

**Valuation Guide**  
Strip Commercial Properties

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# Strip Commercial Properties

## 1.0 Introduction

The introduction of the automobile produced a natural evolution of street oriented commercial retail activity. This type of property, known as strip commercial property, can be found lining most major thoroughfares in any town or city.

### Nature of Strip Commercial Property

Strip commercial properties include a wide variety of retail, office, commercial, and residential uses. Typically a commercial strip is comprised of a number of individually owned properties standing adjacent to one another, but it can also constitute a number of stores owned by one individual or company. This makes for a diverse group of properties. However, the common characteristics are:

- Orientation to the street,

- Exposure to pedestrian or road traffic,

- Commercial retail activities on the ground floor, and

- In some instances residential, office, and/or other commercial activities on upper floors.

Strip commercial properties may be purchased as a real estate investment, or to provide a location for the owner to conduct his or her business. From an assessment point of view, the critical element affecting the value of a strip commercial property is the income generating potential *of the real estate*. This potential is related to a number of factors, primarily location. The desirability of any location will be measured by the amount of exposure to potential customers, accessibility, and availability of parking.

## Type of Strip Commercial Properties Covered in This Guide

The term “strip commercial” as it is used in this guide refers to properties that:

- Are oriented to street or road traffic,
- Contain ground floor commercial activities,
- Are generally located adjacent to other commercial or retail properties, but may stand alone,
- Receive real estate income predominantly from commercial pursuits, and
- Have three storeys or less.

Strip commercial properties not included in this guide include:

- Auto dealerships,
- Hotel and motel properties,
- Larger stand alone properties in excess of 30,000 square feet, and
- Larger multi-tenanted commercial properties with sufficient on-site parking and, not strictly oriented to the street, could be more appropriately categorized as neighborhood shopping centres and should be valued accordingly (see the Shopping Centre Valuation Guide).

## Scope of Valuation Guide

This valuation guide presents a practical valuation tool utilizing the *income approach* to valuing strip commercial properties.

With the accompanying spreadsheets, the valuation guide provides a practical tool for evaluating and determining market value.

The valuation guide is designed as a tool to aid the assessor; it is not intended to replace the assessor’s judgment in the valuation process.

The methods presented in this valuation guide are aimed at deriving values for a number of different types of strip commercial properties.

## 2.0 Analysis of Strip Commercial Property

### 2.1 Property Types

#### Retail

Many strip commercial properties, especially those located away from the urban core, are single-level commercial properties located on major streets or arterial roads. This type of strip commercial property, which can be either single or multi-tenanted, is designed to appeal to vehicle and/or pedestrian traffic.

#### Retail With Office Space / Residential Apartments Above

The other major type of strip commercial property has one or more retail uses on the ground floor and office space or residential apartments on one or more upper floors. Upper floor office space typically consists of self-contained offices with little or no common area. Residential apartments may be rented to the ground floor tenant to provide a place to live and work in one setting, or the apartments may be rented to other individuals to provide an additional source of rental income for the owner of the property.

Strip commercial property with retail space on the ground floor and office / residential space on the upper floors is typically located on main arterial roads and busy thoroughfares. There may be a number of smaller tenants on the ground floor, or a larger tenant such as a drugstore, grocery store, or bank may occupy a substantial portion of the space. Other typical tenants might include a wide range of businesses including video stores, restaurants, convenience stores, and clothing stores.

### 2.2 Analysis of Valuation Approaches

#### Market Sales Comparison

In certain municipalities, there may be a sufficient number of strip commercial property sales over a given period of time to enable valuation on the basis of a sales comparison analysis. When there are sufficient numbers of sales, care must be taken when performing any type of analysis to ensure that the sale price reflects the fee simple interest in the property. There are instances when a strip commercial property is owner-occupied and the owner may sell the business together with the real property at the same time. In such a case, the assessor must take steps to separate the business value from the real property value before using the sales data.

## Income Approach

Except for the owner-occupied sites, strip commercial properties generate rents. The types of lease arrangements vary from net, semi-gross, to gross rents. However, there is usually sufficient information available to establish typical income levels from strip commercial properties. In addition, these properties sell from time to time, providing the basis for establishing market oriented capitalization rates.

In most municipalities, there are sufficient numbers of strip commercial properties to establish typical rental rates and to find meaningful income and expense information.

## Cost Approach

In the cost approach, the value of an improved property is estimated by adding the estimated land value and the estimated cost new of the improvements less depreciation. The cost approach is the only approach that can be applied when neither reliable sales nor income data are available. Furthermore, in certain situations it is sometimes desirable to first perform the cost approach because important facts can be learned about the property that will be useful when performing the sales and/or income approach.

In the case of strip commercial properties, the cost approach is one possible method of measuring value. In most municipalities, however, there is likely to be a sufficient number of sales and/or income information available to complete the other approaches to value, either of which is preferable to the cost approach.

## Recommendation – Income Approach

Because strip commercial properties are frequently bought, sold, and developed on the basis of their expected income, the *income approach* to value reflects the way the market views these properties. The combination of market orientation and significant leasing activity renders the income approach the most appropriate method for the valuation of strip commercial properties. Therefore, the following recommendation is made:

In the assessment of properties in Alberta, the *income approach* is recommended for the valuation of strip commercial properties.

## 2.3 Application of the Income Approach

The income approach to value relies on methods of converting an income stream into a present value estimate. The methods or techniques used in the income approach may be relatively simple, such as income or rent multipliers or direct capitalization. The income approach requires careful application because small variations in its key variables (capitalization rate, duration of income stream, estimated income and expenses, etc.) will be mathematically leveraged into a wide range of estimated value.

In general, there are two methods available to convert future income into a present value:

- Direct capitalization, and
- Discounted cash flow analysis.

Either type of analysis recognizes that money has a time value. That is, given a choice, people would rather receive \$100 today than \$100 one year from now. However, certain people would rather receive \$110 (\$100 + 10%) in one year than \$100 today. The interest rates applied to convert future dollars to cash in the pocket today reflect the time value of money.

The valuation technique commonly used by assessors across Canada is based on the **direct capitalization method**. This technique is widely accepted as a mass appraisal technique. It is also accepted under existing jurisprudence<sup>1</sup> and is relatively easy to use. The valuation approaches presented in this guide employ two variations of the direct capitalization method. Both methods rely on the same principles:

- Capitalization of the net operating income, and
- Gross income multiplier.

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<sup>1</sup> *Bramalea Ltd. v. British Columbia Assessor Area # 9, Vancouver* (1990), 76 D.L.R. (4<sup>th</sup>) 53. (C.A.) Leave to appeal to S.C.C. refused 79 D.L.R. (4<sup>th</sup>) vi. 135 N.R. 318.

## Overview of the Direct Capitalization Method

**The analysis in this section presents a direct capitalization method that is suited to mass appraisal applications. Therefore, the analysis focuses on typical properties.**

Direct capitalization converts or “capitalizes” the expected level of current net earnings into an estimate of market value using a capitalization rate. Therefore, the conversion factor or capitalization rate is a reflection of all the investor’s relative and comparative feelings and aspirations about the property in light of the investment characteristics offered by the asset and in comparison to other investment opportunities in the marketplace.

