



# Rental Leases & Property Valuation

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# agenda

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# introduction

The purpose of this workshop is gain a better understanding of the Income Approach to value

Have a discussion of common valuation errors

Identify lease types and how leases can influence the property valuation





# primary goals

1. Understanding common valuation errors when using the Income Approach to value
2. Recognize the different types of lease structures
3. Leases influence on the rental property value

# Common Errors in Income Approach Valuation

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graph LR; A[NOT CONSISTENTLY APPLYING VACANCY, MANAGEMENT & RESERVES] --- B[MISSING THE POTENTIAL GROSS INCOME]; A --- C[INCLUDING EXPENSES THAT THE TENANT BEARS NOT THE OWNER]; A --- D[LOADING THE APPROPRIATE PROPERTY TAX RATE INTO THE CAPITALIZATION RATE]; A --- E[IS THE VALUE FAIR?]
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MISSING THE POTENTIAL  
GROSS INCOME

INCLUDING EXPENSES  
THAT THE TENANT BEARS  
NOT THE OWNER

NOT CONSISTENTLY  
APPLYING  
VACANCY, MANAGEMENT  
& RESERVES

LOADING THE  
APPROPRIATE PROPERTY  
TAX RATE INTO THE  
CAPITALIZATION RATE

IS THE VALUE FAIR?

# INCOME APPROACH

## DIRECT CAPITALIZATION METHOD

### INCOME FROM RENTALS

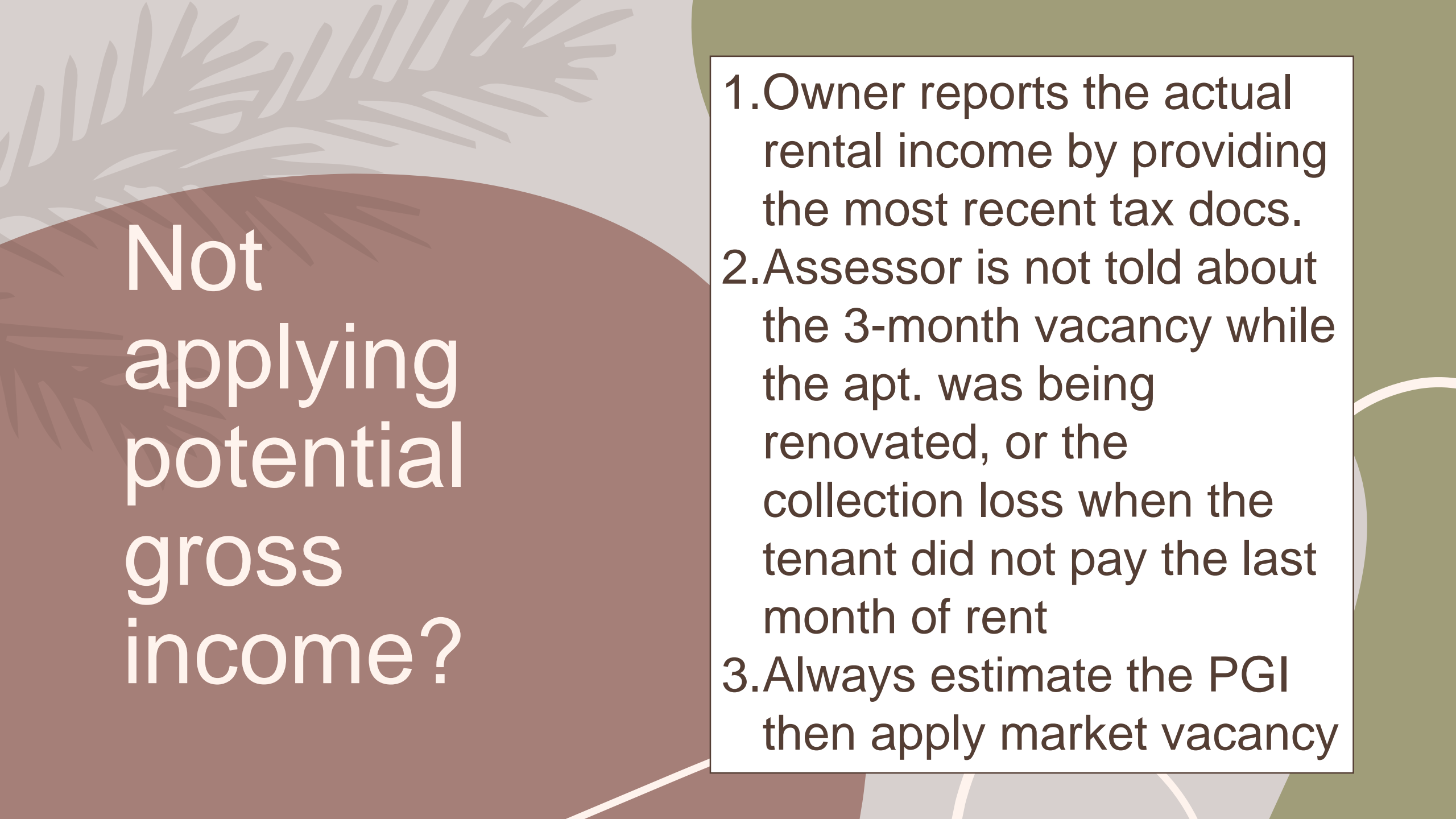
- Potential Gross Income
- Market indicated vacancy
- Adjusted Income

