BBA
THE BANKRUPTCY BAR ASSOCIATION
Southern District of Florida

The *BBA Journal* is published once per year for the price of membership by the Bankruptcy Bar Association of the Southern District of Florida, 7154 N. University Dr., #299, Tamarac, FL 33321, Phone (305) 891-5080, Fax (954) 726-3492, www.bbasdfl.org.

Investors, Users, Cap Rates, and the Income Approach to Commercial Real Estate Valuation

By Matthew Rotolante

The world is awash with capital. It is global and digital. Significant amounts are transferred in a matter of seconds each day. Like weather shifting in the atmosphere, this capital moves in measurable and often predictable ways into various asset classes. As with lightning, tornadoes, and hurricanes, however, these flows can also be fickle and unpredictable, as we have witnessed in the recent recession. The goal, then, is to improve the predictability of these cash flows by creating models that enable us to value the underlying assets in an optimal fashion, and to thereby enable investors and businesses alike to make decisions in a timely and reliable manner. It is the model for valuing commercial real estate on which I focus in this article.

> "In essence, appraisals are necessary to determine value, but when combined with the testimony of a credible broker, a more accurate valuation may be obtained. This is especially important when attempting to prove the legitimacy of a reorganization plan, or deciding whether a 363 sale strategy is feasible."

Methodology

The methodology for calculating the value of commercial real estate is complex and comprises myriad variables. Commercial real estate often competes against stocks and commodities for capital, but there are several large differences between them. While stocks and commodities are standardized contracts that trade more often and have options and future derivatives so that pricing is transparent at any given moment in time, commercial real estate is non-standardized and trades less often. Therefore, the pricing of commercial real estate can be more difficult to verify. I will make the case that if certain methodologies are used, commercial real estate can be priced quite accurately.

Similar to stocks and commodities, commercial real estate is subject to supply and demand. Early in my career I worked on the Chicago Board of Trade (CBOT) Commodities Floor, so I speak from experience when I tell you that many stocks and commodities have supply and demand factors that change drastically over short periods of time which result in large shifts of pricing overnight—or even during the same day. Conversely, many of the supply and demand variables in commercial real estate can be forecasted over longer timelines, and change less often and to a lesser degree. Therefore, the pricing of commercial real estate tends to shift more slowly.

Continued on page 13

ABOUT THE AUTHOR
Matthew Rotolante is Managing Director for the Miami office of Sperry Van Ness International. He is a fourth generation Miami native with an MBA from the University of Miami, and holds the commercial real estate designations of CCIM and SIOR. Email: Matt@SVNSouth.com.

Investors, Users, Cap Rates, and the Income Approach to Commercial Real Estate Valuation

Continued from page 3

APPLICATION

To begin to understand the true value of commercial real estate, one must understand the dynamics behind supply and demand. At the core of this dynamic is the existing NOI (Net Operating Income) or the potential NOI that the property will provide. In the same way that stocks and companies are valued based on their EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization), commercial real estate relies on NOI for valuation. Commercial properties with long-term leases containing fixed terms have NOI that is very predictable. These properties are typically the most reliable and standardized assets among commercial real estate. They trade similar to bonds, and are often called "Coupon Clippers." However, not all properties have long-term, stable leases, and this is where commercial estate valuation gets tricky. It is not simply the property's current NOI that affects its value, but rather what the market believes will happen to this NOI in the future. Even if there is a long-term lease in place with fixed terms, the lessee may go bankrupt and reject the lease as part of its reorganization plan. It may also choose to cram down the lease if the market allows it to do so. In some cases, a zoning law change or simply the path of progress will provide the opportunity for redevelopment to the highest and best use, which will in turn generate a higher exit sale strategy, such as with a condo tower, or potentially an alternative use as we saw with Merrick Park in Coral Gables converting from industrial use to high-end, retail mixed-use. In some cases, redevelopment is not even necessary in order to capitalize on a higher NOI,and one simply needs to find a new tenant that can make more money in the specified location and therefore pay more rent.

The use of the NOI to derive value involves one other variable, which is the Capitalization Rate or "Cap Rate." Different asset classes involve different risks and therefore two properties with the same NOI will likely trade at different prices based on the Cap Rate investors will apply to the property. The Cap Rate calculation is the inverse of the Price/Earnings ratio many investors monitor when dealing with stocks. Earnings are the equivalent of NOI. Instead of Price/Earnings, it is Earnings/Price or NOI/Price. Cap rates tend to vary by geography and the type of asset. The highest quality assets in core markets with the most upside and/or the least amount of risk will trade at lower cap rates, and vice versa for assets that are located in non-core markets which may have less upside and/or carry more risk.

THE TROUBLE WITH APPRAISALS

The most difficult factor in commercial real estate is that no property is exactly like another, so the potential NOI can be a moving target. Every property stands on its own two feet. For this reason, appraisers are often employed to derive value for tax and legal purposes. While appraisers will use comparable sales, cap rates, and rental rate trends to value the property, these factors are typically backward-looking. Highest and best use is something that appraisers often cannot accurately include in their report, if only because they are not working with the current buyers in the market who may be setting new trends. Appraisers may not always account for the possibility of variances and/or public hearings to change the zoning laws to allow for larger development or alternative uses. They also may not be aware of new tenants in the market that can pay higher rates, or existing users that are willing to pay more for the real estate.