In its most basic form, the direct capitalization method is an elementary mathematical ratio involving the estimation of current net operating income (NOI), which is then capitalized into value to produce an estimate of current market value. The overall capitalization rate should capture the return **of** and return **on** investment.

## The Direct Capitalization Method

Market Value	=	$\frac{\text{Net Annual Operating Income}}{\text{Capitalization Rate}}$	V	=	$\frac{\text{NOI}}{R}$
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For example:

$$\begin{aligned} \text{NOI} &= \$100,000 \\ \text{Cap Rate (R)} &= 10\% \\ \text{Market Value} &= \$100,000 \div 0.10 = \$1,000,000 \end{aligned}$$

Although there are other methods of converting expected future income into an estimate of current value (e.g., discounted cash flow), the direct capitalization method lends itself to mass appraisal applications. It is possible to ascertain market values under this formula through proper evaluation of the expected net income and through the selection of an appropriate capitalization rate. However, there are two reasons why it is difficult to achieve precise accuracy with the direct capitalization method:

A large number of investment characteristics have to be evaluated within the selection of the overall capitalization rate, and

The value outcome is predicated on a snapshot of the income that is expected to be produced from the property.<sup>2</sup>

The capitalization rate employed in the valuation of strip commercial properties must also reflect the investment characteristics of the property in comparison to other investment opportunities in the market.

## Overview of the Gross Income Multiplier Method

Where the direct capitalization method capitalizes **net** operating income, the gross income multiplier derives values on the basis of a **gross** income multiplier (GIM), or gross rent multiplier (GRM). **Accordingly, these multipliers are used when data on operating expenses are unavailable.**

By convention, a gross *rent* multiplier is the factor applied to the gross **monthly** rent, and a gross *income* multiplier is the factor applied to the gross **annual** rent.

$$\text{Market Value} = \text{Gross Annual Income} \times \text{Gross Income Multiplier}$$

A GIM is developed through analysis of sales of similar properties. A GIM relates market value evidence to the gross income produced by those properties, as indicated by the following formula:

$$\text{Sales price} \div \text{Gross Income} = \text{Gross Income Multiplier}$$

As a general rule, the higher the similarity and the more robust the sales data, the more accurate the result of a gross income multiplier valuation procedure. A logical extension of this statement is that a gross income multiplier procedure works best with less complex properties that are easier to compare than those with a range and variety of different components and attributes.

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<sup>2</sup> Manufacturers Life Insurance Co. v British Columbia [1996] B.C.J. No. 3046 p.14

## 2.4 Practical Valuation Process

In this valuation guide the *income approach* has been developed into a practical valuation tool utilizing spreadsheets.

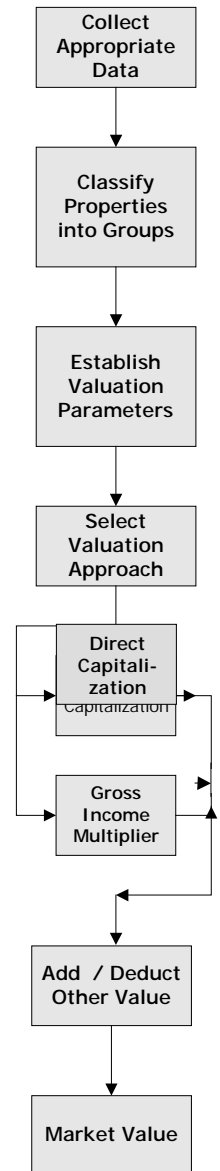
Guidelines and instructions follow on:

- Using the spreadsheets,
- Collecting data,
- Analyzing information,
- Applying valuation techniques,
- Developing the valuation parameters,
- Developing market value, and
- Controlling the quality of assessment values.

## 3.0 Strip Commercial Valuation Process

### Overview

- 1) **Collect appropriate information.**
- 2) **Classify strip commercial properties into homogeneous groups based on:**
  - Physical characteristics,
  - Use, and/or
  - Location.
- 3) **Establish valuation parameters.**
- 4) **Select a valuation process:**
  - Direct capitalization method, or
  - Gross income multiplier method.
- 5) **Apply method to derive value.**
- 6) **Add / deduct for other value, if required.**
- 7) **Reach a MARKET VALUE conclusion.**



## 3.1 Collect Appropriate Data

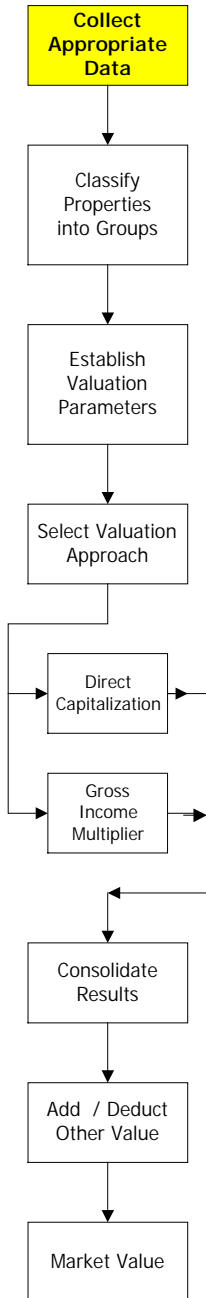
More than any other factor, the type and quality of information that is available dictates the methods that can be used to value properties. The efforts made at the information collection stage will determine the quality of the final analysis.

As discussed previously, there is likely to be a significant amount of data available upon which to base an income approach valuation of a strip commercial property.

Helpful sources of information that can be used in the valuation of strip commercial properties include assessment records, owners, real estate consultants and brokers, real estate publications, and title registration offices.

### Types of information to be collected:

- Detailed property information,
- Income and expense statements,
- Rent roll and typical vacancy rates, and
- Sales data when available.



### Detailed Property Information

To compare strip commercial properties, classify each into the appropriate class or group. To develop useful valuation parameters, obtain pertinent physical and descriptive information about the properties. The information collected should be entered on Form SC1: Strip Commercial Data Entry Form.

### From Assessment Records

Historical information on file in the assessment records is the logical place to begin collecting property information. When possible, the assessor should verify this information when inspecting the property. When the information is not available or obtainable from the inspection, the property owner should be contacted to complete the data collection.

## From Property Inspection

Existing records need to be kept up to date, and all assessed properties should be inspected from time to time. Along with the physical measurements, the following items should be noted when inspecting strip commercial properties.

### LAND:

- Lot size and area including effective frontage and depth,
- General comments on availability of on-site or off-site parking, and
- General comments on location of property.

### BUILDINGS:

- Year built,
- Details of all retail uses on ground floor,
- Details of all upper floor uses (if any):
  - Dimensions and area of all office space,
  - Number of residential apartments,
- General comments on condition of retail space,
- General comments on office / residential space, and
- Level of occupancy.

