GUIDANCE NOTE 3: ACCOUNTING FOR SPACE MARKETING COSTS

In the traditional application of the Direct Capitalization test of valuation, appraisers usually exclude consideration of tenant inducements, free rent periods and leasing commissions (such costs, taken together, generally being referred to as Space Marketing Costs) in the process of calculating the net operating income to be capitalized. This being the case, it may be concluded that capitalization rates extracted from sales and subsequently used in the valuation process, include a built-in provision for some extent of ordinary space market costs.

The common reasons for excluding consideration of space marketing costs is that they are not ordinarily perceived to constitute a typical annual expense which would be incurred in a common year of operating performance, and capitalization rates traditionally do not reflect the incidence of capital costs. Further, if space marketing costs are to be accounted for, so should any resultant change in rental rates.

Whatever reasons may prevail, the process of excluding space marketing costs in the development of the net income to be capitalized is acceptable so long as the same attitude is taken in the derivation of overall capitalization rates from comparable sales and as long as the space marketing costs are relatively the same between the sale properties and the subject property.

However, following the calculation of value by the Direct Capitalization test, the appraiser would still be obliged to account for any extraordinary capital costs (including space marketing costs) which would likely be incurred in the foreseeable future (generally within three years of the date of valuation); the present value of the same constituting an acceptable adjustment to the capitalized value so found.

In the alternative, if space marketing costs are accounted for in the determination of the net income to be capitalized, the appraiser should ensure that the same consideration was taken in the process of abstracting going-in capitalization rates from comparison sales.

In the application of the DCF test, generally accepted valuation standards (GAVS), as defined in the generality of the same, ordinarily and traditionally call for the accountability of space marketing costs in the process of establishing the net earnings to be discounted. Therefore, this convention should be followed as the preferred treatment when using the DCF test.

If the value of the reversion (for use in the DCF test) is based on Direct Capitalization of the terminal year's net income (in contrast to being a function of some other criteria), space marketing costs must be treated in the same manner as they were in establishing the going-in capitalization rate, since the terminal capitalization rate applicable to the net income in the year of reversion is usually a function of adjusting the going-in capitalization rate upwards or downwards to reflect changes in the features of the subject property and in market conditions between the date of appraisal and the date of reversion.

GUIDANCE NOTE 5: TRANSITIONAL USE

Several special circumstances are evolving in the market place.

In respect of older properties in particular, an appraiser should not forget to reflect upon the final estimate of
value found through the income approach, in terms of the resultant value converted to a price per square foot or per acre of the underlying land. Many properties are being purchased for eventual redevelopment of the land; maybe not immediately, but in the foreseeable future, regardless of the present physical and functional state of the buildings. Therefore, the most appropriate expression of value for the property as improved might be best measured by the current value of the land as vacant, irrespective of the ostensible remaining useful life of the existing buildings.

In some cities, trends toward the condominiumization of industrial and office buildings have, for example, resulted in pre-conversion selling prices being as much as double the capitalized income value of the property for continued use as a purely rental investment. The same circumstance took place years ago (and may still be taking place) with rental apartment buildings which were purchased for conversion to strata title (or condominiums). The appraiser should be especially alert to this phenomenon when examining the subject property - and the comparable sales.

GUIDANCE NOTE 7: DISCOUNTED CASH FLOW

If an appraiser elects to use this method or is instructed to do so, the appraiser should first be satisfied that the subject property would trade in a sub-market where typical buyers and sellers employ this approach in their evaluation of such assets. In all probability, the majority of assets which will constitute a typical investment portfolio will be subject to such evaluation. However, since the DCF test is exceptionally delicate, an appraiser should ensure that he or she has the expertise to use this method and has access to the empirical data needed to support the rates of return to be employed in the process.

The DCF test should not be used as the sole test of market value, unless it can be reasonably demonstrated that there is no alternative.

