

Working With the Income Approach

SAMA Annual Meeting
April 21, 2010

2010 SAMA Annual Meeting

- ➔ Overview of SAMA Vision for the 2009 Revaluation.
- ➔ Assessment Fundamentals
- ➔ Overview of the Property Income (Rental) Approach
- ➔ SAMA's Property Income Approach Application and Appeal Results
- ➔ Q&A Session

Vision for the 2009 Revaluation

“To build public trust by providing fair, transparent, understandable and defensible property valuations in a results based, mass appraisal, market value assessment system, used for the distribution of taxation.

The principles for the 2009 revaluation are to implement a market value system that:

1. Permits the use of the cost, sales comparison, and income approach where appropriate in all jurisdictions
2. Uses regulation for properties such as agricultural land, oil and gas well production equipment, linear property and heavy industrial property and
3. Sets the stage for a shorter revaluation cycle.

Assessment Fundamentals

- ⇒ Ad valorem (according to value) system.
- ⇒ Mass appraisal
- ⇒ Base date (June 30, 2006).
- ⇒ Previous system – highly regulated and procedure focused.
- ⇒ 2009 System – more flexible and results oriented.
- ⇒ Three Accepted Approaches to Value
 - Cost Approach
 - Sales Comparison Approach
 - Property Income (Rental) Approach

Overview of the Property Income (Rental) Approach

Property Income (Rental) Approach Overview

- ➔ One of three internationally accepted methods of valuing property;
- ➔ Primary valuation approach for (rental) income producing properties;
- ➔ It is the most accurate reflection of the market activities of buyers and sellers of properties producing rental income;
- ➔ Income Approach is used for mass appraisal in other jurisdictions;
- ➔ Only considers property or rental income. Does not consider owner's personal income.

Reasons for Using Income Approach

- ⇒ Based on the Principle of Anticipation.
- ⇒ Purchasers of an income property pay a sale price now, to receive future benefits (rental income stream)
- ⇒ Accounts for the return on investment expected by typical purchasers of income producing properties.
- ⇒ Primary approach used by industry as the valuator undertakes the same analysis as buyers and sellers of income producing properties.

Income Approach Theory

The market value of a rental property can be estimated as the present worth of the future benefits that will accrue to the owner of a rental property over its economic lifetime.

Income Approach Application

- ⇒ Multi-Residential (Apartments)
 - Income derived from typical apartment rental and other sources (parking, laundry, etc.)
- ⇒ General Commercial
 - Income derived from rental space
 - Rental rates based on typical rent per square foot
- ⇒ Accommodation (Hotels/Motels)
 - Rushmore Approach (industry recognized)
 - Income derived from guest rooms and other revenue sources
 - Accommodation properties as a whole (i.e., buildings) do not rent

Income Approach Application

- ⇒ General Commercial Income
 - Building – rent per square foot

- ⇒ Accommodation (Hotel/Motel) Income
 - includes but is not limited to:
 - Guest rooms
 - Telephone
 - Restaurant
 - Beverage Room
 - VLT's
 - Parking, etc.

Steps Required

- ➔ Identify property types typically purchased for a rental investment
- ➔ Identify all types of income and expenses
- ➔ Establish common units of comparison for analysis and application
- ➔ Develop valuation models
- ➔ Apply models and test

Property Income and Expense Statements

- ⇒ Information maintained in confidence for assessment purposes only;
- ⇒ Only require property, business, or rental Income and Expense (I/E) information, not owner's personal income;
- ⇒ SAMA requested three years of I/E information for analysis (2004-2006);
- ⇒ SAMA entered I/E information to computer database to analyze market rents and typical expenses.

Potential Gross Income (PGI)

- ⇒ Annual economic (market) rent for property at 100% occupancy.
- ⇒ Determine market rents through rental or lease analysis of comparable property.
- ⇒ Appraisers consider market rent versus contract rent:
 - Market Rent = Rent prevailing in the market for property comparable to the subject property.
 - Contract Rent = Actual rent received or specified in a lease. May be above or below market rent.

