ValuationNEWS
from G.A. Farrell & Associates Ltd.

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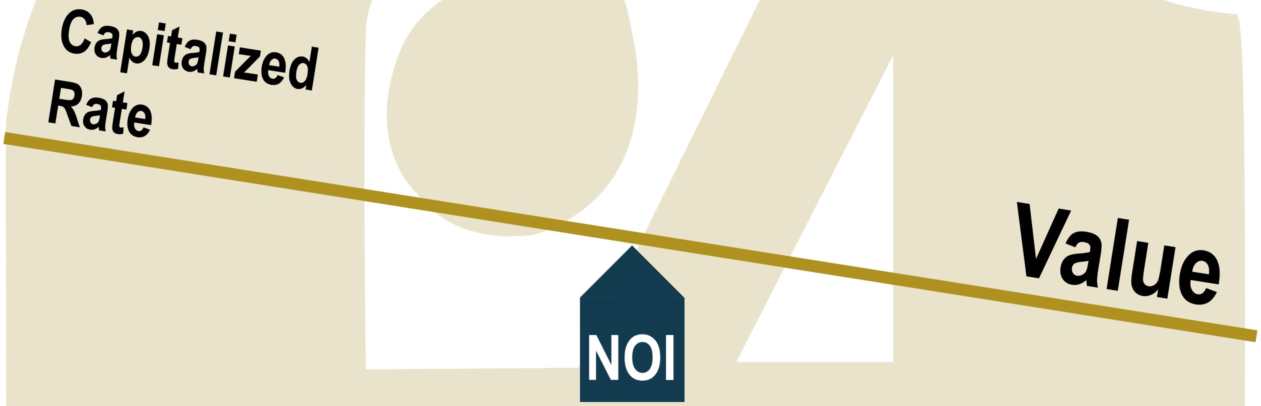
An Examination of the Relationship Between Capitalization Rates, Net Operating Income & Outgoings



When valuing large commercial properties, a common methodology is to calculate the annual Net Operating Income (NOI) of the property and then convert the derived income stream to a capital value (aka capitalization). In order to derive the NOI, it is necessary to estimate the annual potential gross rental income of the property and then subtract a provision for voids (periods when the building might be vacant) and outgoings (expenses such as rates, property tax, insurance, repairs, management).

Previously, it was common practice to utilize a provision for voids and outgoings as a single figure, the most common of which was 25% of the property's annual potential gross income (PGI). Support for this figure was obtained when actual figures for the last 3 years obtained from the owner of the property were analysed.

Recent developments however have necessitated a change in this practice. These developments include falling commercial rents, large office buildings constructed outside of the capital city and the practice of common-area maintenance charges (CAM).

Over the last few years, the local economy has experienced recessionary conditions as energy prices declined and commercial rental rates followed. This meant that with the PGI of a property declining, the provision for voids and outgoings would also drop if the 25% figure was continued. However, in actual fact, the voids and outgoings were actually increasing if anything. The problem then becomes arriving at a consistent figure in the current market which is changing rapidly.

In addition, there has been a growth of large commercial properties outside of Port of Spain. The rental rates for these properties were lower than those obtained for similar ones in Port of Spain as can be expected. This therefore meant that the 25% benchmark would show a lower dollar provision for voids and outgoings than for a similar sized building in the capital which, in actual practice, does not necessarily follow.

Finally, it has now become common practice for large, multi-tenanted, commercial buildings to have a CAM charge in addition to the rent paid. This CAM charge is meant to remove the liability of all maintenance charges from the owner of the property and place it on the tenants. The result of this is that the owner has little or no administration expenses for the property and simplifies the calculation of NOI which would now be calculated by subtracting from the property's PGI, a provision for voids and any personal

We Value

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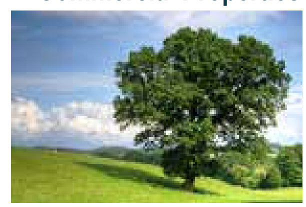
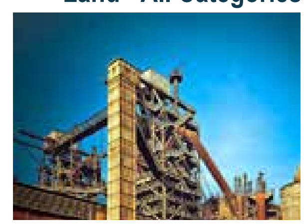
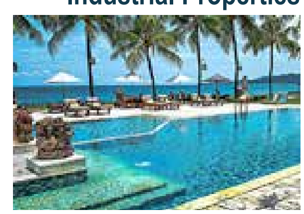
Commercial Properties



Land - All Categories



Industrial Properties



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administrative expenses the owner may have. It should be mentioned that while CAM charges at one time approximated anywhere between 15-25% of rental rates for commercial properties, they are now a significantly larger percentage.

Bearing all of the above in mind, it has now become essential to re-examine the provision for voids and maintenance when calculating NOI especially where there is no CAM charge. In the case of voids, it is necessary to examine the current market by talking to owners, investors, real estate agents and property managers to ascertain the percentage of voids in similar buildings. As for outgoings, while the practice of asking for details of the last 3 years is still important, the information derived therefrom has to be compared on a per square foot basis to CAM charges applied to similar nearby buildings. In cases where the CAM charges are significantly different from the average of the subject, further analysis would be required to determine the reason for the difference.

It should be pointed out that where the capitalization rate of a commercial sale was derived using the 25% methodology for deriving NOI, a re-calculation of the derived rate based on nearby CAM charges would reveal a much lower rate. For illustration purposes we have shown below the case of an office building (with 12,300 ft^2 external area and 10,000 ft2 lettable-area) rented at $12.50 per ft^2 that sold for $15,000,000. Using the 25% figure (10% + 15% for voids and outgoings respectively), an NOI of $1,125,000 is derived which, based on a selling price of $15M, reflects a capitalization rate of 7.5%.

Potential Gross Annual Income	10,000 x 12.50 x 12	$1,500,000
Less Provision for Voids & Outgoings	25%	($375,000)
Net Operating Income		$1,125,000
Capitalized at	7.5%	$15,000,000

However, when recalculated using a monthly figure for outgoings of $2.50 per ft^2, the NOI derived is now $981,000 and based on the selling price of $15M, reflects a capitalization rate of 6.5% (rounded).

Potential Gross Annual Income	10,000 x 12.50 x 12	$1,500,000
Less Provision for Voids	10%	($150,000)
Effective Annual Gross Income		$1,350,000
Less Provision for Outgoings	2.50 x 12,300 x 12	($369,000)
Net Operating Income		($981,000)
Capitalized at	6.5%	$15,000,000

The actual rate per ft^2 to be used would vary depending on the property's historic outgoings as well as the rate for other similar properties. The latter could be obtained either from the owners/agents of these properties and/or by the CAM rate advertised.

Taking all of the above into consideration, there is no doubt that using a rate per ft^2 is a superior methodology for calculating the NOI of a property. Consequently, our company will be adopting this methodology going forward. We welcome all comments and suggestions from you, our stakeholders.

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