The specific methodology associated with use of the DCF test must reflect the procedural application commonly used by the investment community in its evaluation of income producing real estate. The employment of hypothetic, conjectural or purely academic methods and procedures which are not reasonably supported by common market practices, contravenes generally accepted valuation standards. Neither is it satisfactory to employ an uncommon procedure on the basis that a similar process was used to analyze comparison data.

GUIDANCE NOTE 8: BASE YEAR FOR PROCESSING NET EARNINGS

The Base Year for processing net earnings means the 12-month period of time for which the net operating income will be established for Direct Capitalization or, when using the DCF test, for the first year of the investment horizon.

Assets to be appraised from time to time may carry an effective date of valuation being the anniversary date of their acquisition. This date may or may not coincide with the fiscal or operating year upon which revenues and expenses are accounted for. This circumstance gives rise to the need to consider what is usually referred to as the "six-month rule".

This rule means that the Base Year is ordinarily the fiscal year having a start date which is closest to the date of valuation. For example, assume the fiscal year (or operating year) commences January 1, 1989. If the date of valuation is May 1, 1989, the Base Year in this instance would be the 1989 calendar year. If the date of valuation is August 1, 1989, the Base Year would be the 1990 calendar year.

The important point is that the Base Year coincide with the fiscal or operating year of the property so that the appraiser's forecasted earnings can be compared directly with historical and budgeted performance.
In the analysis of comparable transactions to abstract going-in capitalization rates, the same attitude in respect of establishing Base Year earnings should be employed.

When conducting an Audit Appraisal, an external appraiser should confer with the internal appraiser prior to establishing the Base Year, to ensure consistency of methodology.

**GUIDANCE NOTE 9: EXPANSION LAND / SURPLUS DENSITY**

An existing investment property may include a component of surplus land or surplus development density which is being held for future expansion of the existing physical plant. Alternatively, such surplus land or surplus density, while not having potential for deployment by the existing owner or occupant, may possess value on the open market. Either way, the mere presence of these elements may enhance the market value of the developed portion (or the income producing portion) of the subject property.

If investigations reveal the presence of surplus land or surplus development rights, the contributory value thereof should be addressed to the extent of determining how much it enhances the market value of the subject property.

Analysis of these circumstances should be undertaken on a comparative basis, to ensure that double-accounting does not occur. It may be that capitalization rates and other units of value emanating from comparable transactions reflect the presence of some quantity of expansion land and/or surplus density. If such units of comparison are used in the valuation process, there may not be a need to separately calculate an additional element of (contributory) value.

**GUIDANCE NOTE 14: OWNER-OCCUPIED PROPERTIES**

When owner-occupied investment properties are placed on the market, they can either be listed for vacant possession or listed for sale on the basis of the owner-occupant vendor becoming a tenant following disposition, for a prescribed period of time and under specific occupancy (lease) arrangements.

If an owner-occupied, investment-grade property is to be valued on the basis of vacant possession, consideration would have to be given to any extraordinary direct or indirect costs associated with marketing such a property, over and above those costs relating to a sale-leaseback or the sale of other properties which have tenants in occupancy. These considerations would be particularly relevant in the valuation of properties containing apparent problems and when there is an imbalance between supply and demand.

If an owner-occupied, investment-grade property is to be valued on the basis of the vendor becoming a tenant (a sale-leaseback), special consideration would have to be given to the terms and conditions of the attendant lease, especially any atypical circumstances vis-a-vis comparison data relating to general market leasing activity. Such circumstances should be fully described in the report and any value considerations would have to be reflected in the appraisal process.

**GUIDANCE NOTE 17: DEVELOPER’S PROFIT**

While it is clearly established in land development appraisals that without entrepreneurial profit there would be no incentive to convert raw land into subdivided lots, the issue is not so clear with improved properties.

