SAMA
Saskatchewan Assessment Management Agency

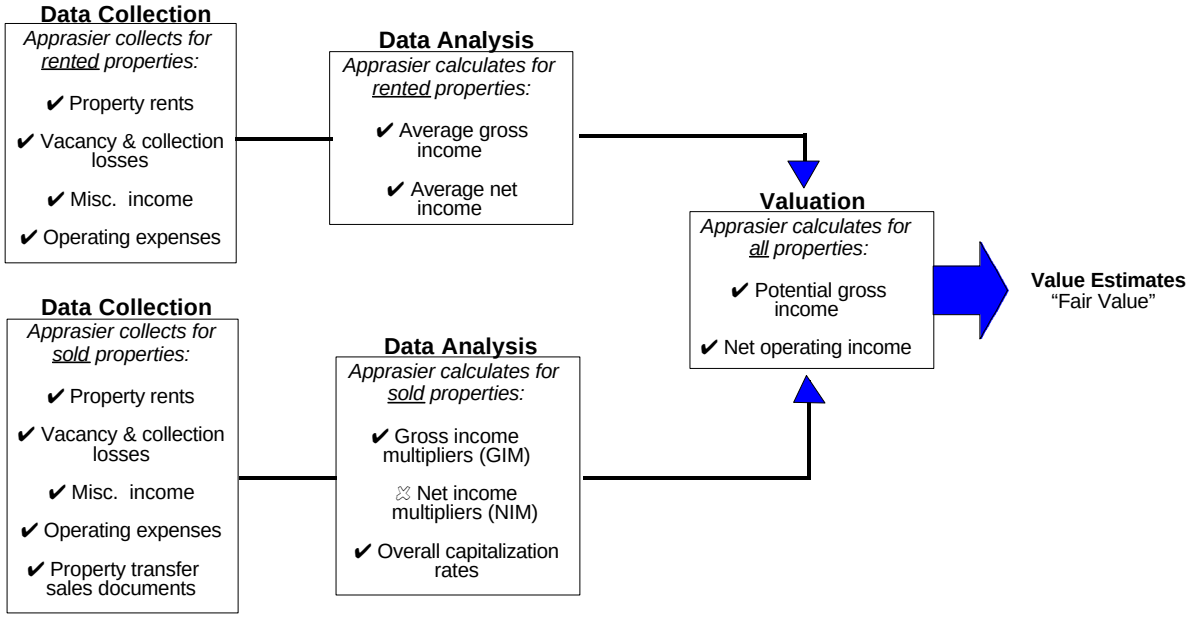
What is the Income Approach?

The *income approach* to value is one of three methods used by appraisers to value real estate (real property). The other two methods of valuation are the *cost approach* and the *sales comparison approach*. Each of the three approaches have specific application to different types of property. The income approach is a common method for valuing commercial real estate.

In general, the income approach is the preferred valuation method for commercial real estate when reliable property rents and operating expenses are available. Sales data is also required to develop income multipliers and overall capitalization rates.

Rental income and operating expenses attributable to the operation of the property itself are used for the income approach to value. Income or expenses associated with the operation of a business conducted on the premises are not relevant or needed for the valuation of the real estate.

The income approach is currently being considered for the assessment valuation of commercial property in Saskatchewan. The income approach is not being considered for the valuation of agricultural land.



What information does the appraiser collect?

The success of the income approach depends largely on the availability of adequate property rents, operating expense and sales data. Vacancy and collection loss data and miscellaneous income data are also relevant information. While complete data is not required for each individual property, there must be sufficient data to develop typical unit rents, typical vacancy and collection loss ratios, and typical expense ratios for various types of properties.

The data collected for rented properties includes:

- *unit rents* (the amount for which a property can reasonably be expected to rent or lease under current market conditions and typical management),
- *vacancy and collection losses* (typical vacancy rates and collection losses under current market conditions and typical management),
- *miscellaneous income* (income from concessions, laundry rooms, parking, recreational facilities, etc.), and
- *operating expenses* (expenses under typical management to operate and maintain the property and to provide for replacements).

The same *unit rent*, *vacancy and collection loss*, *miscellaneous income*, and *operating expense* data is collected for all rented properties that have sold, along with the *sale price* for the property.

How does the appraiser use the rental income, operating expense and sales data?

The income and expense figures used in the income approach must reflect current market conditions and typical management. Actual figures may only be used if they meet this criterion. If actual figures are not available or appear unrepresentative, typical figures must be used.

There are two general approaches to developing typical income and expenses in a mass appraisal context. The first approach is stratification into neighbourhoods, where the average of all available data for the neighbourhood is used to calculate typical unit rents, vacancy and collection loss ratios, and expense ratios. The second approach is to use multiple regression analysis (MRA), whereby typical unit rents, vacancy and collection loss ratios, and expense ratios are estimated as a function of such variables as construction quality, age, location, size of building, and other relevant factors.

The information for rented properties is used to calculate *average gross incomes* and *average net incomes* for the rented properties. A property's gross income is the total rent for the property, less typical vacancy and collection losses, plus any miscellaneous income. A property's net income is the gross income less typical operating expenses.

The information for those rented properties that have sold is used along with the sale price of the property to calculate *gross income multipliers (GIM)* and *overall capitalization rates*. A gross income multiplier is determined by dividing the sale price by the gross income for each commercial property sale. An overall capitalization rate is determined by dividing the net income by the sale price for each commercial property sale. *Net income multipliers* are sometimes used; they are determined by dividing the sale price by the net income.

How does the appraiser value commercial property by the income approach?

The appraiser builds a valuation model that starts with the neighbourhood analysis to identify commercial properties within the same market. The valuation model allows the appraiser to value all comparable properties, even those that have not sold or are not rented. The appraiser may develop either a *gross income model* or a *net income model* from the data that has been collected and already analyzed.

Using the gross income model, the appraiser estimates the *potential gross income* for each property as if it were rented. The potential gross income is derived from the *average gross income* that has been calculated for comparable commercial properties that are rented. Each commercial property is then valued by multiplying the potential gross income by the *gross income multiplier* that was previously derived from the analysis of comparable commercial properties that were both rented and sold. This value estimate becomes the *fair value* for the property.

Using the *net income* model, the appraiser estimates the *net operating income* for each property as if it were rented. The net operating income is derived from the *average net income* that has been calculated for comparable commercial properties that are rented. Each commercial property is then valued by dividing the estimated net operating income by the *overall capitalization rate* that was previously derived from the analysis of comparable commercial properties that were both rented and sold. This value estimate becomes the *fair value* for the property.

The gross income model and net income model are best suited to mass appraisal. Other applications of the income approach are less well-suited to the mass appraisal process. These techniques include discounted cash flow analysis; mortgage-equity analysis; and building residual, land residual and property residual techniques. However, there may be circumstances, such as the appraisal of large investment properties, where the use of these approaches is appropriate.

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