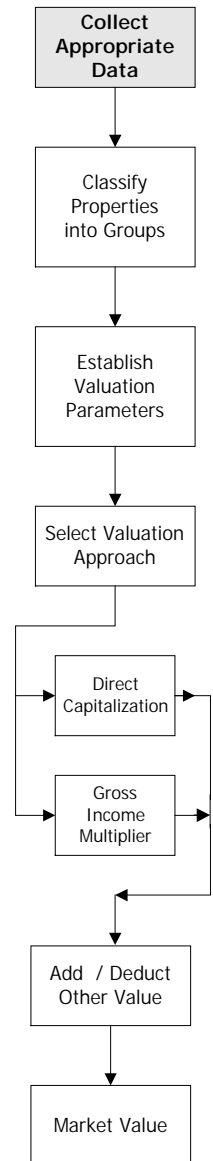
Where there appears to be surplus land, the assessor should note this on the record and review the zoning use by-laws governing the property.

## Rents and Financial Information

The assessor should attempt to collect rental and other financial information from the owner to provide a basis for assessments derived through the income approach.

Obtain Income and Expense and other financial statements, if available. At a minimum, try to ensure the following information is included:

- Typical rent and tenant type,
- Total gross rent per annum,
- Income from other sources, e.g., parking,
- Income collected to cover operating expenses: power, cable, etc. (could be included in gross rent),
- Total operating expenses, and
- Real estate taxes.



## Typical Vacancy Rates

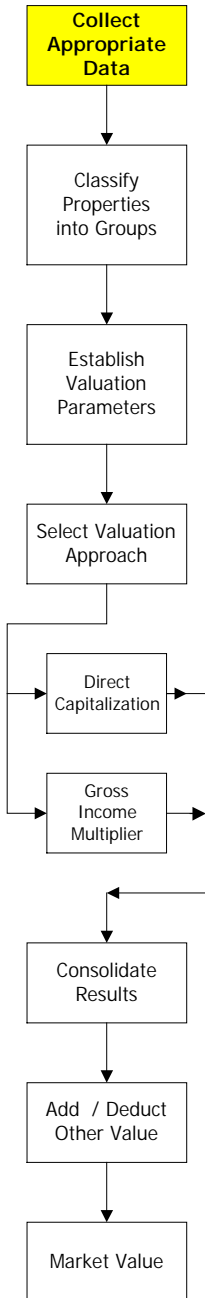
Allowances (or % rates) for vacancy and bad debts should be established over the long term (from three to five years). While providing some flexibility in the valuation process, stabilized rates will help stabilize assessment values and taxes.

The owners are one of the better sources of vacancy information – both through direct questions and through income and expense data. Other sources may include local realtors or appraisers.

## Sales Data

Free market sales of strip commercial properties are likely to be common in most municipalities. When sales data is collected, the following information should be sought:

- Property address and legal description,
- Sales price,
- Date of transfer,
- Instrument number,
- Name and address of vendor and purchaser,
- Interests transferred (fee simple or other),
- Financing conditions, and
- Value of chattels.



The assessor must scrupulously investigate all strip commercial sales to verify whether the sale is truly indicative of market value. There will be instances when, in addition to the sale of the real property, the purchaser is also purchasing the retail business that operates out of the property. In the latter case, the sales data may have to be adjusted or discarded to ensure reliable market value estimates.

## 3.2 Classify Properties Into Homogeneous Groups

The functionality, viability, and value of a strip commercial property largely depends on its attributes: the quality of the physical improvement, the nature of the use of the property, and perhaps most importantly, its location. The valuation of a strip commercial property therefore rests on the analysis of these features. The ability to make comparisons with other strip commercial properties is crucial. Strip property may be classified according to one or more of the following:

- Physical characteristics,
- Use, or
- Location.

To facilitate the mass appraisal process, attempt to group strip commercial properties into homogeneous groups. Classifying properties enhances the comparison process, which facilitates the estimation of value.

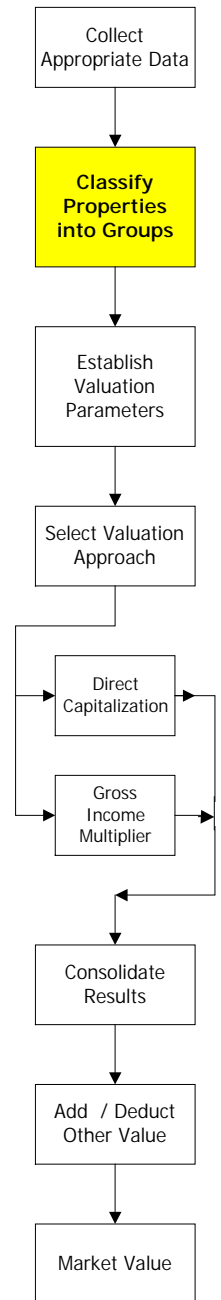
### Physical Characteristics

Although there may be other types of improvements, the primary structure is usually the most important improvement. The value-generating characteristics of a building may be divided into three categories: functional efficiency, durability, and attractiveness / aesthetics.

### Functional Efficiency

Functional efficiency refers to the degree to which a building is suited for its intended use. Although the relationship of a structure to its site is a factor in functional utility (for example, retail stores often require on-site parking), the internal layout of the building is often the primary factor. Attributes such as the size and shape of rooms, ceiling height, circulation patterns, number of storeys, privacy, and storage capacity are primary in determining a property's functional efficiency.

The dynamic aspect of functional efficiency should also be emphasized. With social, economic, and technological changes, functional requirements for a given use are also



subject to change. For example, changes in the tastes and preferences of consumers may have a major effect on the functional criteria for retail store design.

### Durability

Durability essentially refers to construction quality and the ability of a structure to remain productive exclusive of functional considerations. A high quality structure resists deterioration, has lower maintenance costs, and, assuming it remains functional, has a longer economic life. The quality and condition of a building's structural components and subsidiary systems are the primary determinants of construction quality.

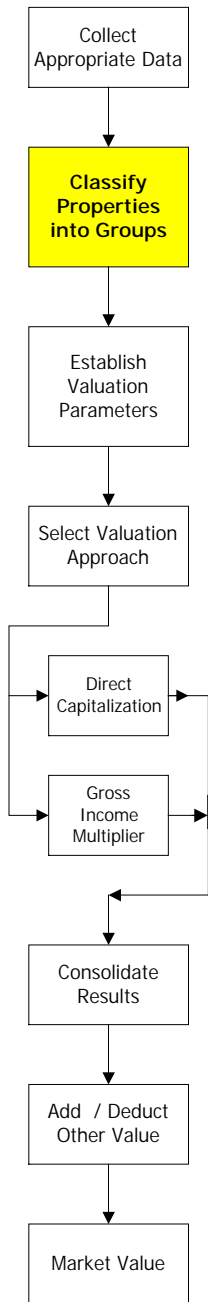
### Attractiveness / Aesthetics

Although attractiveness is somewhat subjective, the aesthetics of a property definitely affect its value. Extreme designs not in keeping with the surrounding area in a commercial district, for example, generally have a shorter period of market acceptance. What is considered attractive is also subject to the changing tastes and preferences of market participants.

### Use

Combined with a ground-floor commercial use, the property may also incorporate office or residential uses on one or more upper floors. Infrequently, some strip commercial properties may also have a secondary commercial use on a second floor of the property, or one-half floor above, or below grade.

The strip commercial property may comprise a single storefront with or without floors above, or it may consist of a row of storefronts under common ownership.



