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Owners of apartment rental properties need to have unemotional valuations

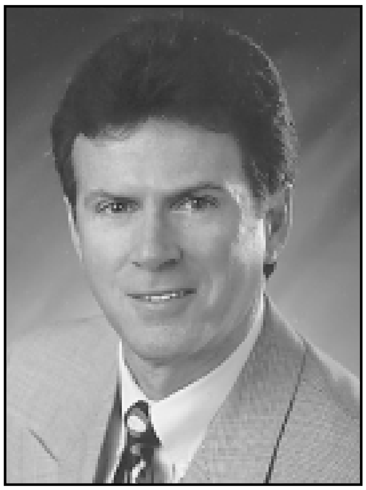
I have been evaluating apartment rental properties for 19 years and I am convinced the person who knows least about true market value of a property is usually the owner.

But I believe most owners would be capable of objectivity if they understood the way to value apartments.

Which brings me to my point: Apartment owners must come to terms with the capitalization method as the only way to appraise a rental property.

You all know about the cost method and the sales comparison method if you have ever read an MAI appraisal. At best they are benchmarks to compare the results of the capitalization method to determine if your conclusion is at the high or low end of the market range of values. And of course "the price I paid for it" method has absolutely no bearing on the current value of a property.

When using the capitalization method, the most important thing to know and understand about your property is the net operating income or NOI.



All things that make any difference regarding the value of your property revolve around this number.

Simply stated: NOI = gross scheduled income minus vacancy minus expenses.

In other words, from whatever your property actually collected in a given year, subtract all of your expenses but not your debt service. What's left is your net operating income. The case study illustrates this concept.

Now that you know your NOI, the capitalization rate of cap rate must be determined to arrive at appraised value. The overall cap rate is the sum of the lender's cap rate and the buyer's cap rate.

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The lender's loan constant is the cash flow requirement to the loan position when the yearly principal and interest together are taken as a percentage of the loan amount.

Example: Assume a loan amount of $100,000 at 10%, amortized over 20 years, as in the case study. Principal/interest payment is $965.12 a month or $11,581 per year, which divided by the $100,000 loan amount, gives you .1158, the loan constant.

The lender's portion of the cap rate is now determined by multiplying the loan constant by the75% loan they are funding. .1158 x .75 = .0868.

The buyer's portion of the cap rate is easier. His 15% return on invested cash is multiplied by the 25% he is putting up in cash: .15 x .25 = .0375.

These cap rates are simply the return both parties must receive on the total purchase price. Thus the combined cap rates of .0868 + .0375 = .1243.

Now the final formula can be computed.

Value = NOI/cap rate. In our case study, the NOI of $190,442 is divided by the cap rate of .1243 for a fair market value of $1,532,116 or $15,321 per unit.

In summary, this property is purchased for $1.53 million with 25% down or $382,500. The mortgage balance of $1,147,500 at the above terms creates annual debt service of $132,883.

When the debt service is subtracted from the NOI of $190,442, the resulting cash flow is $57,559 or 15% return on the $382,500 invested cash.

This exercise confirms the correct market value of $1.53 million.

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