Determining the Value of Commercial Real Estate

By Dean Willmore

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By far, the biggest challenge I have today (and maybe in my career) is how to determine the value of commercial real estate. This is especially difficult with all of the market turmoil we have recently experienced. As an industrial real estate broker in Las Vegas, I have seen valuation swings for commercial property in Las Vegas increase and decrease by more than 400 percent, in just the past 3 years. Why? Commercial real estate has historically been one of the most stable, long-term investment vehicles available, and typically, has not been susceptible to the rollercoaster highs and lows of the stock market, the bubbles and busts of the commodities and precious metals markets, or the shocks and crashes of bonds and currencies.

So, what factor, or combination of factors, has the most impact on commercial real estate value?

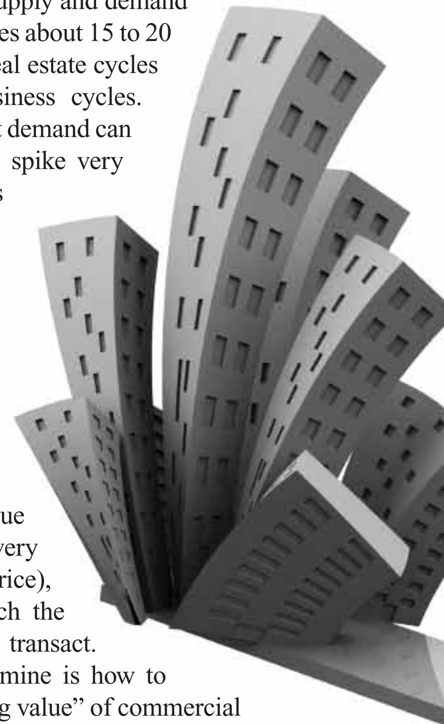
Location, Location, Location

I have been a commercial real estate broker for 30 years and have witnessed several periods of real estate highs and lows. I have brokered during the greatest bull market I believe the commercial real estate industry has ever seen, (from 2004 to 2008), when buyers worked in a feeding frenzy, out-bidding each other (and the purchase price) by hundreds of thousands of dollars, just for the chance to own commercial real estate in Las Vegas.

When I was new to the business, the phrase "location, location, location" was drilled into me by my mentors. I was taught that location was the most important factor in determining real estate value. I still believe that, at the end of the day, a property's location (to transportation arterials, retail services, amenities and roof-tops) is one of the key determining factors (along with its highest and best use) in determining ultimate value and price.

After a few years working in the business, I was sure that interest rates had the biggest impact on commercial real estate valuation. After all, interest rates work in tandem with CAP rates and when interest rates are high, so are CAP rates, which force values down. The reverse is also true (low interest rates), which is why we are still seeing low CAP rates today.

Later on, I believed the single most important factor to commercial real estate appreciation was rent growth. Appraisers use rent (or income) to determine what is known as the "income approach" to value. This rent growth translated into higher sales prices and valuations for commercial real estate. In commercial real estate, rent demand is elastic, meaning that it can change quickly, while rent supply is inelastic, which means it takes a long time to bring new product on line. This supply and demand inelasticity commonly creates about 15 to 20 percent more variation in real estate cycles than in other normal business cycles. Therefore, increasing tenant demand can force rents (and values) to spike very quickly. Rent growth and its partner, operating expense containment, are still considered by many investors as the fundamental method to increase the value of any commercial real estate asset.



Value Defined

We know that market value is a theoretical concept (very distinct from the market price), which is the price at which the buyer and seller can or do transact. What I am trying to determine is how to arrive at the "true underlying value" of commercial real estate. Making this determination can be a bit tricky. For example, the true underlying value is not what appraisers might call the "intrinsic" value, which is a concept most commonly used with land speculation. For instance, what was a citrus grove a few years ago might very well be a booming Regional Mall today. A wise land speculator might be able to spot this intrinsic value, while still a citrus grove.

I am proposing "true underlying value" as a concept that should be invoked in situations like we have today, where there are inefficient markets or disequilibrium situations and prevailing market prices are not reflective of the true underlying, or "real" value. But how do you determine the true underlying value of commercial real estate today?

