CHAPTER 22 - DIRECT CAPITALIZATION

INTRODUCTION
- See workbook for the excluded sections.
- Method is to convert one year’s income into a value indication.
- Good if property is operating on a stabilized basis and adequate sales of similar properties.
- Simple and easy to explain.
- Expresses market thinking.

DERIVATION OF OVERALL CAPITALIZATION RATES
- Value is found by dividing the Net Operating Income (NOI) by the overall capitalization rate, called R₀ or by multiplying the income estimate by an appropriate factor.
- Capitalization Rate is found from comparable sales of similar properties or effective gross income multipliers and net income ratios.

Derivation of R₀ from Comparable Sales
- Good when sufficient sales of competitive type properties are available.
- Comparable’s sale price, rent structure and expenses must be available for analysis.
- Market conditions must be similar to the appraisal date conditions.
- Similar treatment of income and expenses for both comparables and subject required.
- Must ensure no abnormal financing exists as it may affect the sale price.
- Risk level of comparables should be similar to the subject.
- Refer to page 22.4, table 22.2 for derivation of rate from comparable sales.
- Final rate used for the subject is determined by the analysis of and the appraiser’s judgement of the data.

Derivation of R₀ from Effective Gross Income Multipliers
- It may occur that an overall capitalization rate cannot be derived directly because not all data requirements can be met but gross income data can be obtained and verified. In such a case an effective gross income multiplier is derived and used in conjunction with a net income ratio (NIR) to produce an overall capitalization rate. It is the complement of the operating expense ratio (OER). Thus NIR = 1 – OER.
- The formula for deriving the overall capitalization rate from a net income ratio and effective gross income multiplier is:
  - \( R₀ = \frac{\text{NIR}}{\text{EGIM}} \).
- Review the example given on page 22.6 and the data on page 22.4, table 22.2.

Derivation of Gross Income Multipliers (GIM’s)
- GIM’s are used to compare income-producing characteristics of properties.
- Conversion of the PGI or the EGI into an opinion of value by using the relevant GIM.
- Method related to direct capitalization because rates are reciprocals of multipliers.
- Derivation of GIM requires the annual gross income figures of the comparables at the time of sale or their projected income over the first year.
- The sale price of the comparable is divided by the PGI or EGI to arrive at the multiplier.
- The multiplier must be applied on the same basis and timing of income that it is derived – namely, the PGI multiplier is applied to the PGI of the subject property using next year’s expected income if that is the criteria.
- It is a good rule of thumb as long as the incomes have similar characteristics in terms of location, physical and investment attributes.
- Refer to page 22.18 for an example.