### LESS OPERATING EXPENSES

- Utilities
- Insurance
- Grounds (Common Area Maintenance)
- Repairs
- Replacement & Reserves
- Net Operating Income (NOI)
- ~~Property taxes~~

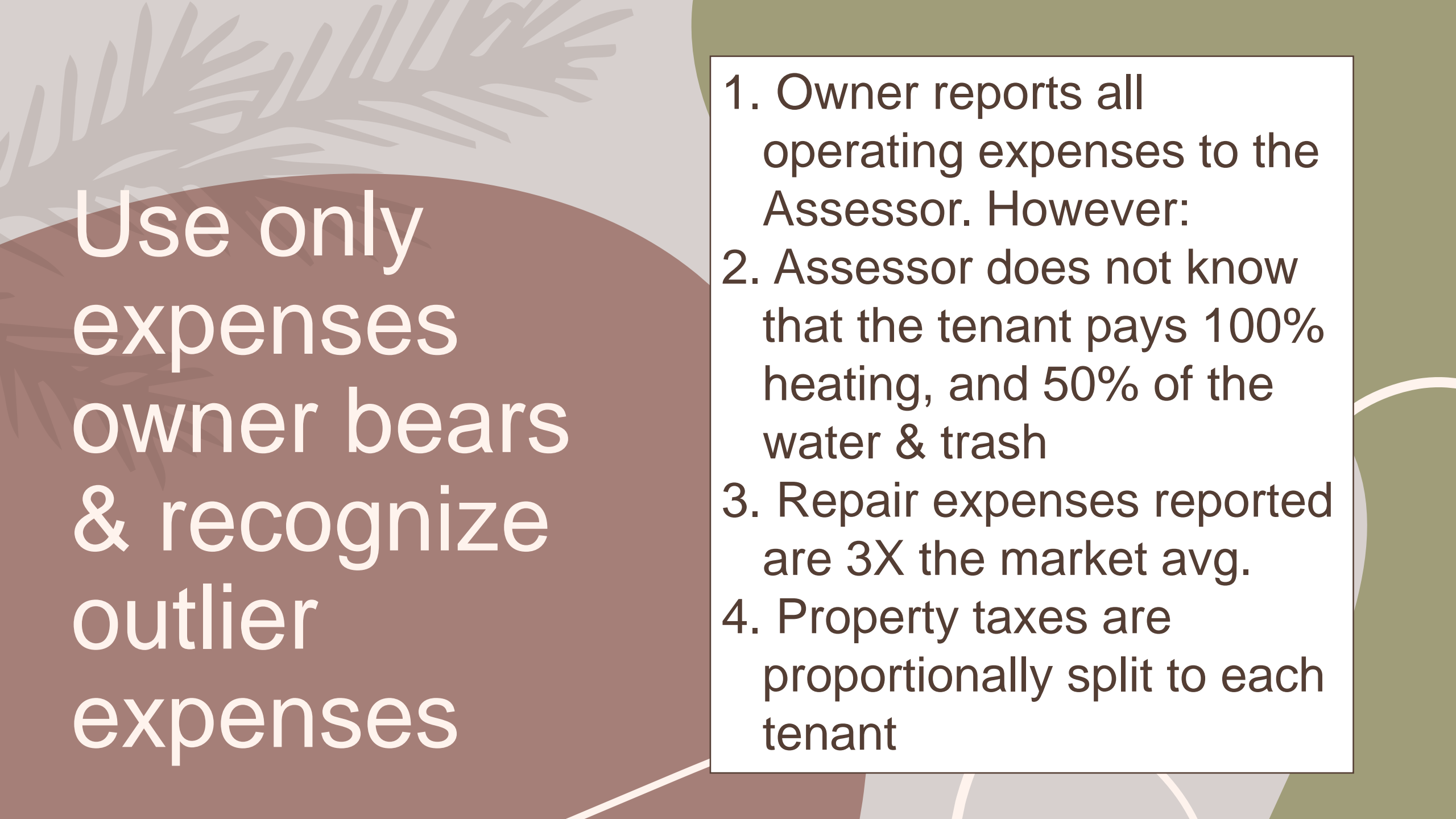
### NOI DIVIDED BY CAPITALIZED TO VALUE

- Base Capitalization Rate
- Plus Property Tax as a tax rate
- Equals the Overall Capitalization Rate (OAR)



Not  
applying  
potential  
gross  
income?

1. Owner reports the actual rental income by providing the most recent tax docs.
2. Assessor is not told about the 3-month vacancy while the apt. was being renovated, or the collection loss when the tenant did not pay the last month of rent
3. Always estimate the PGI then apply market vacancy



Use only  
expenses  
owner bears  
& recognize  
outlier  
expenses

1. Owner reports all operating expenses to the Assessor. However:
2. Assessor does not know that the tenant pays 100% heating, and 50% of the water & trash
3. Repair expenses reported are 3X the market avg.
4. Property taxes are proportionally split to each tenant





Are you evenly  
applying  
vacancy,  
management &  
reserves?

1. Appraiser includes vacancy, management & reserves based the type of property being valued
2. Owner does not provide a vacancy reduction
3. Management is conducted by owner or outsourced
4. Reserve account is uncommon but replacements will be needed over time

# Are you appropriately applying a Capitalization Rate?

1. For assessing taxes are typically loaded into the capitalization rate
2. Tax rate is added to the Base Cap Rate
3. Appraisers should only apply the % tax rate that the owner bears
4. Base Cap Rate is influenced by location, property type, condition, tenant & lending rates

# PROPERTY TAX EXPENSE ALLOCATION

	GROSS LEASE	MODIFIED LEASE	TRIPLE NET LEASE
Net Operating income	\$40,000	\$40,000	\$40,000
Base Rate	8.20	8.20	8.20
+ Taxes Tax Rate	2.30	1.15	0.23
= Total Cap Rate	10.50	9.35	8.43
NOI / Cap Rate			
= Value	381,000	\$427,800	\$474,500

Yellow = Owner pays 100% of taxes

Green = Owner pays 50% of taxes & Tenant pays 50%

Orange = Taxes are paid by Tenant but for a small amount 10% during a vacancy

**NOTICE HOW THE TAX RATE CAN INFLUENCE THE PROPERTY VALUE**

# TYPES OF LEASES – who pays

Lease Type	Utilities	Property Taxes	Insurance	(CAM) Property Maintenance	Structural Repairs
