Private Money Lender Joffrey Long: Shortcut to Commercial Values

How is commercial property valued?   Here's an easy formula to use.

Joffrey Long

NEWPORT BEACH, CALIFORNIA, UNITED STATES OF AMERICA, February 21, 2023 /EINPresswire.com/ -- Commercial real estate: How is it valued?   How can a rough estimate be made?

And what about CAP RATES or CAPITALIZATION RATES ?   What's that all about?

Here's a short version of the formula used by California private money real estate lenders when making loans:

Let's look at a six-unit apt building. It falls into the 5 or more unit category, so it's a commercial loan. The rents from the six units are 2,500 each, so a total monthly income of 15,000, or a total annual income of $180,000 per year. This is called the gross income.

Next step: Operating expenses. Those are the expenses, like taxes, insurance, maintenance, utilities and other expenses necessary to maintain the usability and value of the property.

> "When someone buys a commercial property, they're really buying a stream of income - that's how the value is calculated."
>
> *Joffrey Long*

Two side notes on operating expenses:

One: When calculating commercial values, only the BUILDING's operating expenses are included - not any mortgage payments. For this part, calculating the value of commercial property, mortgage payments are LEFT OUT. They are considered later on, but aren't part of the value.

How does anyone know the operating expenses?   It's necessary to ask the owner, the property manager, or the real estate broker, if there's one involved. Sometimes, it's necessary to estimate.

For our six-unit building, the operating expenses, all the taxes, insurance, maintenance, management, utilities, and other costs total $80,000 per year.

Now, the FIRST TWO STEPS are complete: gross income and operating expenses.

Ready for the next step? NET OPERATING INCOME. A lot of times, people use the term NOI – that stands for net operating income. NOI is simple math. It's the operating income just mentioned, 100,000, minus the expenses of $80,000, which equals an NOI of 100,000. 100,000 is the Net Operating Income.

That NOI of 100,000 per year is the STREAM OF INCOME that was mentioned. People buying a commercial property are buying that STREAM OF INCOME. The benefit of owning the building is being able to collect that stream of net operating income, or the 100,000 per year.

Take a deep breath here and let this sink in, maybe write it down. That stream of income and the return it represents on a certain value or price, is the main factor in how commercial property is valued.

Remember NOT to include/subtract any mortgage payments here. NOI, Cap Rates, and Value are determined without figuring mortgage payments. Any loan payments are considered only when relating the building to a specific buyer's purchase or ownership.

Whew! That's already a lot. Three big steps; gross income, operating expenses, and now, net operating income.

Let's look at the CAP RATE.

Capitalization rates are the rates of return, or how much of a return that NET OPERATING INCOME gives the owner or buyer on the sales price or value of the building. This means, if the NOI is 100,000 and someone says the building is worth 2,000,000, one would take the NOI of 100,000, divide it by 2,000,000, and it gives a figure of .05, or a cap rate of 5%.

Or, say the NOI is 100,000 and the CAP RATE for that type of building should be 6%. To get the value, the 100,000 is divided by .06, giving a property value of 1,666,667.

If the cap rate was only 4%, then the 100,000 NOI would be divided by .04, providing a value of 2,500,000.

Now it's clear that HIGHER cap rates mean LOWER values for a property, LOWER cap rates mean HIGHER values for the property. The net operating income is just divided by the value or proposed sales price, providing the cap rate. Or, if the NOI is 100,000 and a cap rate of 5% is being used, then divide the 100,000 by .05 and it provides a value of $2,000,000.

Where do these cap rates come from? Who decides what the cap rate should be?

Cap rates are a market factor. They change based on changes in interest rates, real estate markets, and vary from property to property and area to area. It helps to invest even a small amount of time, looking at commercial property listings and speaking with lenders or others who are familiar with commercial and cap rates. Following the commercial real estate and lending markets help provide an idea about cap rates and general commercial trends.

Now, we've covered the four basic items to figure out: The gross income, the operating expenses, the Net Operating Income, and the CAP Rate. This can be used to get a basic idea of property values, or at least what the cap rates are on specific properties, based on the available circumstances and individuals involved.

Let’s sum it up by talking about how this works:

There's an inquiry about a commercial property or commercial loan request. First, what is the gross income? Next, find out the operating expenses. Now, net operating income can be calculated. Last, the cap rate or value can be determined, using the information we covered.

These are some easy-to-use tools to work with and get a basic understanding of Cap Rates and valuing commercial real estate. For those working on private money commercial real estate loans, it provides the right questions to ask when working with commercial properties or loans. Knowing about the value and net operating income helps answer the most common question, "how much is the down payment for a commercial loan?"

Note: The author of the article is not an appraiser, so consult with licensed appraisers to determine value. This is just to provide a general idea, not specific values. Don't rely on this to make decisions about real property. Nothing in this article may be considered as any industry standard, generally accepted practice, or standard of care in lending, brokerage, or other aspects of real estate or lending.

Joffrey Long
Southwest Bancorp
+1 818-635-1777
info@asksw.com