# THE INCOME CAPITALIZATION APPROACH

# VALUE INDICATED BY INCOME APPROACH

The Income Approach is a means of estimating the present value of a property based on its income producing characteristics. The future benefits or income which a property is likely to produce are analyzed for the quantity, quality and durability aspects as they relate to the property and its market place. An income capitalization process produces a value estimate and the following six basic steps outline this approach to value.

1. Estimate gross annual economic income.
2. Estimate and deduct expected vacancy and collection loss.
3. Estimate expenses.
4. Deduct these expenses for a net income projection.
5. Study of appropriate capitalization methods and techniques.
6. Capitalization of net income into an estimate of value.

## Estimate of Gross Annual Economic Income

The economic rent may be defined as the rent which the property would command if space were currently available on the open market. Again, the principle of substitution applies where prospective tenants search the market place, compare rental rates and services provided and negotiate the best available market rental rate. The park has 35 spaces with an estimated $20 per night rental rate. Gross potential income the will be as follows:

| | |
|---|---|
| 35 x $20/Night = | $ 700 |
| | x 365 |
| Potential Gross Income | $255,500 |

## Vacancy Allowance

The mobile home/RV park industry has changed over the last ten to fifteen years. RV spaces have a higher turnover due to the short term nature of the users. Market observations of similar properties indicate that a 70% vacancy is typical. For purposes of this report 70% will be employed.

## Expenses

No actual expenses for the subject property were available. Therefore, estimated expenses are used for the expense estimate. The owner pays all of the utilities, makes all repairs, pays taxes and insurance.

Estimated expenses for the property indicate an expense ratio of approximately 70%. This is considered to be reasonable for the subject. Expenses for similar properties are very difficult to

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obtain and verify. RV parks located in the Texas Panhandle typically operate at 55% to 75% of EGI. The comparable expense ratios are from confidential operating records provided the appraiser and are retained in the appraiser's files.

Given the condition, location and current occupancies in the area market, the following pro-forma is considered reasonable:

Pro-Forma Income Statement at Stabilized Occupancy

| | |
|---|---|
| Gross Potential Income | $255,500 |
| Less Vacancy @ 70% | ($178,850) |
| Effective Gross Income | $ 76,650 |
| Less Expenses 70% | ($ 53,655) |
| | $ 22,995 |

Capitalization Methods and Techniques

Having estimated the subject's annual net income, the next step involves a capitalization method used in valuing the whole property. A proper capitalization method and technique must be determined, and the following discussion outlines the most applicable income approach tools when considering this property's specific characteristics. Due to the lack of market data, the Band of Investment Technique is considered to be the best indicator.

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## Band of Investment

The Band of Investment Technique is considered indicative of current market conditions. Investors are considering the available mortgage terms plus return to equity or "cash-on-cash" return. Examination of market data has revealed equity dividend rates in the range of 6.8% to 18.7%. An applicable rate of 12% is considered reasonable. This is based on the typical investor requirement of a 6-7 year pay-back on the investment.

It has been estimated that a 70% loan at 5% interest for 15 years would be available for the subject. The mortgage constant for such a loan is .0949. These terms can then be combined into an overall capitalization rate by using the Band of Investment Technique as follows:

| | | | | | | |
|---|---|---|---|---|---|---|
| Mortgage Amount x Constant | = | .70 | x | .0949 | = | .0664 |
| Equity x Equity Dividend | = | .30 | x | .1200 | = | .0360 |
| Indicated Capitalization Rate | | | | | | .1024 |
| Indicated Capitalization Rate | | | | Say, | | 10.25% to 10.75% |

Given the current money market, the rates produced by the Band of Investment Technique are considered reasonable and supportable. These rates can then be applied to the estimated net income:

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| Net Income | ÷ | OAR | = | Indicated Value |
|---|---|---|---|---|
| $22,995 | ÷ | .1075 | = | $213,907 |
| $22,995 | ÷ | .1025 | = | $224,341 |

Indicated Value by Income Approach Say, **$220,000**