Gross	Owner	Owner	Owner	Owner	Owner
Modify Gross	Shared	Shared	Shared	Shared	Shared
Single Net	Tenant	Tenant or Owner	Tenant or Owner	Owner	Owner
Double Net	Tenant	Tenant	Tenant	Owner	Owner
Triple Net	Tenant	Tenant	Tenant	Tenant	Owner
Absolute Net	Tenant	Tenant	Tenant	Tenant	Tenant

# Gross lease type

## DEFINITION

All expenses are **paid by the owner/landlord**

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## TYPE OF TENANT

Government tenant, **short term tenant**, small leased spaces, **mini storage**,

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## OWNER EXPENSES

Highest operating expenses. 30% to 50% of rental income

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## CAPITALIZATION RATE

Load the full tax factor into the Cap Rate.

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## VALUE

**Is related to the strength of tenancy, reliability of occupancy over time, location and condition of building.**

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# Absolute lease type

## DEFINITION

All expenses which are **paid by the Tenant**

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## TYPE OF TENANT

Single occupancy tenant, **Long term tenant**, ground lease, tenants may be pharmacies, Home Depot, build to suit properties

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## OWNER EXPENSES

No operating expenses. Expense very low. Expenses for bookkeeping & accounting

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## CAPITALIZATION RATE

Taxes are passed on to the tenant so the Capitalization Rate does not load the taxes or only a small portion. Cap rates are commonly lower for these types of properties.

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## VALUE

**Is related to the strength of tenancy, reliability of occupancy over time, location and condition of building.**

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# Triple Net lease type

## DEFINITION

Most all expenses which are **paid by the Tenant. Except building structural repairs**

## TYPE OF TENANT

Locations with high demand. Owner can dictate lease structure. Well positioned Class A buildings. Tenant are office, retail, single occupancy.