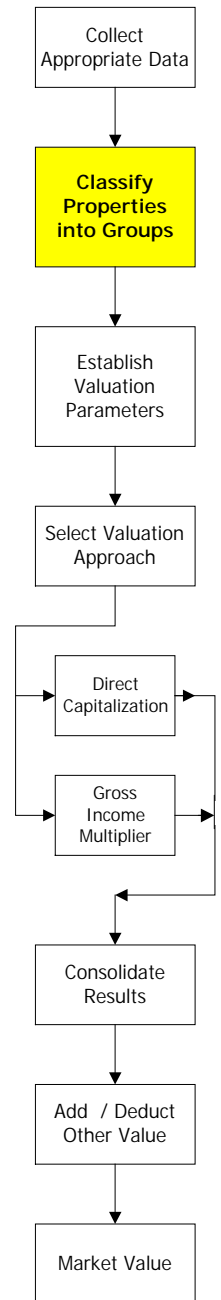
## Locational Characteristics

The most important single attribute of land is its location. The essence of location involves space and the need to transport people, goods, and services from one geographic location to another. The locational requirements of a given parcel of land depend on its use.

## Example of Strip Commercial Classification

The classification of strip commercial property and the classes established relate entirely to the type of strip commercial property found in each municipality. An example of a typical classification system is set out in the following table.

<b>Class</b>	<b>Attributes</b>	<b>Use</b>	<b>Location</b>
Class 1	Various	All uses	Poor location
Class 2	>1 floor	Commercial / residential	Downtown
Class 3	1 floor	Commercial	Downtown
Class 4	1 floor, old	Commercial w parking	Highway or arterial
Class 5	1 floor, new	Commercial w parking	Highway or arterial



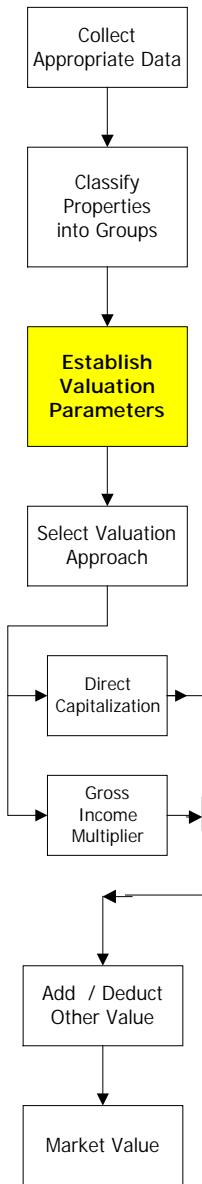
### 3.3 Establish Market Rents and Valuation Parameters

From the data collected, it should be possible to determine various valuation factors by class of strip commercial property.

From records, property inspections, and other sources, a number of statistics should be compiled to identify each class of strip commercial property.

Table 1: Strip Commercial Property Descriptive Data – Class 5\*

Unit of Comparison	Mean/ Median	Std. Dev.
Number of Units	2	.61
Average Unit Size	1588	416
Year Built	1986	3.1
Land/Bldg. Ratio	3.03	.4
Number in Class	42	



In addition to the descriptive data shown in Table 1, collecting detailed income and expense data permits the assessor to generate statistics such as those shown on Table 2.

In the analysis of rents, storefronts are categorized according to the different qualities of retail space within the given class of strip commercial property. For example, corner locations have higher exposure and therefore command higher rents than interior sites. Not all categories of storefront will be present in each class of strip commercial property.

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\* This sample data is for illustrative purposes only. It is not to be used in the valuation of properties.

Table 2: Example of Strip Commercial Valuation Parameters\*

**NET RENTS**

Profile Summary	Class 1		Class 2		Class 3		Class 4		Class 5	
	Poor location		Downtown >1 storey comm/ res.		Downtown 1 storey commercial		Older highway commercial		Newer highway commercial	
Parameter	Mean	Range	Mean	Range	Mean	Range	Mean	Range	Mean	Range
<b>Ground Floor Uses</b>										
Corner Location	\$7.45	\$0.32	\$8.10	\$0.45	\$9.62	\$0.74	\$11.47	\$0.68	\$14.80	\$1.40
Inferior Storefront	\$6.03	\$0.26	\$6.56	\$0.36	\$7.79	\$0.60	\$9.29	\$0.55	\$11.99	\$1.13
Standard Storefront	\$6.71	\$0.29	\$7.29	\$0.41	\$8.66	\$0.67	\$10.32	\$0.61	\$13.32	\$1.26
Superior Storefront	\$7.38	\$0.32	\$8.02	\$0.45	\$9.52	\$0.73	\$11.36	\$0.67	\$14.65	\$1.39
Other (e.g. Basement)	\$3.50	\$0.25	\$4.00	\$0.31	\$4.60	\$0.40	\$5.10	\$0.42	\$5.50	\$0.61
<b>Upper Floor Commercial</b>										
Retail	\$4.21	\$0.21	\$4.80	\$0.42	\$5.42	\$0.61	\$5.77	\$0.69	\$6.50	\$0.75
Office	\$4.50	\$0.54	\$5.10	\$0.72	\$5.83	\$0.63	\$6.10	\$0.59	\$6.47	\$0.52
<b>Upper Floor Apartments (Monthly)</b>										
Bachelor	\$460	\$21	\$525	\$21	\$655	\$39	\$505	\$25	\$575	\$32
One Bedroom	\$552	\$29	\$720	\$28	\$738	\$32	\$685	\$27	\$722	\$34
Two Bedroom	\$691	\$35	\$780	\$22	\$804	\$27	\$772	\$22	\$830	\$26
Operating Expense Recoveries Residential Units	\$1,600	\$330	\$2,000	\$294	\$2,120	\$178	\$1,872	\$561		
Expense Recoveries per SF Commercial	\$1.34	\$0.21	\$1.87	\$0.78	\$2.08	\$0.61	\$1.99	\$0.69	\$2.24	\$0.75
Taxes Recovered per SF Commercial	\$1.77	\$0.33	\$2.01	\$0.52	\$2.11	\$0.70	\$1.88	\$0.46	\$2.20	\$0.39
Parking Space Revenue (Per space per year)	\$357	\$123	\$712	\$231						
Vacancy and Collection Allowance	7.0%		7.0%		6.0%		5.0%		5.0%	
Expenses as a % of Gross Income	42.0%	5.3%	40.3%	4.8%	39.6%	3.2%	41.1%	2.9%	39.5%	3.3%
Gross Income Multiplier	4.40	0.90	4.75	0.75	4.85	0.38	4.70	0.36	4.60	0.40
Capitalization Rates (Base)	12.8%	2.2%	11.6%	2.0%	11.2%	1.3%	11.8%	2.0%	12.0%	2.0%

\* This sample data is for illustrative purposes only. It is not to be used in the valuation of properties

### 3.4 Select Valuation Process

Depending on the income information available, one or both of the following approaches to value can be used:

Direct capitalization

- Income **and** expense data

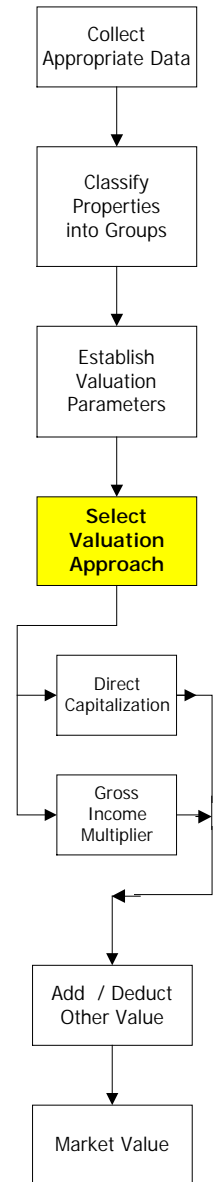
Gross income multiplier

- Sales data
- Income data

**Only one approach need be applied.**

If the leases for strip commercial properties in the municipality are predominantly of a gross or semi-gross nature, and if there are sufficient sales to generate the appropriate valuation parameters, consider a GIM approach.

