Unit 13 Outline

**Learning Objectives**

Study of this unit should enable the student to

* identify the principle that is fundamental to the income capitalization approach;
* define gross income and potential gross income;
* compare and contrast market rent, scheduled rent, and historical rent;
* define effective gross income and net operating income;
* calculate vacancy and collection loss;
* classify operating expenses as variable expenses, fixed expenses, or reserves for replacement;
* distinguish expenses for accounting purposes from expenses for appraisal purposes;
* reconstruct an operating statement;
* develop a GRM (or GIM) and opinion of value for a subject property;
* complete the Income section of the URAR form; and
* derive an operating expense ratio, net income ratio, and break-even ratio.

**Unit Outline**

I. Overview

II. The Income-Based Approaches to Appraisal

A. Income Capitalization and the Principle of Anticipation

1. Income capitalization approach—the appraiser estimates the market value of property based on its anticipated income

2. Gross income/rent multiplier—the appraiser compares rents (and other income, if any) of similar properties with their selling prices to arrive at a determination of value for the subject property

III. Potential Gross Income—total potential income from all sources during a specific period of time, usually a year

A. Rent—major source of income from most investments in real estate

1. Market rent (also called economic rent)—estimate of a property's rent potential

2. Scheduled rent (also called contract rent)—rent currently being paid by agreement between tenant and landlord

3. Historical rent—scheduled rent paid in past years

## Exercise 13-1

B. Outside Economic Factors—national, regional, and local factors also may have to be analyzed in deriving market rent

C. Other Income—non-real estate income, such as income from vending machines, laundry services and parking

## Exercise 13-2

IV. Effective Gross Income—estimated gross income reduced by percentage of market rent that will probably be lost due to vacancies and/or collection losses

## Exercise 13-3

V. Net Operating Income (NOI)—effective gross income less operating expenses

A. Classification of Operating Expenses

1. Variable expenses—out-of-pocket costs incurred for wages, repairs and other items

2. Fixed expenses—more or less permanent costs that do not vary according to occupancy, such as real estate taxes

3. Reserves for replacement—allowances set up for building and equipment items with relatively short life expectancy

B. Expenses for Accounting Purposes versus Expenses for Appraisal Purposes—expenses to the owner that are not operating expenses of real estate

1. Financing costs

2. Income tax payments

3. Depreciation charges on buildings or other improvements

4. Capital improvements

C. Reconstructing the Operating Statement (Figure 13.1)—eliminating inapplicable expenses and adjusting the remaining valid expenses, if necessary

 1. The operating statement can be prepared using either

 a. Cash basis accounting—revenue recorded when received;

 expenses recorded when paid

b. Accrual basis accounting—revenue recorded for period whether or not it has been received during period; expenses recorded for period whether or not they have been paid during period

## Exercise 13-4

VI. Operating Statement Ratios—show the effect on value of varying expense levels in relation to income

A. Operating expense ratio—ratio of total operating expenses to effective gross income—formula: operating expenses divided by effective gross income equal operating expense ratio

B. Net income ratio—ratio of net operating income to effective gross income—formula: net operating income divided by effective gross income equals net income ratio

C. Breakeven ratio—ratio of operating expenses plus the property's annual debt service to potential gross income—formula: operating expenses plus debt service divided by potential gross income equals break-even ratio

## Exercise 13-5

D. Gross income multiplier (also called potential gross income multiplier) and gross rent multiplier—substitute for a more elaborate income capitalization analysis

 1. Each relates the sales price of a property to its rental income

 2. Effective gross income multiplier results when vacancy and collection losses

 are deducted from gross income before multiplier is derived

**Exercise 13-6**

E. Applying the GRM to residential properties—sales price divided by gross rent equals GRM

 1. Estimate the subject property’s monthly market rent

2. Calculate gross rent multipliers from recently sold comparable properties that were rented at the time of sale

3. Based on rent multiplier analysis, derive the appropriate GRM for the subject property

4. Form an opinion of market value by multiplying the amount of the monthly market rent by the subject property’s GRM

 F. Income approach using the URAR form—Figure 13.2

1. Enter subject property’s monthly market rent estimate derived from marketplace

 2. Enter GRM applicable to subject

 3. Multiply monthly market rent estimate by GRM, and

 4. Enter value opinion indicated by income approach

## Summary

## Review Questions