## OWNER EXPENSES

Low operating expenses. Account for management, & reserves in Income approach. 5% to 10% of rental income

## CAPITALIZATION RATE

Little to no tax factor in the Cap Rate because taxes are passed to the tenant. Cap rates are commonly lower for these types of properties.

## VALUE

**Is related to the strength of tenancy, reliability of occupancy over time, location and condition of building.**

# Double Net lease type

## DEFINITION

Certain expenses are appropriated to **Tenants**. Often Tenant pays for utilities they use. Heat & Electric paid directly to vendor. Water, taxes, CAM may be prorated to tenant from owner.

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## TYPE OF TENANT

Common lease is a stable market with a balanced vacancy. Tenants are office, retail, industrial, single occupancy.

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## OWNER EXPENSES

Average operating expenses. Account for management, reserves and owners portion of operating expenses. Income approach expenses are 15% to 25% of rental income

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## CAPITALIZATION RATE

Tax factor in the Cap Rate is calculated based on the % owner has to bear. Cap rate selection may vary depending on location, property type, tenancy, and condition.

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## VALUE

**Is related to the strength of tenancy, reliability of occupancy over time, location and condition of building.**

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# Single Net lease type

## DEFINITION

Certain expenses are appropriated to **Tenants**. Often Tenant pays for utilities they use. Heat & Electric paid directly to vendor. Water, taxes, CAM may be prorated to tenant from owner.

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## TYPE OF TENANT

Most common are Apartments. Common lease is a stable market with a balanced vacancy

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## OWNER EXPENSES

Average operating expenses. Account for management, reserves and owners portion of operating expenses. Income approach expenses are 15% to 25% of rental income

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## CAPITALIZATION RATE

Tax factor in the Cap Rate is calculated based on the % owner has to bear. Cap rate selection may vary depending on location, property type, tenancy, and condition.

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## VALUE

Is related to the strength of tenancy, reliability of occupancy over time, location and condition of building.

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# Modified Gross lease type

## DEFINITION

Tenant pays a base rent than pays a proportional share of some of the expenses such as taxes, utilities, insurance and maintenance.

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## TYPE OF TENANT

Tenants in multi-tenanted buildings with common areas.

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## OWNER EXPENSES

Owner expenses can vary. Account for management, reserves and owners portion of operating expenses.

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## CAPITALIZATION RATE

Tax factor in the Cap Rate is calculated based on the % owner has to bear. Cap rate selection may vary depending on location, property type, tenancy, and condition.

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## VALUE

**Is related to the strength of tenancy, reliability of occupancy over time, location and condition of building.**

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# Gross Sales lease type

## DEFINITION

Tenant pays all rent or a portion of rent based on gross sales from their business. The tenant pays based on revenues (sales). This is more common for seasonal businesses and restaurants.

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## TYPE OF TENANT

Tenants in seasonal locations where sale volume varies greatly. The percentage rent can vary, but commonly it is between 5% and 7% of sales.

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## OWNER EXPENSES

Owner expenses can vary greatly. Getting a history of the rent and expenses is important to estimate an appropriate value.

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## CAPITALIZATION RATE

Tax factor in the Cap Rate is calculated based on the % owner has to bear. Cap rate selection may vary depending on location, property type, tenancy, and condition.

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## VALUE

**Is related to the strength of tenancy, reliability of occupancy over time, location and condition of building.**

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# OPERATING EXPENSE ALLOCATION

Operating Expense	Apartment	Office	Retail	Shopping	Restaurant	Single Occupancy	Industrial
	Net	Net	Net Net	Net Net	Net Net	Triple Net	Triple Net
Heat Util.	Tenant	Tenant	Tenant	Tenant	Tenant	Tenant	Tenant
Electric Util.	Tenant	Tenant	Tenant	Tenant	Tenant	Tenant	Tenant
Water/Sewer	Owner	Owner	Tenant	Shared	Tenant	Tenant	Tenant
Insurance	Owner	Owner	Shared	Shared	Shared	Tenant	Tenant
Grounds/ Plowing	Owner	Owner	Tenant	Owner	Tenant	Tenant	Tenant
Repairs	Owner	Owner	Owner	Shared	Owner	Tenant	shared

# OPERATING EXPENSE ALLOCATION

Operating Expense	Apartment	Office	Retail	Shopping	Restaurant	Single Occupancy	Industrial
Owner's Operating Expenses to Income	23% - 30%	15% - 25%	8% - 15%	8% - 15%	8% - 15%	1% - 10%	1% - 10%