When there are net leases, or in cases where the gross income multipliers cannot be determined, consider using the direct capitalization method.



## 3.5 Apply Method to Derive Value

Apply either the GIM or direct capitalization method to produce a market value estimate.

### Review of Gross Income Multiplier (GIM) Method

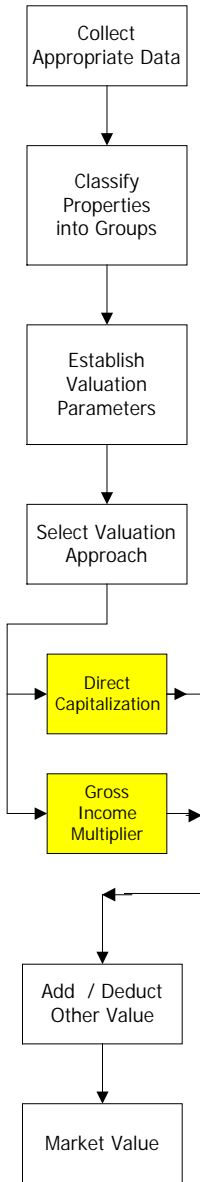
- 1) Establish **actual** gross income, utilizing actual rents.
- 2) Establish **typical** gross income, based on typical rents and income.
- 3) Compare actual gross income with typical gross income. Where actual income falls outside of the range permitted (for example + or – 5% from the median gross income for the class), apply typical gross income.
- 4) Deduct long-term vacancy rate from typical gross income to produce the effective gross income (EGI);
- 5) Multiply the EGI by the gross income multiplier to produce an estimated market value.
- 6) **Where warranted**, adjust the estimated market value to account for any property-specific irregularities.

### Establish Actual Gross Income

Using the income figures supplied by the property owner, determine the actual gross rent on Form SC2: Strip Commercial Income Analysis and Gross Income Multiplier. (An example is provided in section 5.) The part of Form SC2 dealing with calculating actual gross income is shown on Figure 1. If the income figures are unavailable, apply the **typical** rent and income per unit for that class of multi-residential property.

### Typical Gross Income vs. Actual Gross Income

**The potential gross income from all strip commercial properties should reflect the typical rental rates found in that class of property.** The potential gross income can be determined from actual rental rates, but the resulting amount should only be applied in the valuation when it reflects the expected typical rent from that class of strip commercial property.



The potential gross income is calculated by establishing the typical rent for **all space** in the building as of the valuation date.

**Figure 1: Calculation of Actual Effective Gross Income**

1104 12th St SW	Roll: 123789	SC Class: 2	Value Date: 1-Jul-97
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Actual rents as of date:	Jan-97	Typical rents are:	Net
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ACTUAL RENTS		TYPICAL RENTS	
Ground Floor Area	Area in sq.ft.	Rent per sq.ft.	Annual Rent
Corner location	1,200	\$7.45	\$8,940
Inferior storefront	0	-	\$0
Standard storefront	4,000	\$7.07	\$28,280
Superior storefront	0	-	\$0
Other (e.g. Basement)	800	\$2.00	\$1,600
<b>Upper Floor Area</b>			
Retail	0	-	\$0
Office	0	-	\$0
<b>Total Area in sq.ft.</b>	<b>6,000</b>		
Upper Floor Apts.	# of Units	Rent per Unit	
Bachelors	0	\$0	\$0
1 Bedrooms	4	\$654	\$31,392
2 Bedrooms	0	\$0	\$0
<b>Total Rental Income</b>	<b>4</b>		<b>\$70,212</b>

Other Income			
Parking Spaces	0	-	\$0
Operating Expense Recoveries per sq.ft.		\$1.81	\$10,880
Taxes Recovered		\$1.95	\$11,700
Expense Recoveries per Res. Unit per yr		\$1,864	\$7,455
Other :			\$0
<b>Other Income</b>			<b>\$30,035</b>

<b>Total Gross Income</b>	<b>Actual</b>	<b>\$100,247</b>
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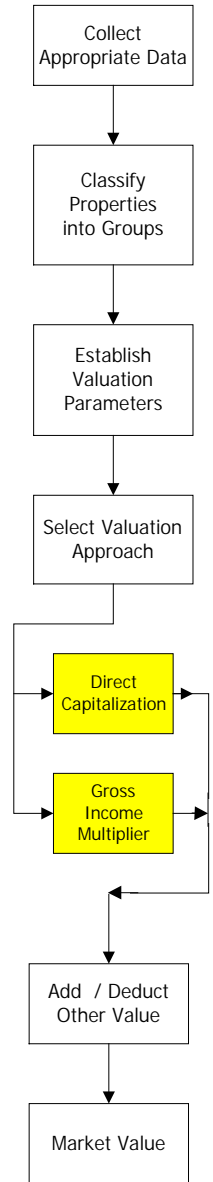
<b>Total Gross Income</b>	<b>Typical</b>	<b>\$107,920</b>
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<b>Discrepancy Allowance</b>	5.0%
Difference between Actual and Typical	-7.11%
<b>Income used in valuation</b>	<b>\$107,920</b>
Less vacancy and collection allowance:	7.0%
<b>Total Effective Income</b>	<b>\$100,366</b>

Use Actual ONLY if within Allowable Range
Use Typical if Actual not within Range



## Compare Actual Gross Income to Typical Gross Income

By inserting a “discrepancy allowance” in Form SC2, the assessor can determine whether the actual income falls within a certain percentage of the typical income. The example provided in Figure 1 indicates a discrepancy allowance of + or – 5%. If the actual gross income falls within this range, then the actual income is applied. If the actual income falls outside the range provided by the discrepancy allowance, or if no income figures are available, then typical income is applied to establish the effective gross income.

## Estimate Effective Gross Income

Deduct a vacancy and collection allowance from the gross income estimate. Virtually all properties will be vacant at some time during their remaining lives. If, in fact, a property does not have a vacancy, the actual rent may be too low. In any case, it would still be correct to deduct a vacancy allowance from the potential gross income of the property, since a prudent investor anticipates some vacancy.