Vacancy, Collection Loss & Expense Ratios

- ⇒ Vacancy- Adjustment for typical vacancy that is expected to occur. Analyze vacancy rates for comparable properties.
- ⇒ Collection Loss- Loss resulting from failure of tenants to pay rent. Analyze these bad debt amounts to determine typical adjustments for comparable properties.
- ⇒ Expense Ratios- Determine typical expenses or expense ratios through analysis of property income and expense statements

Analyzing Property Expenses

PROPER EXPENSES

- ⇒ Management
- ⇒ Salaries
- ⇒ Utilities
- ⇒ Supplies and Materials
- ⇒ Repairs and Maintenance
- ⇒ Property Taxes*
- ⇒ Insurance
- ⇒ Miscellaneous
- ⇒ Reserves for Replacement*

IMPROPER EXPENSES

- ⇒ Depreciation
- ⇒ Debt Service (Mortgage Payment)
- ⇒ Income Taxes
- ⇒ Capital Improvements
- ⇒ Owner's Business Expenses

Calculating Net Operating Income

- 1) Gross Potential Income (PGI),
[100% Occupancy / Market Rent]
- 2) - Vacancy and Collection Loss
- 3) = Effective Gross Income
- 4) - Expenses
- 5) = Net Operating Income

Calculating Net Operating Income

Gross Potential Income (PGI)	50000
@ 100% Occupancy & Market Rent	
- Vacancy and Collection Loss (6%)	3000
= Effective Gross Income	47000
- Expenses	10000
= Net Operating Income (NOI)	37000

Capitalization

- ➔ “Capitalization” is the process of converting the future anticipated benefits of ownership (rental income stream) of a property into an estimate of present worth or value.
- ➔ “Capitalization Rate” (often referred to as “Cap Rate”) expresses the relationship between the net income stream of a property and its sale price.
- ➔ “Income Multiplier” expresses the relationship between a property’s income (before expenses) and its sale price.

Development of Capitalization Rate from Sales

$$\text{Capitalization Rate (R)} = \text{Net Operating Income (NOI) / Sale Price}$$

Example:

$$\begin{aligned} &\$37,000 \text{ (NOI)} / \$370,000 \text{ (Sale Price)} \\ &= 10\% \text{ Capitalization Rate} \end{aligned}$$

Development of Effective Gross Income Multiplier from Sales

Effective Gross Income Multiplier (M) =
Sale Price / Effective Gross Income (I)

Example:

\$370,000 (Sale Price) / \$47,000 (I)
= 7.87 Effective Gross Income Multiplier (M)

Income Approach Valuation

- ➔ Determine appropriate capitalization rate (or effective gross income multiplier) to value subject property through analysis of rates for comparable properties that sold.
- ➔ Capitalization rates and effective gross income multipliers determined by location, property type, property age, income quality.

Application of Capitalization Rates

Property Value (V) =
Net Operating Income (NOI) /
Capitalization Rate (R)

$$(V = I / R)$$

$$V = \$35,000 / 10\% \\ = \$350,000$$

Application of Income Multipliers

Property Value (V) =
Effective Gross Income (I) x
Effective Gross Income Multiplier (M)

$$(V = I \times M)$$
$$V = \$40,000 \times 7.87$$
$$= \$314,800$$

SAMA's Property Income Approach Application for 2009

1) Multi-Residential

- (Majority of apartments province-wide)

2) Accommodation

- (Hotels and Motels province-wide)

3) Shopping Malls

- (Regional and Community Enclosed Malls province-wide)

4) General Commercial

- (Retail, Office, Warehouse, etc - Moose Jaw, Yorkton, Estevan)

SAMA's Property Income Approach Application for 2009

- ➔ A total of 2347 properties were valued using the Income Approach
 - 1086 General Commercial
 - 747 Apartments
 - 501 Hotels/Motels
 - 13 Malls

2009 Property Income Approach Appeal Results - SAMA

- ➔ General Commercial – 1086 properties
 - Appeal Counts
 - 117 Appeals filed
 - 100 Withdrawn
 - 11 Dismissed
 - 6 Allowed

2009 Property Income Approach Appeal Results - SAMA

➔ Apartments – 747 properties

- Appeal Counts
 - 17 Appeals filed
 - 14 Withdrawn
 - 2 Dismissed
 - 1 Allowed

2009 Property Income Approach Appeal Results - SAMA

➔ Hotels/Motels – 501 properties

- Appeal Counts
 - 67 Appeals filed
 - 38 Withdrawn
 - 19 Dismissed
 - 10 Allowed

2009 Property Income Approach Appeal Results - SAMA

⇒ Malls – 13 properties

- Appeal Counts
 - 3 Appeals filed
 - 1 Withdrawn
 - 1 Dismissed
 - 1 Allowed

2009 Property Income Approach Appeal Results Summary - SAMA

- ➔ Total Income Approach Appeals
 - 204 properties out of 2347
- Less than 10% of properties appealed
- Overall taxable assessment change for the 204 properties was approximately a 6.5% reduction

Questions?

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