative in your projections.

3 Determine all your operational expenses. Many Realtors and owners do not include certain costs in calculating NOI because they don't know the proper application of the income approach or they want the NOI to look better than it is. Leaving out certain costs can have a dramatic impact on property value. A $1,000 addition to the NOI can reduce property value by $16,000 or more.

OPERATIONAL COSTS

Many investors exclude operational costs as property management and maintenance costs. The owner or realtor may say that the owner did all the work, but this is irrelevant to CMHC and financial institutions. They will factor in these costs when determining how much they will lend you.

These cost values differ per geographical region and estimates differ between lenders, but use 5 per cent for property management fees and $750 per unit for annual maintenance.

Other costs include realty taxes, insurance, utilities you pay for (common area electricity, etc.), rental fees (eg. hot water tanks), garbage pickup, janitorial, security, website, advertising, inspection and association fees, cleaning supplies, legal, accounting, commissions (for finding new tenants), landscaping or snow removal and pest control. You may also want to factor in a reserve for major repairs.

Don't include one-time major costs such as replacing a roof, painting the building, re-paving the parking lot etc. These one-time "capital" costs are depreciated over time and are handled as a different line item in your financial statements.

Other types of investment properties, like retail plazas, usually pass on most of its operational costs to its tenants through CAM (Common Area Maintenance) or

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TMI (Taxes-Maintenance-Insurance)—also called Additional Rent—so NOI calculations are generally simpler.

4 Deduct the operational costs above from your expected income to calculate your 'true' NOI. For example, an apartment building with $110,000 in gross income and expenses of $48,000 has a NOI of $62,000. Don't be surprised when the buyer's NOI numbers invariably come out to be less than the seller's. This is often a fundamental part of the negotiation process.

5 The key point about the income approach is that an investment property should be primarily priced according to how much profit it generates for the owner. That's a major reason why a well-run, 10-plex with all tenants at market rates could fetch more than a poorly-managed 20-plex.

6 Now, the key calculation: divide the NOI amount by the 'cap rate' you want to determine the approximate value of the property.

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KNOW THE CAP RATE

Capitalization rate is a ratio that expresses the relationship between a property's current year's net income and the value of the property. It is particularly useful in financially comparing two widely differing properties. However, it doesn't factor in the state of repair of a property, its appreciation potential, location, geographic area growth potential, local area crime, tenant demographics and other value-impacting considerations.

How do you decide what the cap rate should be? Two common ways (or sometimes both) that cap rates may be established by a buyer or seller is:

- Compare cap rates of comparable types of properties that have recently sold in the area
- What kind of return could you expect to get if you purchased some other type of investment, say stocks, bonds or term deposits?

A buyer will always look for the highest cap rate possible while a seller is looking for the lowest cap rate.

AVERAGE RATES

Arguably, cap rates for investment properties range from 6 to 9 per cent. In the last couple of years, however, I've seen some go for less than 4 per cent, with the average being around 4.5 to 5 per cent. In today's market, 8 per cent is exceptional with the major caveat that the property may have significant issues that must be factored into the cost.

Using the earlier example, divide $62,000 by the cap rate you are looking to achieve, say 6 per cent. This example property has an estimated value of $1.04 million. If the buyer was demanding a price of $1.2 million (with a $62,000 NOI), then the cap rate would be 5.2 per cent ($62,000 divided by $1.2 million).

Some investors will look at other types of investments they could put their money into and simply state that they want an "Eight Cap" before they will look at a property. This effectively means they want a property with a high NOI at a deeply discounted price (don't we all?). Pragmatically, this criterion could be achieved if the investor was willing to buy a distressed property that required further cash infusion to extract the potential upside.

Let's say this costs the investor $40,000. Using a 'Six Cap,' if you could reduce your electricity bill, for example, by $10,000 per year (which goes straight to your NOI bottom line), then you are effectively increasing the value of the property by $167,000 ($10,000 ÷ 6 per cent). If you were also able to raise the rents by a total NOI of $8,000, then you add a further $134,000. With the right investment property, repairs and upgrades that reduce costs and/or lead to increasing rents can quickly get you back your investment, and rapidly build new value. ■