BOXWOOD MEANS
Know the value of Main Street®

DIRECT CAPITALIZATION

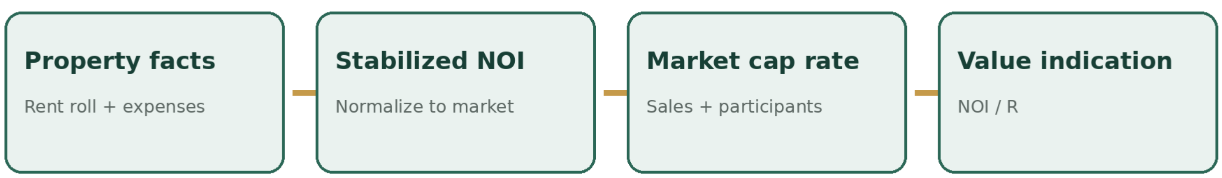
A credible income approach for stabilized and non-complex small-cap CRE properties

Why direct capitalization may be the more appropriate – and sometimes more credible – method when timing differences are not material, and the scope allows for a commercial evaluation.

BOTTOM LINE Direct capitalization is not a lesser solution than DCF analysis. For a stabilized small-cap CRE asset without material time-sensitive cash-flow events, it may be the more appropriate and transparent expression of market value.

The method fits the assignment when the cash flow is in equilibrium

A DCF explicitly models each future period. Direct capitalization captures investor expectations – income growth, risk, required return, and eventual resale – in a single rate derived from transactions and other market information. When operations are stabilized and no material time-sensitive cash-flow events are present, direct capitalization may be more appropriate and transparent because it relies on fewer speculative inputs. In that scenario, additional DCF forecast periods may create an appearance of precision without producing a meaningfully different or better-supported value conclusion.



Direct capitalization makes the value logic visible: stabilize the income, support the rate, and conclude the value.

Why lenders can rely on it

- **It is anchored to how comparable assets trade.** A market-based cap rate applied to a relatively stable NOI reflects solid pricing confirmation – in contrast with a concluded value based on a modeled discount rate and terminal value.
- **It concentrates review on the assumptions that matter most.** Loan officers and underwriters can challenge rent, vacancy, expenses, reserves, and the selected cap rate directly, with less model opacity and fewer speculative inputs.
- **It is proportionate to collateral complexity.** Federal interagency guidance emphasizes credible results, sufficient support, and a valuation scope appropriate to the risk and complexity of the transaction. Such guidance is especially relevant when considering the use of commercial evaluations to value small-cap CRE assets.
- **It has strong institutional precedent.** Freddie Mac's current multifamily guide, e.g., says DCF is typically redundant for small, stabilized properties and calls for direct-cap rate support from comparable sales, local market data, and published sources.

THE CREDIT QUESTION IS NOT "DIRECT CAP OR DCF?"

Use the simplest method that fully captures the property's material cash-flow risks

DIRECT CAP IS WELL-SUITED WHEN

- Occupancy and operations are stabilized
- Contract rents are generally at or near market
- Lease expirations and rent steps do not create a material timing effect
- No major renovation, lease-up, repositioning, or unusual capital program is underway
- A representative stabilized NOI can be developed from property and market evidence
- Comparable sales and other market data support an overall cap rate

USE A DCF WHEN

- Material near-term rollover, downtime, tenant improvements, or leasing commissions are expected
- Below-/above-market leases or contractual rent steps materially affect value
- The property is in lease-up, renovation, conversion, or stabilization
- A major tenant concentration or known vacancy creates lumpy cash flow
- Large capital expenditures or nonrecurring income/expense changes are time-sensitive
- Market participants price the property primarily through multi-period cash-flow analysis

A practical acceptance standard for Boxwood commercial evaluations

Lending and credit teams should be able to answer "yes" to three questions: (1) Is stabilized NOI supported by the rent roll, operating history, and market evidence? (2) Are nonrecurring items and reserves handled consistently? (3) Is the cap rate supported by comparable transactions and market data?

Recommended credit-file language: Direct capitalization is considered appropriate because the property is operating at stabilized occupancy, the subject's near-term lease events are not expected to create a material timing effect, and both stabilized NOI and the overall capitalization rate are supported by property-specific and market evidence. A DCF would be expected if those conditions were not met.

The right conclusion

The chosen method should be judged by fit, evidence, and transparency – not by the number of forecast periods. For stabilized and non-complex small-cap CRE income properties, a well-supported direct capitalization analysis contained within a commercial evaluation can be both reliable and more readily reviewable. DCF, typically incorporated within a full appraisal, remain the appropriate escalation tools when the timing of cash flows is itself a material value driver.

Disclaimer: This collateral valuation perspective is for discussion purposes only. The eligibility and use of a commercial evaluation remain subject to the institution's appraisal/evaluation and underwriting policies as well as applicable law and supervisory guidance.