

# **A Brief Discussion of Commercial Real Estate Appraisal**

**Gong, FANGQIANG and Shen, XIAOWEI, China**

**Key Words:** Commercial Real Estate, Income based Methodology

## **SUMMARY**

Appraisal of commercial real estate is always a difficulty due to the diversified usage and complicate situation of various commercial real estates. In the appraisal practices, a lot of problems have been encountered in this area. Our opinion is that methods used in appraisal of commercial real estate should base on value influencing factors and own characteristics of various commercial real estates’.

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Commercial Real Estate includes commercial retail, (department stores, supermarkets, shopping malls, etc.), hotel, office building, restaurants, gymnastics, clubs and etc.

## 1. CHARACTERISTICS AND BASIC APPRAISAL ROUTINE OF COMMERCIAL REAL ESTATE

(1) Commercial real estates' income and profit generation can be categorized into two types: Real estate developers sells its development to market directly or engages reselling in the secondary market (usually these are small community type of retail stores operating in mid to lower end level market that scatters and generally do not concentrate in one area are its characteristic); certainly, this profit generation method, strictly speaking, it is still within the filed of real estate development. The second type is long term investment management where the developer itself manages the properties or it is leased.



(2) Inside a shopping mall usually there are various types of retail shops such as gift shops, restaurants, and entertainment; sometimes the type of business of the stores may have a good effect for one store and others, but it may also have adverse effects. Different business types will have different income ratio and if income based valuation is used then market survey analysis should be the basis to determine the different discount rates.

(3) Rental as its main business. The owners of commercial real estates often rent the property for others to manage or do business; and, some tenants will rent a property then reconfigure it and rent to a third party. Therefore, when conducting an appraisal it is imperative to clearly investigate the ownership of the real estate, and clarify whether the appraisal is at land lord's interest or tenant's interest.

(4) Stylish or sophisticated interior decoration. In order to create a comfortable shopping atmosphere, commercial properties usually will have stylish or sophisticated interior decorations; and, sometimes it is necessary to accurately estimate its value. Furthermore, commercial interior designs often changes and a new tenant will need to renovate in order to keep its own brand image or style; therefore, during an appraisal one should clearly analyze if the current fixtures of the interior decorations can be adequately utilized and if the current fixtures cannot be utilized, then the cost of renovation should be considered into the effect of appraising value.

(5) Smaller shops' transaction is relatively frequent, and the larger commercial properties usually only lease out as its operating method. Due to the limitation in collecting case study in the market transaction, when conducting an appraisal, one should carry out a thorough market survey on the close by region, the spread of retail variety and the market supply and demand situation – all these factors should be carefully analyzed.

## **2、 THE MAIN AREA FACTOR OF AFFECTING COMMERCE REAL ESTATE PRICE**

(1) Regional prosperity, The most important factor that influences the price of the commercial real estate is the prosperity of the region where the property is located. And, the level of prosperity is determined by the grade of the commercial district located, management level, traffic volume, consumption structures and level.

(2) Traffic and Transportation condition. During the appraisal for commercial real estate, there are two sides to be considered: 1) customer side, one need to consider if public transportation passes the property being evaluate, the number of routes that does pass through, the time interval of the buses and the population inside the public transportation network. Also, parking spaces needs to be considered. 2) Proprietor side, one needs to consider the conveniences for trucks up and off loads.

## **3. COMMERCIAL REAL ESTATES PRICE FACTORS**

(1) Proximity to the main street. Generally speaking, the property should be as close to the street as possible. If there are various sides of the property that is exposed to the main street then it is advantageous for the property to increase its price.

(2) Internal Layout. Commercial properties' internal layout should be designed to favor the arrangement of shelves and counters; also it should encourage customer stay. Usually, large commercial properties need to be divided for lease. Therefore, the layout needs to be flexible enough to be divided.

(3) Storey of Building. The unit that is located on the lower floors or ground floor usually is more advantageous; however, if there's escalator then the disadvantage of the higher floors can be diminished.

(4) Area: The property should have suitable area and size that operation demands.

(5) Height. The room height of a commercial real estate should be suitable and adequate. If the height is too low then it creates discomfort and pressure which is not beneficial for operating the business. But, if the height is too high then the construction cost will increase and not favorable for increasing the real estate's price.

(6) Storage space

(7) Interior decoration and construction framework.. Interior decoration has a big portion of a commercial real estate's value; and, a same house can have a different price with different styles of interior decoration. In addition, the value of the property can also be affected by the material used for the construction frame work.

