Valuation Impact

A lender's criteria for valuing a commercial property are different from those for a residential property. With a commercial property the lender wants to assess how viable the commercial investment is likely to be. Cash flow is an important criterion as the lender will look at the borrower's projected cash flow to be sure that income from rent will cover the costs of repaying the loan and managing the property as well as returning some profit.

Valuers consider data on rental yields achieved over the last 12 months as well as comparable data on sales in the area and the quality of the area/suburb itself (such as type of properties for sale, the number of vacant properties in the vicinity, industry types).

In addition to these, services (like on-site parking, transport, proximity to shops), current lease terms and tenant history contribute to the valuation.

Essentially, there are three ways to value a commercial property:

Direct Comparison Approach

The **direct comparison approach** uses the recent sale details of similar properties (similar in size, location and if possible, tenants) as comparables. This method is quite common, and is often used in combination with the Income Approach.

Cost Approach

The **cost approach**, also called the replacement cost approach, is not as common. And it's just what it sounds like, determining a value for what it would cost to replace the property.

Income Approach

This is the most common way of valuing commercial real estate. There are two commonly used income approaches to value a property.

The simpler way is the **capitalisation rate method**. *Capitalisation Rate, more commonly called the "Cap Rate", is a ratio, usually expressed in a percent, that is calculated by dividing the Net Operating Income into the Price of the Property*. The cap rate method of valuing a property is where you determine what is a reasonable cap rate for the subject property (by looking at other property sales), then dividing that rate into the NOI for the property (*NOI is The Net Operating Income. It's equal to income minus vacancy minus operating expenses*). Or, you could figure out the asking cap rate of the property by dividing the NOI by the asking price.

- **Net operating income (NOI).** This is all the income from the property minus the expenses. However, this doesn't include the payment of the mortgage or loans on the property and non-recurring Capital Expenses and Reserves.
- **Capitalisation rate or 'cap rates'.** This is the estimation of the value of the business, or the profitability of a property. Cap rates are also used to compare properties that you may have recently sold.

Where this gets tricky is when properties are vacant, or where the leases are set to expire in the upcoming year. This is often when you are forced to make some assumptions.

The other income method is the DCF method, or the **Discounted Cash Flow method**. The DCF method is often used in valuing large properties like downtown office buildings or property portfolios. It’s not simple, and it’s a bit subjective. Multiple year cash flow projections, assumptions about lease rates and property improvements and expense projections are used to calculate what the property is worth today. Basically, you figure out all of the cash that will be paid out and all of the cash that will be brought in on a monthly basis over a specific period of time (usually the time you plan to hold the building for). Then you determine what those future cashflows are worth today. There are computer software programs that help with these types of valuations because there are many variables and many calculations involved.