In a pure market sense, developer’s profit is the difference between the sum of hard and soft costs of production (including builder’s profit) and the selling price upon completion. In a stable market, a profit figure must usually be anticipated for the development to proceed. If the market falls after the project is commenced, the anticipated profit can be in jeopardy. In a rising market, profit can be substantial.
Hence developer's profit is not an intrinsic cost; it will vary with the market. But if it does in fact vary with the market, it is the market that determines developer's profit, not the other way round.

It would be wise counsel for the appraiser, if employing a cost analysis as one of the approaches to value, to characterize the market at the time of valuation. The reader would then comprehend the basis of this important entry, one that could contribute over 25% of value by a cost analysis.

As to quantum, research into the development market should afford the valuer his best evidence. Whether profit should be calculated on total costs, including land, for example is a matter that only the market can determine.

No cost analysis should disregard developer's profit. It must be explained if it is included, and particularly if it is not.

GUIDANCE NOTE 18: MARKET RENTS AND ASKING RENTS

The process of estimating the current market rent of the leasable space within the property which is the object of an appraisal usually includes a survey of competing buildings.

The purpose of rental surveys is to determine the most probable rent which is being achieved at the time of appraisal. The quoted, listed or asking rents in competing properties only represent the level of rental values offered by the landlord or broker, thus establishing the upper limits of rental value in the market. The operative word is "achievable". Consequently, market surveys should be sufficiently comprehensive to permit the determination of the difference between asking rents and achievable rents, the latter representing the true expression of market rents.

In conjunction with the performance of a rental survey, it is equally as important to determine the prevailing level of competing tenant inducements (TI's). In the rental market, rental rates are ordinarily expressed in terms of "face rates", meaning the quantity of rent appearing on the face of a lease or other form of occupancy agreement. While face rates, in contrast to net effective rates (face rates reduced by the average annual amount of tenant inducements) are the operative amounts used in the determination of total potential rental income, tenant inducements and other space marketing costs (such as leasing commissions) may have to be accounted for at some point in the valuation process.

In summary, the final objective of a rental survey conducted for the purpose of estimating current market rents is to elicit sufficient information to allow the appraiser to adequately estimate the achievable (market) rent which the space in question would bring at the date of appraisal. Tenant inducements and other space marketing costs must also be determined as a part of a properly conducted rental survey.

GUIDANCE NOTE 19: ACCOUNTING FOR AMORTIZATION OF LEASEHOLDS

Revenue generated by an income-producing property may include periodic payments from tenants representing amortization of leasehold improvements, amortization of specified components of a building or, at times, may constitute repayment of loans made by a landlord to a tenant for leasehold improvements.

In the conduct of due diligence, the appraiser should determine the nature and extent of such receivables and, most importantly, whether they constitute "additional rent" under the terms and conditions of the relevant lease(s). If such receivables do not constitute additional rent, the landlord may not have recourse to the tenant in the event of default. Evaluating the foregoing circumstances will assist the appraiser in determining the weight to be accorded to this classification of earnings in the appraisal process.
It should be noted that "amortization income" may include a component of interest on the outstanding balance, in addition to straight capital recapture. In such an event, both components of income should be treated together.

Amortization income may or may not have (or call for) a corresponding entry on the expense side of the ledger. In the normal course of analysis, it will only be necessary to account for a corresponding expense entry when the capital expenditures which create the amortization payments have been made for the purpose of reducing periodic operating expenses (i.e., in lieu of expensing certain items of a building, its components and services or, for example, maintenance and upkeep equipment).

Capital expenditures made for chattels, fixtures, furnishings and equipment, are commonly amortized over a prescribed period of time and generally constitute a sub-classification of operating expenses in the operation of hospitality facilities, apartment buildings, etc. In such an event, the appraiser will ordinarily account for the same in a manner consistent with generally accepted accounting principles.

On occasion, chattels and equipment will be leased from a company furnishing chattels, equipment and frequently replaceable items. In such an instance, the rent payable therefore will stand in place of annual provisions for amortization (replacement) of such items.

In the process of determining which methods of treatment should be accounted for in the valuation process, the appraiser should have regard to typical practice employed by the owners of the property and/or by their professional advisers (especially in accountancy).

