



## Valuing properties in today's challenging economy

By STACEY HANSEN

Essex Realty Management Inc.

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Given higher vacancies and lower rents needed to keep existing tenants at many commercial properties, how does one determine the market value of that property today? Valuing commercial real estate in typical economic times is usually rather straightforward, in that ample information and comparable sales of like-kind properties are usually available. We are obviously not in a typical economy right now. Appraisers are facing the challenges of finding comparable sales and then being able to determine any underlying conditions of the sales that affected the sale price in order to establish a properties' value.

### Three methods of valuation

Of the three methods of valuation (sales comparison, income capitalization and cost approach), most income producing properties bear a heavier weight toward the income capitalization and the sales comparison approach. The income capitalization approach utilizes the net operating income divided by a capitalization rate. With high vacancies and lower rents, the net operating income of a property could potentially be less than when the property was purchased, resulting in a lower property value than when it was purchased.



Stacey Hansen

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Even small rent decreases given to assist tenants during these tough times can result in lower property values, as the operating expenses will remain approximately the same regardless of tenant rents. In addition, cap rates on the few transactions that have closed recently have increased, which also reduces the property values. According to

Moody's/REAL Commercial Property Price Index, asset values have dropped 29.5 percent year to date through April 2009 since cresting in October 2007.

### **Obtaining sales comps in today's market**

With few recent property sales, obtaining sales comps can be difficult to locate. Sales transactions have decreased nationwide for all property types for the fiscal year ending September 2009, by \$775.6 million, a decrease of 32.3 percent from 2008 and only 7 percent of the volume recorded in 2007, according to data from **Real Capital Analytics**. The good news is that sales activity in San Diego for 2010 is expected to increase over 2009, especially in the second half of the year, as stated in the Grubb & Ellis 2010 Forecast Report. Hopes are the dollar volume of investment transactions will increase 20 percent to 30 percent over the 2009 levels.

### **The valuation process**

Real estate appraisers evaluate the sales comps they can find and then determine the conditions of the sale. Sale prices do not always represent the property's market value. Sales of bank-owned properties, bankruptcy sales, portfolio packages and other sales need to be adjusted to bring the sale value back to an "arms length" transaction, otherwise it is not a useful comparable of the property's market value. For example, a sale could be a part of a larger portfolio purchase, so the sale price might be lower than if the property was sold to an owner-user. The property financials are reviewed for vacancies, rent concessions and other factors that can affect the net operating income. One method of utilizing the sales comparison approach is to use the net operating income of each comparable sale and dividing that by the property square footage to arrive at a net value per square foot. Once this calculation has been made for all the comps, the sales price per square foot most similar to the property being valued can be used in the valuation process. Since many factors are taken into account by the appraiser, the end market value of a property is still subjective.

### **What lies ahead**

It is not anticipated that occupancy and rental rates will be improving in the near future. Therefore, until the economy stabilizes, valuing commercial real estate will continue to be an interesting challenge.

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*Hansen is senior property manager based in the San Diego office of Essex Realty Management Inc. With more than 20 years of commercial real estate experience, she handles lease renewal negotiations, tenant retention programs, vendor and construction contract evaluations and lease administration*