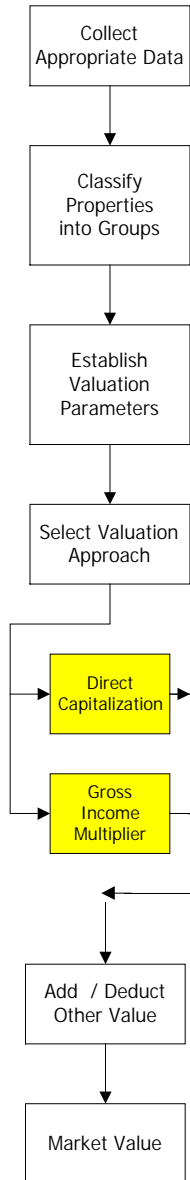
Vacancy losses are usually combined with collection losses and expressed as a percentage of potential gross income. This percentage is estimated by studying the property and analyzing trends in the neighborhood and area.

Applying a vacancy rate that reflects long-term conditions (over a period of 3 to 5 years) stabilizes the assessment base and fluctuations in property taxes from year to year.

## Gross Income Multiplier

Multiply the effective gross income by the gross income multiplier to produce a value estimate.

Once the effective gross income has been established, the market value of the property can be determined by applying the gross income multiplier.



## Example of Gross Income Multiplier Calculation

Effective Gross Income	\$100,366
GIM	4.75
<b>Market Value Estimate</b>	<b>\$476,739</b>

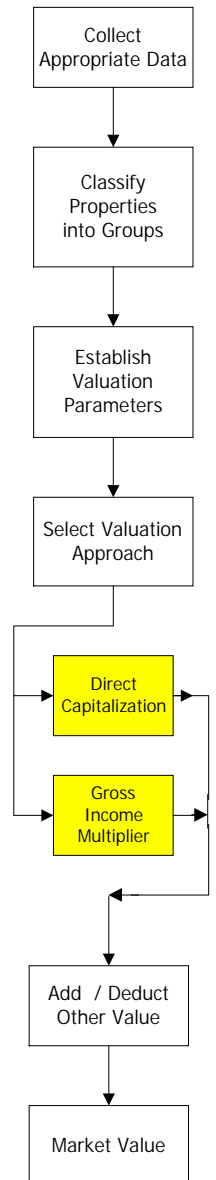
### Adjustments to the Market Value Estimate

If, during the income and expense analysis stage, there is a discrepancy between the market value based on typical gross income and the market value based on actual sales, the assessor must consider whether there is any justification for an adjustment to the market value estimate.

In cases where a discrepancy arises based on a comparison with actual sales, the assessor must revisit the valuation parameters. Either the parameters have not been derived with sufficient certainty or the property does not fit properly within the established parameters.

Applying an adjustment to the market value estimate is one method of accounting for anomalies in the marketplace. This will cover rare situations where the property is obsolete or does not fit suitably within the classes determined in the valuation parameters.

**Note:** A GIM developed in the analysis of one class of strip commercial property is generally not applicable to other classes of strip commercial property.



## Review of Direct Capitalization Process

The direct capitalization process builds on the effective gross income established in the gross income multiplier analysis.

- 1) Determine the effective gross income.
- 2) Deduct expenses to determine net operating income (NOI) attributable to the real estate.
- 3) Establish the base capitalization rate from market sales data and adjust it by the effective tax rate to obtain the overall capitalization rate (OAC).
- 4) Capitalize the NOI by the OAC to derive the estimated market value.
- 5) When warranted, adjust the estimated market value to account for any property-specific irregularities.

### Expenses and Net Operating Income

After analyzing rents and the effective gross income (on Form SC2), the assessor should determine the appropriate expenses to be applied to derive the net operating income (NOI). Again, if **actual** expenses are within a prescribed range of the **typical** expense (set by the discrepancy allowance), deduct the actual expenses from the effective gross income to derive NOI. If actual expenses do not fall within the allowed range, apply the typical expense ratio for that class. (See Figure 2.)

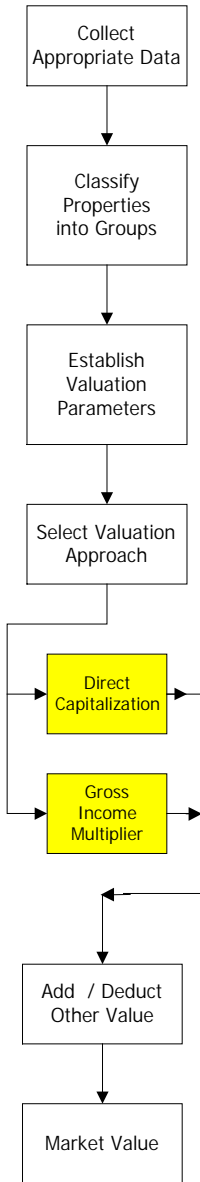
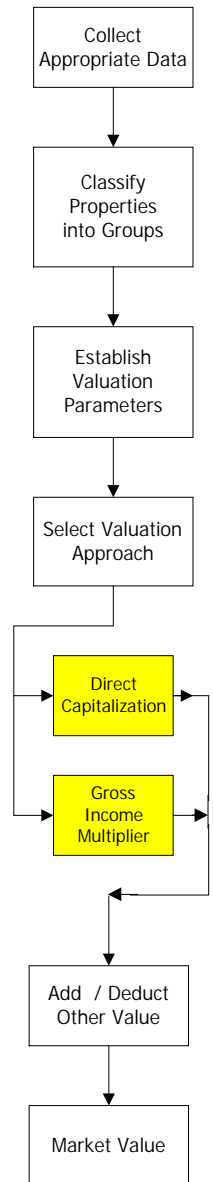


Figure 2. Determination of Expenses and Net Operating Income\*

Address	1104 12th St SW		<b>Class Statistics</b>	
Roll #	123789		Class	<b>2</b>
Value Date	1-Jul-97		No. in class	42
<b>Effective Gross Income</b>			<b>\$100,366</b>	
<b>Expenses</b>	<b>Actual</b>	<b>% of EGI</b>	<b>Typical % of EGI</b>	
Utilities	\$7,060	7.0%	7.5%	
Administration/ Management	\$9,850	9.8%	10.0%	
Operating	\$6,122	6.1%	6.5%	
Other	\$2,840	2.8%	2.5%	
<b>Sub-Total</b>	<b>\$25,872</b>	<b>25.8%</b>	<b>26.5%</b>	
Property Taxes	\$12,850	12.8%	13.9%	
<b>Discrepancy Allowance Range</b>		5.0%		
Difference between Actual and Typical		-2.64%		
Expense Rate used in calculation		<b>25.8%</b>		
<b>Net Operating Income</b>		<b>\$74,472</b>		

*Use Actual ONLY if within allowable range*  
*Use Typical if Actual not within allowable range*



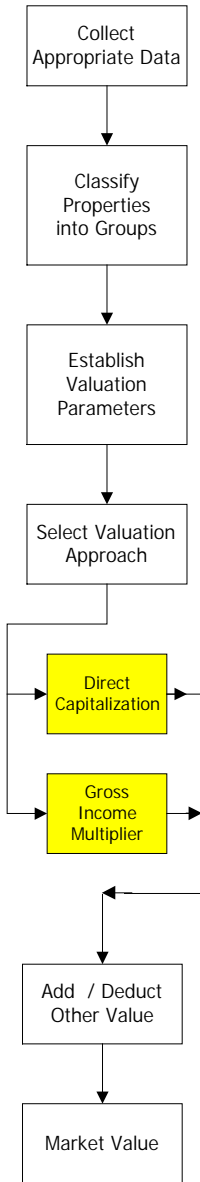
### Select Appropriate Capitalization Rate

The income approach assumes that when selecting a capitalization rate to value property, investors will estimate the duration of the income stream and its risk, or the likelihood of receiving the revenue. The risk of an income stream refers to its certainty; that is, how likely it is that the investor will receive the revenue. The greater the uncertainty of the income, the higher the capitalization rate. Not all investments are subject to the same level of risk. Therefore, not all income streams should be capitalized at the same rate.