(8) Possibility to Sublease. The agreements between land lord and tenant sometimes do not allow tenants to sublease the unit or property and this regulation affects the flexibility of commercial properties investment, hence affecting the properties' value.

(9) Inter-changeability of different type of retail format.

(10) Ownership distribution. There are cases where there are multiple owners for the property and sometimes it is not possible to unify the atmosphere of the plaza or mall; hence, long vacancies will affect the property's appraised value.

(11) Availability of central air condition and the level of management fee.

#### **4. COMMON COMMERCIAL REAL ESTATE APPRAISAL METHOD**

(1) Income Based Methodology

One of the main characteristic of commercial real estate is its ability to generate income, and the value of the commercial real estate usually reflects the property's income potential; therefore, income based methodology is the most common methodology for appraisal.

Income based methodology is based on the expectation theory. Although, the theory and processing steps had been proven; in practical operation adjustments are needed by taking

consideration of different type of commercial real estates. Income based real estates can be divided into two categories: lease type and commercial operating type. Lease type real estates can calculate its pure income according to the lease contract within the lease period, however, in order to attract popular retail stores the rent offered may be lowered than the market rental rate. Because there is guarantee from the lease contract, hence the risk of leasing is relatively lower and the discount rate can be lowered accordingly. When the lease period is ended, the lease rate can be re-determined by the market rate to judge future income.

Commercial operating type mainly depend on operation for income, therefore it is difficult to obtain first hand information on rental rates. Regarding this type of appraisal subject, the income can be estimated through the operating revenue in theory; but, in practice, it is difficult to separate income from operation an income from real estate. There has not been a better quantitative method available, and the judgment of value mainly relies on the real estate experiences of the appraiser and it is difficult to accurately appraise the income that the real estate generates. According to our experiences and referencing with the US real estate appraisal for similar issues, we found that the income of the commercial operating type real estate can be ascertain through comparison with similar cases and adjust the appraisal for the rental income accordingly.

The confirmation of discount rate is difficult issue when using the income based methodology. In practice, discount rate can use accumulation method to estimate. Generally speaking, discount rate includes: risk free interest, risk premium and inflation rate. Inflation rate is include in the risk free interest and risk premium rate and under the current condition, inflation rate has a weak correlation and incomplete effect on income; therefore, discount rate usually use risk free and risk premium rate to ascertain.

Risk free interest rate is the lowest return rate that a investor should get. Foreign appraisal organization usually use long term government bonds as the rate for risk free interest; in China, bank's savings account interest rate is used for risk free interest rate. Risk premium rate confirmation should consider the investment risk premium, management liable compensation, compensation of lack of liquidity and ease to get financing. These factors affects the net income of the commercial real estate; therefore, in theory, different net income model should correspond to the different discount rate. When choosing a branded retailer for estimating net income flow, the income generated from real estate is more reliable than an ordinary retailer that has leased the property; and, the corresponding discount rate is low. Currently, the zone error lies in choosing a single discount rate and there is no consideration of the relationship between income flow and discount rate; hence, affects the accuracy of the appraisal results.

We used the income based methodology to evaluate X mall in X region in X city, we proceeded to analyze our subject's risk when confirming the discount rate.

Capitalization rate(discount rate) is the sum of risk free rate and risk premium. Risk free rate can be refer as the interest 2.25% of 1 year bank deposit; while risk premium should be determined by consolidating all kinds risk evaluated entity would possibly encounter during forecasting period. The appraise subject's ownership is scattered, the shopping plaza's first and second floor have largely been sold separately and the third floor is also sold separately. According to the market survey, it has shown clearly where in X region the unified management shopping plaza's performance is better than the shopping plaza that is managed by separate owners; and, the overall lease rates of the unified management shopping plaza is higher and the vacancy rate is lower. The shopping plaza that is under unified management usually has a unified theme and it is easier to upgrade the level of its retail format. However, in the shopping plaza where the ownership is scattered, every owner makes their own decision on tenants; and, the tenants are individually ran enterprises. Hence, the retail format lack orderliness and influences the overall operating condition and it is reflected in market survey data mentioned above.

