

FINANCIAL STRATEGIES

Smart use of fiscal planning & action



ALEC J. PACELLA

Exit, Stage Left

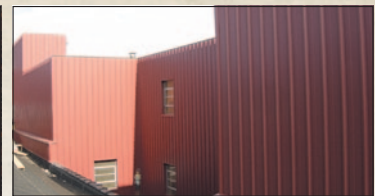
If I've seen it once, I've seen it a hundred times. An investor is valuing a property, spending countless hours pouring over all of the leases, challenging all of the expenses, examining the condition of the structure and verifying current market conditions. But little, if any, thought is given to an exit strategy and the value of the property at the point in the future when the investor plans to sell the property. This month, we are going to talk about the end of the holding period, specifically discussing the various ways to estimate future value. By overlooking the potential future value of the property, what initially looks like a good investment could turn out to be a real home run. Or it could turn out to be a disaster.

When analyzing an investment property, one of the first things an investor needs to do is plan for an end; how long is the anticipated hold period? Maybe the strategy is to turn around a troubled property and sell after two or three years. Or maybe the strategy is to collect a steady and stable income stream from the property for several years and then move on. But no matter how long the planned hold period is, an anticipated ending date should be considered. Even if the investor plans to hold the property "forever," you cannot figure out important investment measures, such as

internal rate of return and net present value, without a future value. And there are two primary methods to do this – the easy way and the hard way.

The easy way is centered on the concept of appreciation. Suppose an investor buys a property for \$1 million and believes that the value will increase by 1% a year. Under this assumption, the property will be worth \$1,010,000 in the second year, \$1,051,010 in the fifth year, \$1,082,857 in the eighth year, etc. The only items needed for this method is the rate of annual appreciation. I call this the "easy" way in terms of the actual calcula-

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tion, which is simple compounding. But determining an accurate annual appreciation rate can be a challenge. A common way to do this is model an appreciation rate based on the historical rates achieved by similar properties in a similar area. For instance, suppose the subject property is an industrial building in Solon. I would collect recent sales comparables of similar industrial buildings in Solon, determine the annual appreciation for each by comparing the original purchase price to the sale price and then form an average for the sample. There are a couple of things to note when using this method. First, the rate has a greater impact (and thus margin of error) as the time horizon grows. In the original example above, increasing the appreciation rate from 1% to 2% will result in a \$10,000 increase in value if a two-year hold but nearly a \$100,000 increase in value if an eight-year hold. And second, the rate could be flat or even negative. Although no one invests to lose money, if all of the surrounding comparables are decreasing in value, the investor needs to be true to thyself.

The hard way is a variant of the same approach that most investors use when acquiring a property and incorporates our old friend, the CAP rate. But

Daus, You Know?

FALLEN KING King James II, a 68,000-square-foot office building in Westlake, recently sold for \$750,000 or \$11 psf. Purchased by an investor group out of Pennsylvania, the building was totally vacant at sale. **KICKING IT UP** A recent survey by Real Capital Analytics showed that, out of the 1,000 top investors since 2006, only 11 were more active now as compared to two years ago. This select group included HRPT, a REIT that purchased North Point Tower in 2008 and the Shurtech facility in Avon in 2009. —AP

instead of applying it to current NOI (Net Operating Income), at the beginning of the hold period, it is applied to future NOI, at the end of the hold period. There are a couple of things that make this the hard way. First, a future CAP rate has to be implied. Determining a CAP rate is difficult to do for a property for sale right now, let alone one for sale in three, five or even 10 years from now. I wish I had some magic dust to help but the bottom line is that a future CAP is nothing more than an educated guess, with less emphasis on “educated” and more emphasis on “guess.” For what it’s worth, my standard rule of thumb is to stick within 50 basis points of the going-in CAP rate (unless the property is a serious value-added property, in which case I’m probably not using a going-in CAP rate in the first place). And second, a future

NOI needs to be determined, which opens up a whole new can of worms. You will recall that NOI is income less expenses. On the income side, we need to estimate market rent and any additional income as well as future occupancy. And on the expense side, we need to estimate items such as real estate tax, utilities, common area maintenance and repairs, among others. What we ultimately end up with is a stool made with three very shaky legs.

However, it is based on accepted logic (CAP rate divided by NOI equals Value) and well-defined assumptions. For this reason, even though this method is more difficult, it is also more popular when estimating a future value.

Irregardless of the method, investors will often build a sensitivity allowance which accommodates potential variances in future value. For example, there will be a low future value, a high future value and a most likely future value. By including a range of possibilities, the investor will be able to illustrate a range of performance that helps tighten up those shaky legs. **P**

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