Regardless, appraisals play a very necessary role in and lie at the heart of the value discovery phase in a SARE (Single Asset Real Estate) bankruptcy case. They facilitate a push and pull process with each side attempting to provide expert witnesses and data that allow them to anchor value in a manner that will support their respective positions. Strategies vary and can include a 363 sale, cramdown, reorganization, relief from stay, and more. The stakes can be high and will often hinge on the ultimate value assigned to the asset and/or the legitimacy of plans to increase that asset's value, so it is often worthwhile to leverage as much expertise as possible to support the correct value. As part of an appraiser's research and in order to verify the data and ensure an arms-length transaction, appraisers will spend a large amount of time calling the commercial real estate brokers who sold or leased the properties referenced in their reports. In such a case, an active, veteran commercial broker will be more in tune with the value of a property than an appraiser, and also will be more aware of the inherent variables that affect that value. This is not to say that a commercial real estate broker will always know the exact value, but rather that that broker receives empirical feedback daily on active listings and is on the front end of the market and can therefore more accurately read the pulse of the market. In essence, appraisals are necessary to determine value, but when combined with the testimony of a credible broker, a more accurate valuation may be obtained. This is especially important when attempting to prove the legitimacy of a reorganization plan, or deciding whether a 363 sale strategy is feasible.

ACTIVE LISTINGS AS A TOOL

The truth of the matter is that an active listing itself is the ultimate test of true value. The FDIC has guidelines in place for assets in receivership, also known as "Loss Share Banks." FDIC guidelines recommend the use of an experienced and knowledgeable broker for every REO property, and that reductions in price only take place after a certain amount of time has passed, in most cases three months. Simply listing a property, however, does not guarantee results. In order to ensure that this live testing of the market is truly indicative of value, the bankruptcy estate must hire a commercial real estate broker who employs methodologies that consider all possible uses, and perhaps most importantly, who helps ensure that every possible purchasing group has the opportunity to review the

Continued on page 14

Investors, Users, Cap Rates, and the Income Approach to Commercial Real Estate Valuation

Continued from page 13

property. While it may appear to be common sense that a broker should enlist the entire market, including other brokers, to sell the property, one must consider the human motives inherent in such a process in the same way that a creditor must consider the motives of the debtor and vice versa. As the price of a property falls below the market value, the pool of buyers increases significantly. In many cases, if a property is priced below market value, the broker will not need to spend any money marketing the property, and neither will that broker need to solicit cooperating brokers to bring their customers to the table and thus be forced to split the commission. One must also consider that in such a case the property will sell faster.

So in fact, we see that brokers are often incentivized to manipulate a price to be lower than market value in order to save on marketing fees, to pocket both sides of the commission, and to spend less time on the property. Of course, a good and ethical broker will rise above such tactics and take the time to add value to the asset through creative property management techniques that will lower expenses, while at the same time bringing tenants to lease up the property. If capital expenditures, such as tenant improvements, must be made to implement these strategies, then each instance must be measured on its own merits based on a present value analysis. A good commercial broker, such as those with the CCIM (Certified Commercial Investment Member) designation, can advise on the benefits and disadvantages with a break-even analysis of such an expenditure on a present value basis using IRR (Internal Rates of Return) and NPV (Net Present Value). Both the reduction of expenses and the increase in rental income will enhance NOI in the short term. This increase can then be leveraged at the market capitalization rate for that specific asset class, thus exponentially increasing the value for the bankruptcy estate.

A REAL-LIFE EXAMPLE

An example of such a scenario might be spending $90,000 in tenant improvements to land a good credit tenant in a retail center who will sign a 5-year net lease (expenses paid by tenant) with a total value of $720,000, or $144,000 per year for a 6,000 sq. ft. retail space at a rate of $24/ft2. If we assume the cap rate of comparable retail space is 8.5%, then we can calculate that the increased income of $144,000 per year will yield an increase in price of the asset by $1,694,117 ($144,000/8.5% = $1,694,117). Therefore, the $90,000 spent to attract this tenant results in a return of over 1,800% to the bankruptcy estate when the property is sold—a tidy profit, to say the least. Not all scenarios are so easily calculated or so handsomely profitable, but you get the idea.

ADDITIONAL CONSIDERATIONS

As a final note, many properties in bankruptcy are owner-operated. While there is always capital readily available to purchase income property that is occupied, owner-operated vacant properties such as manufacturing facilities can be more problematic to sell. An investor who is willing to purchase a vacant, single-tenant property will often pay less, because the investor is discounting for the lease up period, the tenant improvements, and the risk associated with owning such a property. On average, there can be up to a 20-30% premium in the value that a user can afford to pay above and beyond that of an investor. In addition to the discounts previously mentioned, this 20-30% premium is due to what I call the "Five Pillars of a User Purchase Decision." These five pillars are (1) Interest Deduction on the Mortgage, (2) Depreciation (which can include accelerated depreciation), (3) Paying down the Principal, (4) Appreciation of the Asset, and (5) the ability to employ subsidized financing by the Small Business Administration. Often, a bankruptcy estate sale is not willing to entertain such financing, but the small business loan program allows qualifying participants to purchase a property with as little as a 10% down payment with fixed terms as long as 10 years, and at a very competitive rate. This possibility may drive up the value of a property significantly. In addition, the underwriter will look to the EBITDA and cash flow of the company to service the debt, and so as long as the property appraises, the deal can be struck at an even higher price than what market rents might support. It is plausible, then, that a bankruptcy estate might receive subsidies on both sides of a 363 sale with a cramdown on the existing SBA loan and a higher value provided by the financing of a new SBA loan.

FINAL REMARKS

The key in all cases is finding the right user or investor for the property. A user who can purchase "off the rack" as if the property is tailored to fit that user's operations will often pay more than another user who must make significant improvements to the property. An investor who is willing to pay today for the pro forma of higher cash flows in the future will often pay more than an investor who is only willing to pay for current cash flows. A broker who is familiar with the property's market and already knows the users and investors in the community will be instrumental in assuring that the maximum value is obtained for the bankruptcy estate. ■