GUIDANCE NOTE 20: RENTAL GUARANTEES

At times an investment property will be sold, or offered for sale, subject to rental guarantees. For the purpose of this Guidance Note, the term "rental guarantee" shall mean that the owner/vendor has undertaken to guarantee that the rental paid, or payable, by one or more tenants will be a stated amount, or will not fall below a stated amount; the guarantor pledging to make up any deficiency, and for a prescribed period of time. Another form of a rental guarantee might be a situation wherein the owner/vendor has, or will, enter into a head lease of certain defined space, again for a prescribed period of time.

To be secure and to constitute proper weight in the appraisal process, such guarantees must be registered on title to ensure that such guarantees are capable of flowing to successive owners.

Another stipulation, in a more practical sense, is that the guaranteed rental not exceed the market rental of the demised premises as at the date of valuation.

In any event, the appraiser should exercise special diligence in evaluating the amount of weight which should be accorded to rental guarantees.

GUIDANCE NOTE 21: ACCOUNTING FOR PERCENTAGE (OVERAGE) RENT

A development proposal for a retail project may contain provisions for the leasing of space to retail merchants whose lease(s) will contain a percentage-of-sales clause.

If the property is still in the development stage or has not reached the stage of operation following completion when retail sales can be predicted with reasonable certainty, the preferred valuation treatment of such properties is to ignore accounting for potential percentage (or overage) rent; as such a procedure could be considered subjective and conjectural.
When deliberating the question of accounting for prospective earnings of a proposed or new project, the element of weight to be given to all sources of revenue must be determined in the light of reasonable probabilities, as well as in regard to how the market would react to such matters.

**GUIDANCE NOTE 22: UNSECURED SOURCES OF REVENUE**

Certain major investment properties might possess the ability to realize additional revenue from sources which have no physical, legal or other presence at the date of valuation. For example, a property might have the potential for creating additional rentable space, or may possess the potential for realizing incidental revenue from billboard advertising, car wash facilities in an underground garage, revenues produced from special landlord services, etc.

The preferred treatment of unsecured revenue from an existing source is to isolate and value such revenues independent of the property itself, unless such revenue only constitutes miscellaneous or sundry income.

The preferred treatment of unsecured revenue from a potential (yet unrealized) source is to omit consideration thereof in the formal valuation process. Nonetheless, if the potential revenue is a significant matter, the appraiser may desire (or may find it appropriate) to comment on the possible contribution which such sources of revenue might have on the valuation of the property once they become realized earnings; said comments could appear in the Letter of Transmittal and/or in the body of the report.

**GUIDANCE NOTE 23: TRANSACTIONAL COSTS**

Transactional costs are commonly defined as those costs and expenses which are associated with the sale or leasing of a property; such as brokerage fees, legal and other closing costs, transfer of title taxes, etc.

While such costs are frequently, if not commonly, accounted for in the United States in the process of calculating market values and/or the rates of return on property sales, such is not the common practice in Canada. In fact, transactional costs are not accounted for in Canada in the process of determining yields on transactions in the securities market (whereas they commonly are accounted for in the U.S.)

The preferred treatment, therefore, is to exclude transactional costs when valuing investment properties in Canada, especially when calculating the proceeds of resale in the determination of the reversionary (or terminal) value of an asset in the DCF test of value. If, under certain circumstances, transactional costs must or should be accounted for, the appraiser should ensure that the rates of return used in the valuation process reflect such circumstances.

**GUIDANCE NOTE 24: CASH EQUIVALENT SELLING PRICE/MARKET VALUE**

Portfolio valuations, especially those performed by pension fund asset administrators, frequently require real estate holdings to be viewed on the basis of a "cash equivalent selling price"; especially when one of their responsibilities relates to measuring portfolio performance.