These operating expense rates include Vacancy, Management and Reserves

## PROPERTY TAX EXPENSE ALLOCATION

Operating Expense	Apartment	Office	Retail	Shopping	Restaurant	Single Occupancy	Industrial
Property Taxes	Owner	Shared	Shared	Shared	Tenant	Tenant	Tenant

Owner's property taxes are accounted for by loading on to the base capitalization rate

Only add the percentage of property taxes the owner is required to pay to the base capitalization rate to get the overall capitalization rate



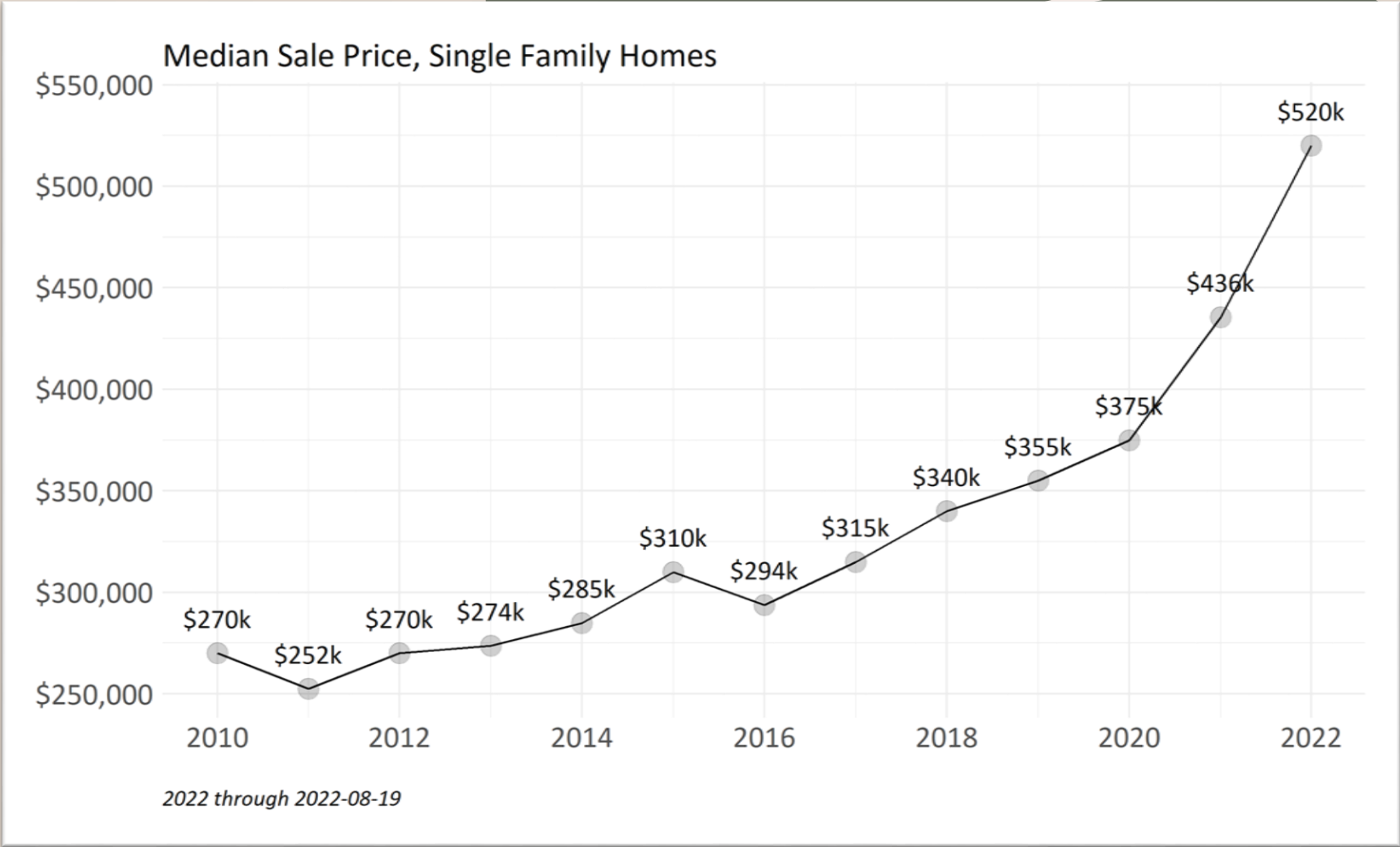
thank you

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# BTV median 1-family house value





# BTV median condo house value