**The value of the income stream is determined by capitalizing net operating income. Selecting an appropriate capitalization rate is essential for estimating a realistic and equitable market value for the property.**

\* This sample data is for illustrative purposes only. It is not to be used in the valuation of properties.

$$\text{VALUE} = \text{NET INCOME} \div \text{CAPITALIZATION RATE}$$



The capitalization rate to be applied to value a strip commercial property arises from analysis of two types of information:

1. The primary source is the analysis of sales of similar properties, e.g., a strip commercial property.
2. As an investment opportunity a strip commercial property competes with other investment opportunities. From an investment point of view the more similar the characteristics of the associated income stream (i.e., the frequency of payment, its potential for growth, and the risks associated with the income), the more comparable the investment and the more comparable the capitalization rate.

Therefore when strip commercial sales information is not available, capitalization rates are often established in comparison to mortgage rates and a combination of mortgage and equity rates. However, this and other methods of establishing capitalization rates should be contemplated only when appropriate sales data is not available and as a check on the capitalization rates generated through analysis of sales.

### Capitalization Rate Guidelines

The income approach is based on the present worth of **future** benefits. Therefore, when applying capitalization rates take into account the expected **future** income at the time of the valuation.

A number of influences could affect the capitalization rate to be applied to a strip commercial property. In general, favourable conditions should lower the capitalization rate and raise the value, and negative conditions should raise the capitalization rate and lower the value. Some of the issues to consider when establishing a capitalization rate are:

- Economic conditions,
- Competition, and expected changes in competition,
- Location - roads, parking, access, visibility,
- Property age and condition, and
- Property design.

## Effective Tax Rate

There are two ways to deal with the impact of property taxes when valuing a strip commercial property:

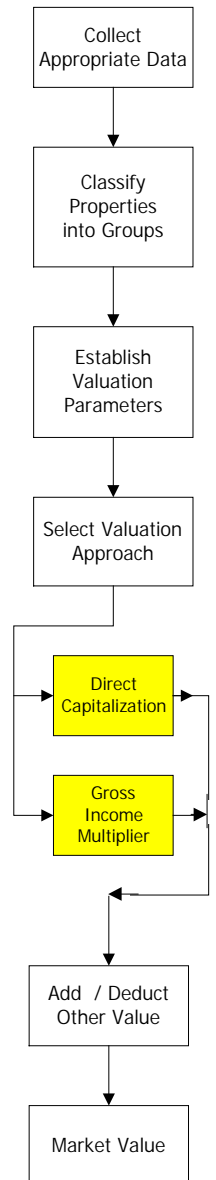
1. Deduct the actual property taxes charged as part of fixed expenses (before determining net income). Under this approach, the “net income” produced is entirely attributable to the rental income stream of the property, and the capitalization rate employed in the valuation process is the “base rate”. The base rate is to be established as outlined above.
2. The recommended method of accounting for property taxes is to determine the effective tax rate and add this amount to the base capitalization rate. Under this method property taxes are not included as part of the expenses, but are accounted for in deriving the capitalization rate.

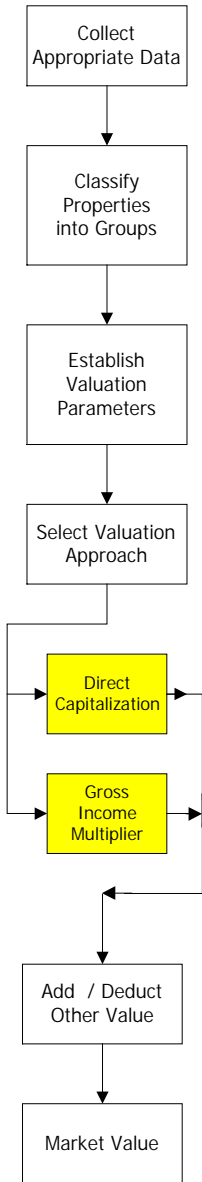
The best way to determine effective tax rates is to apply the current taxes against properties that have recently sold.

### Effective Tax Rate Calculation

Property taxes	\$62,000
Market value of a property	\$2,000,000
Effective tax rate:	$\$62,000 / \$2,000,000 = 3.1\%$

This effective tax rate of 3.1 percent is added to the base capitalization rate to determine the overall capitalization rate to be applied in assessing the market value of the income stream.





## Example of Direct Capitalization Value Calculation

<b>Net income</b>	<b>\$74,472</b>
Base cap rate	11.6%
Effective tax rate	3.1%
Total cap rate	<u>14.7%</u>
<b>Value</b>	<b>\$506,612</b>

**When warranted**, adjust the estimated market value to account for discrepancies between the market value based on typical income and market value based on a comparison with actual sales.

## Consolidation of Findings

If both gross income multiplier and capitalization rate data are available, two value estimates can be generated for the property. If both approaches are applied, it is up to the assessor to determine how much weight to apply to each method in the final estimate of value.

As a general guideline, emphasis should be placed on:

- The method that has superior data, and data with smaller coefficients of dispersion, and

- The method where the characteristics of the comparable properties are most similar to the subject property.

**Note:** This guide explains both methods of valuation but does not necessarily recommend that both methods be employed in all instances. The assessor must decide whether to use the Gross Income Method or the Direct Capitalization Method, or both. In many municipalities it will likely be neither appropriate nor possible to employ both methods of valuation.

## 3.6 Add / Deduct Other Components of Value

From time to time the foregoing analysis will not entirely capture the value of a property. A lump sum addition or deduction will be required. For example, the property may require extensive repairs to fix structural damage or another curable item and this amount can be noted and deducted from the value total as an “other value” item.

### Adjustments to the Market Value Estimate

If there are extenuating circumstances to suggest that the property may never be able to achieve the typical gross income indicated by the class, the assessor may wish to depart from an assessment based on typical rents. Applying an adjustment to the market value estimate is one method of accounting for anomalies in the marketplace. This will cover the rare situations where the property is obsolete or does not fit within the classes determined.

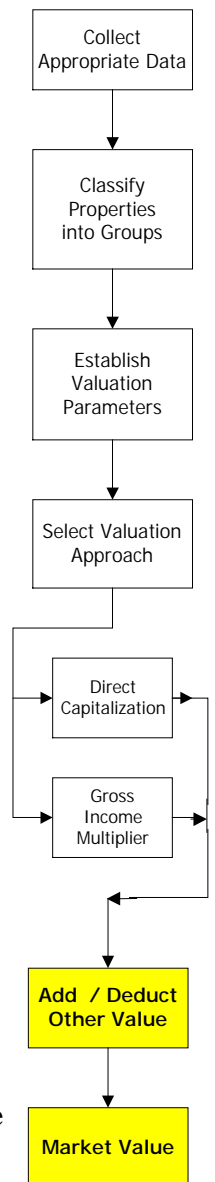
In some situations the property is subject to a one-time, extraordinary maintenance expense that should be accounted for as part of the value. The “Other Value” line at the bottom of Form MR3 allows for these adjustments.

