

Opportunity and Risk with the Two Basic Approaches to CRE Property Valuation

👤 STEVEN MAKOWSKI 📅 DECEMBER 14, 2022

The valuation of commercial real estate assets is fundamental to a lender's decision to extend credit. Firms like Boxwood Means are often summoned to render commercial evaluation services by developing valuation reports that employ the sales comparison approach, income approach or both. Based on their internal appraisal and evaluation guidelines, bank clients determine which valuation method best suits their needs while considering various factors about the subject collateral, loan terms, and intended loan purpose among other considerations.

One of those other factors is current CRE market conditions, and it's fair to say that as deal volume has plummeted and asset prices [waver](#), lenders need to be mindful of the elevated risk associated with their chosen valuation methods and tools. So, it may be instructive to examine some property valuation fundamentals and then present a couple of scenarios that illustrate the opportunities (or benefits) and risks produced by these valuation approaches.

Sales Comparison Approach

The sales comparison approach utilizes recent market sales of comparable CRE assets. Ideally, comparable sales would be similar in location, possess comparable building and land size, be reasonably analogous in terms of building condition, and have recently traded. This approach is the most common with any evaluation or appraisal, as it provides solid insight into any given market's behavior, buyers' appetite, or pattern of sales for similar CRE properties. This method is best suited for 100% owner-occupied properties where a business owner owns the building she occupies for commercial operating purposes. That being said, a standalone sales comparison approach is also a very reasonable and cost-effective solution for non-complex, income-producing properties in support of less risky nonfinancial or subsequent transactions like loan renewals or extensions, credit reviews, loan servicing, and portfolio monitoring.



Income Approach

The income approach to valuation is a more detailed financial analysis where either contractual or market-level rents are reduced by the property's actual or market-level operating expenses to yield a net operating income (NOI). In turn, the NOI is divided by a market-driven capitalization (or "cap") rate to produce a property valuation. This approach is recommended in cases where a subject property is partially or fully leased by one or more tenants and, importantly, in situations where there is a stabilized NOI along with an expectation that the future income stream will be stable.

Valuations of more complex, multi-tenant investment properties involving, e.g., un-stabilized occupancies or substantial vacancies, many tenants with varying lease maturities, and/or construction or redevelopment scenarios, etc., are best handled with a discounted cashflow (DCF) analysis. Based on prudent and market-driven assumptions, the DCF approach applies a

discount rate to both the expected future NOI over a specified holding period and the expected terminal value (i.e., net sales price) to arrive at the net present value of the asset.¹

While each valuation approach has its merits, the fact is that the sales comparison approach is often coupled with the income approach in conducting appraisals and evaluations. Importantly, this combined analysis enables the evaluator to bracket the difference between the results of the two valuation methods and reconcile to a final and typically more reliable market value conclusion.

Sample Property Valuation Scenarios

As discussed above, the sales comparison and income approaches to value can be wielded separately or in tandem. Based on thousands of evaluation assignments each year with 300 national clients, we find that each project dictates which valuation method best suits the circumstances and collateral. Let's explore a couple of examples for illustration purposes.

▪ Rural Location of Asset

Subject properties in rural areas often present the biggest challenge to finding similar, close, and recent comparable sales. These locations are generally much less active than markets in and around larger cities and more populated areas. As a result, these more problematic areas typically produce older – or what we as evaluators term “stale” – comparables. While we sometimes must rely on these older sales transactions, by default they also tend to be the best available in the market (relative to location) and produce a reasonable valuation estimate when adjusted for current market trends.² When we find ourselves in this predicament, though, the income approach, in combination with the sales method, or simply on its own, may produce a better, timelier, and reliable result. Why? Because while the sales-only report in a rural location may incorporate sales comps that are several years old, rent comparables employed with the income approach may be more prevalent and reflect more current market conditions.

▪ Multi-Tenant or Mixed-Use Property

A second scenario involves a potential mismatch between the collateral type and a client's preferred choice of valuation method, as expressed by the type of evaluation report that a client may order. Take the example of a small multi-tenant building, e.g., apartment or office, or mixed-use asset with, e.g., retail at street level and several apartments above. We strongly recommend the sales and income approach – especially when the intended use is a loan origination that establishes a new valuation that is central to the LTV calculation and a key risk factor for lenders. While sole reliance on the sales comparison approach may be acceptable for nonfinancial transactions by banks as mentioned above, it's a far riskier proposition when the bank's loan proceeds to the borrower are based exclusively on sales transactions in the immediate market that may be overly dated. As logical and prudent as it is to proceed with an evaluation including both sales and income approaches on new loans for such income-producing assets, nevertheless some clients view the risk of certain small-balance collateral to be sufficiently low to move forward with the sales only approach.

▪ Special Purpose Real Estate

Like the multi-tenant example above, our last scenario involves a similar outcome and recommendation that emphasizes the importance of the income approach. Certain special use property types tend to be relatively sparse in many markets, so again it's a bit of a crap shoot to rely

exclusively on the sales comparison approach. Take, for example, a 60% occupied self-storage facility where the borrower fails to deliver a current rent roll and operating statement, and the bank needs a property valuation for a pending foreclosure. Though some clients will request a sales-only valuation, it's the asset's net income that drives value in this case and will deliver the most reliable market value conclusion in the absence of appropriate and nearby sales comps. In this situation, we advise clients that the sales and income approach where the income is derived from market-level rents and expenses in lieu of missing financials is the lender's best course of action. This is especially true for special purpose, income-producing properties like self-storage facilities where the income approach is conventionally given greater weight.

Boxwood's appraisers, analysts and operations staff encounter scenarios similar to the aforementioned on nearly a daily basis. If you have a challenging subject property and/or are uncertain about which Boxwood FieldSmart Evaluation product might be best, feel free to [contact](#) our team for advice.

¹ The above-mentioned cap and discount rates employed to derive property income and value are expected to be reasonable and appropriate estimates of the rate of return that lenders and investors may demand under typical and sustainable market conditions and also reflecting different risks associated with property type, location, and borrower creditworthiness among other factors. Note that with its FieldSmart Evaluations Boxwood exclusively performs the income approach using the direct capitalization method.

² Analyses typically include a market conditions factor in the adjustment grid. Also, sales listings which are incorporated into Boxwood's FieldSmart Sales and FieldSmart SI (Sales and Income) reports offer some further insight into how the market has moved since the selected sales comps traded.