Factors that Create Value:

Value pertains to the relationship between a thing desired and a potential purchaser. The important word here is *relationship,* meaning that value is not inherent in any object. Value is created by and varies with changes in this relationship.

The four essential factors involved in this relationship and that, when acting together, create value in any object are: 1) Desire, 2) Utility, 3) Scarcity, and 4) Effective Purchasing Power. These factors cannot create value by themselves, but must work in concert for any object to have value.

Credit's Affect of Commercial Real Estate:

Although location, interest rates, rent growth, and CAP rates have a significant impact on commercial real estate valuation, I believe that credit — which creates liquidity — has the biggest impact. What we are seeing today in Las Vegas, and many other markets, provides all the evidence needed to support this conclusion.

We live today in a world of virtual money. Money can go from our employer, to our bank account, to our favorite retailer or restaurant, without ever materializing. Money is no longer a physical commodity and since 1971, no longer metal, but is intangible; it is this virtual money which dominates our money supply. In our electronic age, "nothing" serves as money, too. Like credit, money has become a matter of belief; it is trust-incorporated.

The proliferation of more sophisticated forms of credit in the past 20 years, characterized by such things as hedge funds, collateralized debt obligations, derivatives, and credit default swaps, created an age of easy money and, more than anything else, this liquidity drove the value of commercial real estate through the roof.

TABLE 1
COMMERCIAL REAL ESTATE CREDIT SOURCES

2005	2011 – Present Day
Banks (Aggressive Lending/Limited Regulatory Oversight)	**Banks** (Many Liquidated, Consolidated or Impaired/ Strict Regulatory Oversight)
CMBS (At peak close to 30% of debt market)	**CMBS** (Limited Issuance)
Life Insurance Companies (Active)	**Life Insurance Companies** (Limited)
Hard Money Lenders (Several)	**Hard Money Lenders** (Gone)
Seller Financing (Not Significant)	**Seller Financing** (Becoming more Prevalent)

Imagine if the next time you went to buy a car, the dealer would only accept cash and financial institutions were no longer making auto loans. What do you think would happen to the price of automobiles? How many restaurants, grocery stores, and other businesses would survive on a cash-only basis?

Valuation Today

Today, commercial real estate must still be valued using the three traditional methods: cost, income, and market data approach. When combined, all three are very effective in arriving at the current market value. But properties should be segmented with attention to liquidity and financing issues.

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The real estate industry has been shocked and awed at credit's awesome impact on valuation. Buyers no longer have easy money to purchase real estate, so they can either negotiate the price down, or wait for market conditions (the utility and scarcity of commercial real estate) to change – which, of course, it has. Is it any wonder, then, why industrial buildings, which used to sell for 200 dollars per square-foot in Las Vegas are now selling for 40 or 50 dollars per square-foot?

True Underlying Market Value

Real estate has many unique characteristics; one of which is the ability to be improved upon, or developed. Steel, lumber, concrete, and all the other commodities used to improve real estate have real value. They are desired, useful and scarce. Recently, many appraisal reports abbreviate or entirely delete the cost approach to value. This is unfortunate because recent market comparables of all-cash sales have diluted the perceived value of commercial real estate to the point that it fails to even come close to the replacement cost of the asset. The appraisal term for today's phenomenon when there is too much disparity between the cost approach and the market comparables approach is "external economic obsolescence," which in layman's terms means a really bad market. Today, the cost approach is most often used only for new construction and project renovations. However, during the mid-2000 commercial real estate boom, the cost approach was included in most all commercial real estate appraisal reports, even though the replacement cost was much *less* than the other indicators of value. The cost approach was helpful then because it provided a restraint on appraised value, when market comparables and rents were skyrocketing. By not employing the cost approach today, we create a valuation double-standard (it is okay to use it when the market is good, but not ok when the market is experiencing "external economic obsolescence").