There may also be surplus land as part of the property that is undeveloped because of market conditions. This surplus land has to be valued separately and added to the market value arrived at above.

## 3.7 Final Value Conclusion

**Market value is determined by analyzing the physical and income characteristics of strip commercial properties and compiling this information into homogeneous groups or classes. The value of one property in a class is based on its actual performance but is bounded by the typical values generated by all other properties in that class. Then, if required, any additional value is added to this total to produce an overall Market Value for the property.**

If there are sufficient sales to allow for a valuation based on the *comparable sales approach*, the assessor may consider carrying out this alternative method of valuation and then reconciling the separate estimates of value.



## 4.0 *Validation of Results*

The strength of an assessment system rests on 1) its ability to produce appropriate market values and 2) its ability to treat similar properties fairly and consistently.

To accomplish these ends, the valuation process should reflect the views and methods used in the marketplace. The process should be applicable to all properties, but it should have enough flexibility to deal with the variations and market conditions encountered. There are three areas where the quality of the results can be ensured quickly and efficiently:

1. Valuation parameters,
2. Check against sales values, and
3. Data filters.

### Valuation Parameters

The proposed system sets up a table of valuation parameters. Ideally, this information is researched, collected, and analyzed by local assessors. For each valuation parameter, a median and appropriate range of potential values are provided.

If the assessor stays within these valuation parameters, the whole system is applied fairly and consistently (i.e., the results of any strip commercial property analysis is validated within certain parameters).

The process also requires an assessor to give a reason for applying a different parameter. In this way, the process incorporates flexibility and accountability.

### Check Against Sales Values

To ensure that the assessment values developed are in line with the market, the assessor should check them against any sales. Sales have inferences for the values of similar properties. A level of comfort can be developed about the assessment values on a dollar per rental unit measure.

### Data Filters

Another way to ensure consistent and reliable results is to place data filters on the input. For example, rent for class 2 strip commercial properties must fall between \$3.00 and \$10.00 per square foot.

## ***5.0 Example of Strip Commercial Valuation***

The following example of a strip commercial market value analysis is set up on a three-page spreadsheet. Values and pertinent data are entered in the blank (white) cells. All shaded cells are either formulas or “look-up” cells and should not be over-written.

### **Form SC1 – Strip Commercial Data Entry**

On this form, the assessor enters all the pertinent physical and descriptive data about the subject property. The data entered on this worksheet is carried forward to Forms SC2 and SC3 as required.

### **Form SC2 – Strip Commercial Income Analysis and Gross Income Multiplier**

The second form analyzes the actual and typical rents and income for a property.

In addition, a section of the form analyzes value based upon a Gross Income Multiplier, if available.

### **Form SC3 – Strip Commercial Expense Analysis and Value Summary**

In the third form, the assessor enters the actual and typical expenses for that class of strip commercial property and the valuation parameters used in determining the final value of the property. Given this information, the spreadsheet calculates the appropriate market value for the property.

## Form SC1 – Strip Commercial Data Entry Form

LINE				
1.1	<b>Address</b>	1104 12th St SW	<b>Value Date</b>	1-Jul-97
1.2	Municipality	Edmonton	Property Class	2
1.3	Roll #	123789	Measurements in:	Feet
<b>Building Data</b>		<b>Property Details - Rentable Areas</b>		
1.4	Year built	1983	<b>Ground Floor Uses</b>	<b>No. of units</b>
1.5	Renovations	No	<b>Total Area: sq.ft.</b>	
1.6	Number of storefronts	4	Corner Location	1
1.7	Number of floors	2	Inferior Storefront	
1.8	On-site parking spaces	0	Standard Storefront	3
1.9	Municipal parking (y/n)	Yes	Superior Storefront	
1.10	<b>Inspection Notes</b>		<b>Upper Floor Uses</b>	
1.11	Inspection date	12-May-96	Retail	
1.12	Condition (Fair, Avg, Good)	Avg	Office	
1.13	Location (Fair, Avg, Good)	Avg	Bachelor Apartment	
1.14	Quality (Fair, Avg, Good)	Avg	1 Bedroom Apartment	4
1.15	Rental appeal	Avg	2 Bedroom Apartment	
1.16	Tenant type	General retail	<b>Other</b>	
1.17	Food, pharmacy and 2 clothing stores		Basement	1
			Other:	0
			<b>Total Rentable Area</b>	
				<b>9,200.0</b>
1.18	Location comment	Near centre of town, numerous hotels nearby		
1.19	Site comment	Level & landscaped		
1.20	Other comment			
1.21	<b>Sale Data</b>			
1.22	Sales price	\$396,000	Real estate price @ 100% interest	\$396,000
1.23	Sales date		Financing	
1.24	Instrument number		Effect of financing (+/- %)	0.0%
1.25	Interests transferred	100.0%	Final price @ market financing	\$396,000
1.26	Value of chattels & bus.	\$0	Market Sale ? (yes/no):	yes
1.27	Vendor name			
1.28	Vendor address			
1.29	Purchaser name			
1.30	Purchaser address			



## Form SC3 – Strip Commercial Expense Analysis and Value Summary

LINE			Class Statistics		
	Address	1104 12th St SW		Class	2
	Roll #	123789		No. in class	42
3.1	Value Date	1-Jul-97			
	<b>Effective Gross Income</b>	<b>\$100,366</b>			
	<b>Expenses</b>	<i>Actual</i>	<i>% of EGI</i>	<b>Typical % of EGI</b>	
3.2	Utilities	\$7,060	7.0%	7.5%	
3.3	Administration/ Management	\$9,850	9.8%	10.0%	
3.4	Operating	\$6,122	6.1%	6.5%	
3.5	Other	\$2,840	2.8%	2.5%	
	<b>Sub-Total</b>	<b>\$25,872</b>	<b>25.8%</b>	<b>26.5%</b>	
3.6	Property Taxes	\$12,850	12.8%	13.9%	
3.7	<b>Discrepancy Allowance Range</b>		5.0%		
	Difference between Actual and Typical Expense Rate used in calculation		-2.64%	Use Actual ONLY if within allowable range	
			<b>25.8%</b>	Use Typical if Actual not within allowable range	
	<b>Net Operating Income</b>	<b>\$74,472</b>			
	<b>Value by Direct Capitalization of NOI</b>				
3.8	<b>Net Income</b>	\$74,472		<b>Capitalization Rate Class 2</b>	
3.9	Cap Rate	14.70%		Base Cap Rate	11.60%
	<b>Value Estimate</b>	<b>\$506,612</b>		Effective Tax Rate	3.10%
3.10	Other Value	\$0		<b>Overall Cap (OAC)</b>	<b>14.70%</b>
	<b>Final Market Value</b>	<b>\$507,000</b>			