BUSI 442: LESSON 1

Suggested Answers to Selected Review and Discussion Questions

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1. There are several different types of reserve funds that are used to address repairs and maintenance. These varying types address different components: Reserve Fund "A" addresses major components and is to be used solely for the purpose of major repair, Reserve Fund "B" is to be used for all other repair and replacements other than major items and finally Common Surplus Fund "C" is to be applied against future common expense. These differences are important to note as units in buildings with good maintenance and healthy reserves may trade for a greater sum than a unit in a poorly maintained building with low reserves. In addition, buildings with a healthy Reserve Fund "A" may be more valuable than those with a healthy "B" or "C" fund as major expenses tend to be more costly.

2. Appraisers use stabilized NOI in the income method of appraisal as the basis for the market value estimate. Stabilized NOI may be described as the typical expected annual income.

   The use of stabilized versus non-stabilized NOI becomes an issue when considering repairs and maintenance and capital upgrading. When a single-year NOI is used in capitalization, the exact timing of future capital expenditures for replacement of fixtures is not forecasted. Although the decision is to replace a fixture may be postponed or even repaired in the short run, this cost will eventually be incurred - ignoring this replacement cost will overstate value. One way to address this is by a replacement reserve, where an annual amount is set aside to cover future expenses. This stabilizes the property expenditures, as opposed to dramatic fluctuations in years where capital expenses are required. However, market practice varies with respect to whether or not replacement reserves are deducted. What is most crucial is for the subject property to be analyzed in the same way as comparables used for capitalization rate calculations, so that you are comparing apples to apples.

   Note that this is not an issue in a dynamic discounted cash flow (DCF) analysis because expenses are forecasted and the actual costs recognized in the year in which they occur.

3. The logic underlying the derivation of overall capitalization rate (OCR) is that they are market-derived and the three suggested methods in determining the OCR are:

   Direct Market Comparison - the OCR is found by taking the ratio of stabilized NOI to value in exchange of similar properties recently sold;

   Weighted Average Method - using recent sales, the OCR is broken down into a return to debt and a return to equity (equity dividend rate). The equity dividend rate is then used, together with financing details for the subject property, to determine an overall rate for the subject property; and the

   Summation Method - this method develops a discount rate by taking the risk-free rate prevailing in the market (e.g. the rate on term deposits) and adding to it premiums for the added risk and lack of liquidity associated with a real estate investment.

   In general, the direct market comparison method is the preferred method because it is simple to understand, direct, and accurate.

4. When converting gross income (whether potential (PGI) or effective gross income (EGI)) into a value indication, multipliers can be used. When relying on income multipliers (GIM or EGIM), the properties analyzed must be comparable to the subject property and to one another in terms of physical, locational, and investment characteristics. Properties with similar, or even identical multipliers can have different operating expense ratios and therefore, may not be comparable for valuation purposes. It is important to test the comparability of market data using the operating expense ratio.

   Multipliers are not able to measure a property's income efficiency over another and this is done through NOI ratios (NOI divided by EGI). Some factors affecting NOI include unit mix, physical building efficiencies/super-adequacies, rent controls and where it is evident that purchasers are sensitive to the effects of NOI ratios on GIM/EGIM, adjustments to the multiplier should be undertaken to recognize variances in those NOI ratios.