Due to the scattered ownership situation of the appraised subject, each land lord acts own their own which caused a poor overall planning and without an unified theme - these factors caused an out of date management concept. Only the south side and west side of the X mall can normally be leased, the rest of the mall units have a very high vacancy rate. The mall's overall operation is in deficit and the high vacancy rate caused the mall to save on costs, and caused most of the facility cannot properly function such as escalators and central air conditions are all not operational. Hence, caused the mall business environment to become worse and resulted the mall units cannot be properly rent out. Thus, under this kind of income model, the investment risk of this real estate is relative high with more difficulty to manage and lower liquidity. By considering all these risk factors, we take the risk premium as 6.75%, which finally lead to a discount rate of  $r=9\%$ .



(2) Resell and sublease of small sized commercial real estate is more frequent, thus, is also much easier to get comparison cases. Therefore, market comparison method is also a frequently used method when doing the commercial real estate appraisal. For example, when we're appraising a certain store in a certain underground marketplace located in \*\*department store, \*\*district and \*\*city, we need to take comprehensive consideration of the regional and individual factor of the value of real

estate and evaluate the real estate by using market comparison method.

表 1： 比较因素一览表

Factors Comparison	Content
Regional factors	Ease of Transportation
	Level of Prosperity
	Completeness of Public Facilities
	Regional Planning
Individual Factors	Operating Conditions
	Storey
	Age
	Area(size)
	Overall Layout
	Location
	Market Acceptability

Meanwhile, when using income based method to evaluate objective rent amount, we can also use market comparison method to make an estimate at the same time. Various modifying factors could be determined by statistical methods (e.g. linear regression) in the precondition of sufficient market researches have been conducted.

**5、 DIFFICULTIES IN APPLYING VALUATION TECHNIQUES**

We need to face various cases in estimating value of different commercial building. They belong to retail, mall, whole building according to real valuation. And there are vacant and uncompleted projects as well. In valuating these properties, we use the same techniques and thinking method, but we need to fine tune and fix the real case.

(1) Valuation of whole floor

In valuating a whole floor, we can use method of comparison and return analysis. However, if we only have individual flats selling data and running out of whole floor case, the valuation process will be much harsher.

For example, when we are evaluating the 9<sup>th</sup> floor of \*\* shopping mall by using market

comparisons methods, considering the fact that all of our trading cases are small or median size, with relatively broad purchase group, more flexible rent and sale mechanism, stronger market acceptance, which is much different from the situation for the whole floor of estate, whose price is influenced by purchase group, operating model, and buyer's capital strength. The acceptance of whole floor is not that good as for small/median size shops, thus, price



adjustment for whole floor trading is necessary. Through our market research, the trading floor of whole floor of commercial real estate is about 8%-10% lower than that of small/median sized stores.

### (2) Various flats on the same floor

In order to increase efficiency, we will evaluate one flat in a floor, and then use this figure to estimate the remaining flats in the same floor of a building. However, we have to have a full picture of various flats on the same floor, and understanding of price determining factors is very important key to this technique. We applied this valuation method in valuating 2 floors retail properties in XX region. We used market comparison to find out the value of one flat in these 2 floors, and then estimated the remaining rooms.

Here is the extract from the original report: there are 17 flats in this valuation, according to the location (including escalator and corridor), area, shape and corner location, we separate the whole floor into 3 classes. Based on the floor plan provided, class one includes XX flat beside escalator, class two includes 4 flats which are facing the elevator and 8 flats besides the main corridor of the mall. 8 flats which are beside the sub-corridor and corner belong to class three. According to the location (including escalator and corridor), area, shape corner location and past trade record, class 2 and class 3 should enjoy 5% and 10% rental discount when compare with class 1. So the rental fees of Class 2 and Class 3 flat are XX and XX respectively.



### (3) Vacancy Commercial buildings for a long time

Because of many reasons, some commercial buildings have been keeping idle, and some of them are not caused by the property itself. So in



valuating these properties, considering the situations of the target is a very important key to success. the highest and best use of the subject property is very necessary. And this is the most difficult part of this kind of valuation. For example, when we are evaluating the idle commercial building on the XX district, considering the fact that disperse property right of above the 4<sup>th</sup> and 5<sup>th</sup> is poor in near of the market, but considering the property that the 4<sup>th</sup> and 5<sup>th</sup> floor is the whole tier ,2 straight elevators and 2 hand elevators move to the 4<sup>th</sup> floor, It is beneficial to change management model and formats, it is suitable to manage drinking and dining, entertainment, it would change office building to rent at dispatch. Passing by investment, disperse property right of the 4<sup>th</sup> and 5<sup>th</sup> is poor, but above the 4<sup>th</sup> and 5<sup>th</sup> floor manage drinking and dining, entertainment as the whole tier, through the research, the personnel evaluates the net income of the property.

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