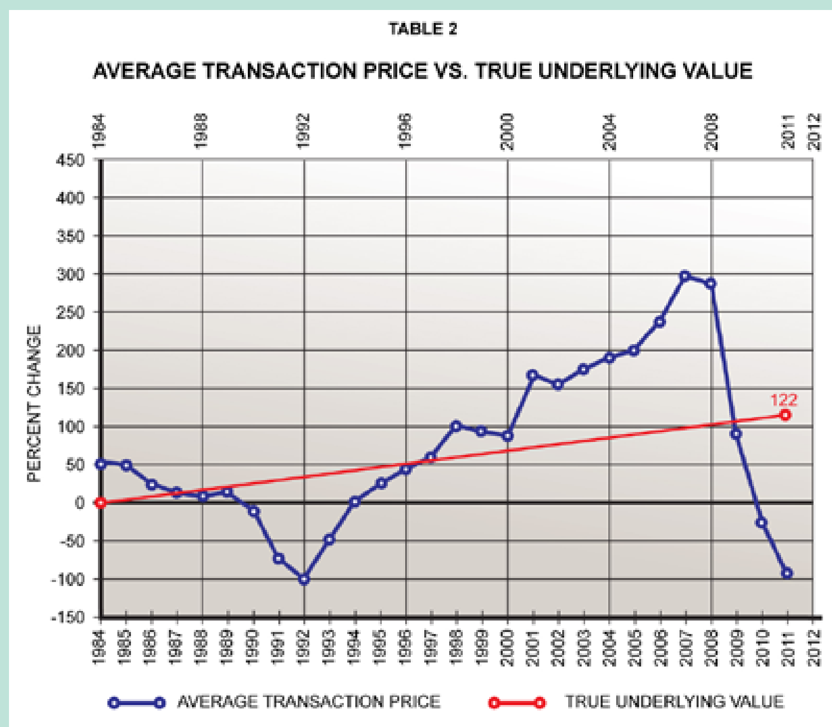
The poor economy has also had the effect of forcing rents down to a point where landlords are no longer acting without compulsion, and are forced to accept rents well below market just to keep their tenants in business. This has made the income approach to value unreliable in determining a property's true underlying market value.

In my opinion, the cost approach is the only reliable method available today to determine a commercial property's underlying market value. The cost approach combines the use of real, tangible commodity values with market comparable values of the land, as if vacant. It serves as the arbitrator of value in an era of virtual money. The cost approach provides an unbiased opinion of value in an economy where effective purchasing power has been removed from the marketplace. It also is an extremely useful tool to determine when the market is approaching equilibrium. All-cash real estate transactions are skewing the value of real estate today, just as easy credit buoyed commercial real estate values beyond reason a few years ago. The cost approach provides a true benchmark for value. The true underlying value starts with the highest and best use of the land and then the cost to replace the actual improvements thereon.

Some of the conclusions that can be drawn are: 1) Transaction prices reflect market liquidity to a much higher degree than the property characteristics, 2) Liquidity and transaction prices are related, 3) Transaction prices dropped steeply when liquidity was removed from the market.

Someone once said, "The worth of a thing is what it will bring." While I believe this is true, I also believe it costs something to create that thing, and the price paid may have nothing to do with its value. Although a property's true underlying value is theoretical, so is all real estate appraisal and valuation; it is all based on opinion. My opinion is that commercial real estate should be valued today with emphasis given to its estimated replacement cost, and that a property's true underlying value is an extremely useful tool to help determine what a property is actually worth.

Due to space limitation requirements, this article has been abbreviated from its original format. If you would like a complete copy of Mr. Willmore's article, please contact him at dwillmore@comre.com.



The table to the left represents changes in commercial real estate values from 1984 to the present, versus the true underlying value during the same period. This graph is meant to illustrate the effect of market liquidity on the underlying value, where the property's characteristics remain constant during this period. The true underlying value in this example represents the cost of the property or its "book value," which, with respect to business enterprises, is equal to the asset's cost at acquisition, less accumulated depreciation. The replacement cost approach is similar to book value in this respect and because the book value of stock and the replacement cost of real estate are both based on historical cost, they may differ from market value.