A New Income Approach for Today's Distressed Properties

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One of the benefits of being in the real estate consulting business for the past 40 years is that "been there and done that." Well here we go again- it's time to bring out the old appraisal tools we used in the last down-cycle.

So how do we handle the current situation; where net operating income has plummeted, the cost of capital is through the roof or not available, but most investors believe commercial real estate market will be back to "normal"- two to three years from now? No matter what type of DCF technique you use- it isn't fair to penalize the property's value by discounting the 10-year net operating income projection using a discount rate based on the current high cost of capital.

The Solution

The solution, as always, comes down to- "look at the market." How will a typical buyer analyze a potential real estate investment at this point in time- i.e. what is the projection of net operating income, where will the acquisition capital come from and what will it cost? Based on previous cycles- this is what often happens:

-The projection of net operating income starts with the current depressed NOI and models a recovery. Depending on the local market, the type of asset and other factors- the recovery back to 2019 levels will probably be 1 to 3 years from now.

-The initial acquisition capital will probably come from a variety of sources which also depend on the local market and type of asset.

-Debt capital will cost significantly more than it did at the end of 2019. Interest rates will be higher and Loan-to-value ratios will be much lower. Amortization rates will be much shorter.

-Equity capital might also cost more because of the reduced leverage. In some cases, the initial acquisition might be all-cash.

-Terminal capitalization rates, however, will probably remain the same since they are not a factor for 10-years when hopefully everything has recovered.

-The big change to the acquisition analysis is the addition of a Refinancing Event. Most investors buying commercial real estate today, with the high cost of capital, will structure their investment to include a refinancing that will take place after the market returns to normal. Again, depending on the local market and type of asset- this will probably occur 2 to 3 years from now.

Case Study Example

The only way to accurately include such a refinancing event into the Income Approach is to use Mortgage-Equity Appraisal Software with Refinancing model. Let's see what this looks like with a short example.

A commercial piece of real estate was heavily impacted by COVID-19. During 2019, its Net Operating Income was $1,000,000, but today it is much lower. A typical investor looking to acquire this property today would project the NOI to slowly recover over the next four years reaching its 2019 level in 2023. An NOI recovery might look like this:

2020-	$250,000
2021-	$500,000
2022-	$750,000
2023-	$1,000,000

After reaching the 2023 stabilized level of $1,000,000 the NOI is projected to increase at a 3% annual inflation rate.

Based on the current depressed Debt and Equity markets- the following is the cost of capital for these two components:

Initial Mortgage:

-Interest	10%
-Loan-to-Value	50%
-Amortization	20 years

Equity:

-Equity Yield	18%

Terminal Rates:

-Capitalization	8%
-Sales Expenses	2%

Using a Mortgage-Equity Appraisal Software with a Refinancing component- along with the projected NOI and the Cost of Capital detailed above, the value today would be $7,707,000. The buyer would then obtain a $3,854,000 mortgage (50%) with an annual debt service of $446,000. Today's value of $7,707,000 equates to a 13% cap rate on 2019 NOI of $1,000,000.

Once the property reaches the $1,000,000 stabilized NOI in 2023, the buyer would refinance the mortgage on the following terms assumed at that point in time:

Refinance Mortgage:

-Interest	5%
-Loan-to-Value	70%
-Amortization	25 years

Using a Mortgage-Equity Appraisal Software with Refinancing- along with the projected NOI starting in 2024 and the cost of capital detailed above, the value would be $13,467,000. The buyer would be able to obtain a $9,427,000 mortgage (70%) with an annual debt service of $661,000.

The value of $13,467,000 equates to a 7.4% cap rate on the stabilized NOI of $1,000,000

The Mortgage-Equity Appraisal Model performs a discounted cash flow valuation based on the projected 10-year NOI, the initial financing terms and debt service, the refinancing terms including the refinancing proceeds and new debt service, terminal value, equity residual and equity yield.

This results in a current Market Value of $9,289,000 which is a 10.7% cap rate on 2019 NOI.

The following table shows the annual cash flows and overall IRR to each component.

	Value	IRR
Total Property	$ 9,289	12.35%
Mortgage Component	$ 3,854	6.31%
Equity Component	$ 5,435	18.00%

Cash Flows	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Total Property	$ 250	$ 500	$ 750	$ 1,000	$ 1,030	$ 1,061	$ 1,093	$ 1,126	$ 1,159	$ 16,260
Mortgage	$ 446	$ 446	$ 446	$ (5,425)	$ 661	$ 661	$ 661	$ 661	$ 661	$ 8,762
Equity	$ (196)	$ 54	$ 304	$ 6,330	$ 369	$ 400	$ 431	$ 464	$ 498	$ 7,498
Ratios										
Debt Coverage Ratio	0.6	1.1	1.7	1.5	1.6	1.6	1.7	1.7	1.8	24.6
Debt Yield	6.5%	13.0%	19.5%	25.9%	26.7%	27.5%	28.4%	29.2%	30.1%	31.0%
Equity Dividend Rate	-3.6%	1.0%	5.6%	116.5%	6.8%	7.4%	7.9%	8.5%	9.2%	9.8%

Notice the Refinancing Event in 2023 with the lender adding more debt capital and the equity investor taking proceeds from the refinancing.

The IRR for the Equity Component of 18% proves the value of the Equity Component.

The IRR for the Mortgage Component is the weight average interest rate of the two financings during the 10-year term.

Conclusion

The Mortgage-Equity Appraisal Software with Refinancing produces a valuation that takes into account current conditions in today's market where NOI is depressed, but will recover, and financing is expensive, but will also improve over the short term. To value the property assuming the expensive financing would continue over the 10-year holding period is not logical and produces a value that a seller would not accept unless it was a "forced sale" which is not Market Value.

Lastly, the Mortgage-Equity Appraisal Software with Refinancing also calculates the overall discount rate for each valuation:

-Initial Value of $7,707,000-	15.1%
-Refinancing Value of $13,467,000-	10.2%
-Market Value of $9,289,000-	12.4%

More Information

For more information on the Mortgage-Equity Appraisal Software with Refinancing- CLICK HERE

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