External appraisers should be alert to this possibility and should inquire, when taking instructions, if properties to be valued should be viewed on this basis. If such a requirement exists, it will ordinarily be necessary for the external appraiser to be made aware of the assumptions and contingent conditions used by the internal appraiser; because consistency in methods and procedures is of paramount importance in measuring performance on a consistent basis. Should special assumptions and conditions be warranted in the appraisal process, the external appraiser’s report should clearly define the purpose and function for which the
valuation has been commissioned. The cash equivalent selling price of an asset would not necessarily be coincident with the price at which the asset would sell for in the open market, even on an all-cash basis.

GUIDANCE NOTE 25: VALUING A PROPERTY AS FINANCED VERSUS ON AN ALL CASH BASIS

Instructions issued to an appraiser will ordinarily indicate whether or not the property is to be valued on an all cash basis or in consideration of the existing financing in place. The appraiser may occasionally be requested to value a property on the basis that a proposed refinancing is hypothetically in place as at the date of valuation. Regardless of the nature of the instructions, the appraiser should explicitly indicate the basis of the valuation in the Letter of Transmittal and in other relevant sections of the report.

When a property is being valued for the function of obtaining financing, the property should be viewed on the basis of an all cash transaction; the reason being that in the event of a repossession by the lender, the lender will be concerned with disposal of the asset on an all cash basis. In other words, the lender will be looking at its equity in redemption.

Asset administrators may also request a property be valued on an all cash basis, depending upon the reporting and recording requirements associated with the administrator's responsibilities.

Other than the two foregoing circumstances, if permanent financing is in place and if such financing would ordinarily be transferable with title to a third party in the event of a sale, the appraiser would most likely be instructed to value the asset as financed. The influence of favourable financing; i.e., of financing which creates positive leverage, will usually result in a higher estimate of market value vis-a-vis the value of the property considered on an all cash basis.

GUIDANCE NOTE 26: INFLUENCE OF FINANCING ON CAP RATES AND DISCOUNT RATES

It is widely recognized that overall Cap Rates and Discount Rates abstracted from sales which transpire in the market can differ significantly depending on whether the sale properties were financed, or traded on an all cash basis at the date of sale. Investors responding to personal interviews or to written surveys will also tend to alter their opinions depending on the proposition put before them in respect of financing, or the absence thereof.

The point to be made is that if a property is to be valued on an all cash basis, the Cap Rates and Discount Rates to be used in the appraisal process should be derived from transactional and opinion evidence under the same conditions. The corollary situation would apply when properties are valued subject to existing financing.

Appraisers familiar with the mortgage-equity test of valuing a property are well aware that cash-on-cash rates of return (equity dividend rates) may differ substantially from overall cap rates, depending upon the specific terms and conditions of the mortgage debt in place. The same circumstances may apply in the DCF test, although not to the same extent since Discount Rates (or the IRR) used in the DCF test tend to be more money market driven than cash-on-mh rates of return. More particularly, Discount Rates applicable to the valuation of an asset on an as financed basis will not ordinarily be subject to an increase until the ratio of debt to full value exceeds roughly 75 %, or unless the property is being valued in a falling market; the extent of the increase being governed by the perception of increased risk associated with thinning pre-tax cash flows.

Placing the foregoing discussion in a numerical perspective, transactional evidence indicates overall cap rates may differ by as much as 100 basis points between financed properties and those which trade in an all cash basis. The process of adjusting cap rates in one direction or the other can be quite difficult and can be
heavily subjective. Hence, appraisers are best advised to rely on overall cap rates abstracted from sales of properties which trade under financial circumstances similar to the property being valued. (Use of the mortgage-equity test would tend to resolve discrepancies; however this latter test is not commonly used in the analysis or valuation of major investment properties.).

If the DCF test is employed in the process of valuing a financed property, appraisers should be especially alert to the ratio of debt service to net operating income when deciding whether or not to adjust basic discount rates. The ultimate decision will command an exercise in considerable judgment; there being no mathematical methods to furnish assistance in this regard.