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Valuation Excellence since 1932

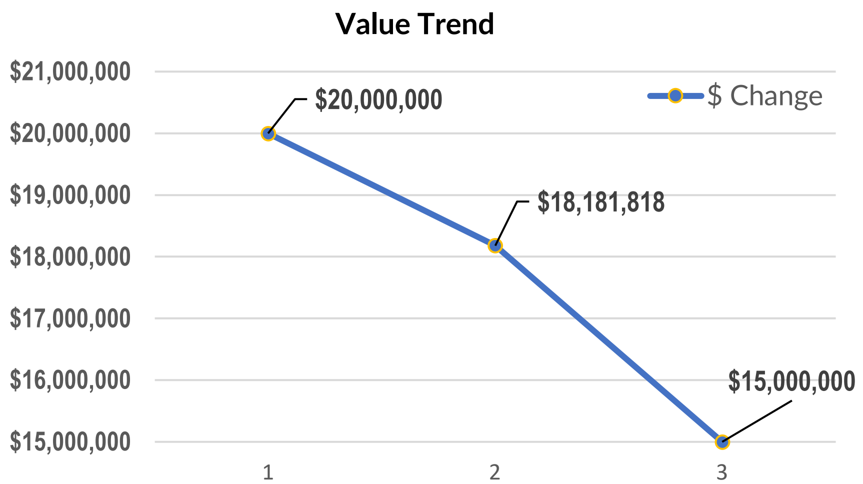
It's Gifting Time Again

In 2020, Marshall & Stevens experienced a great increase in gift tax valuations due to the reduction in value of businesses and real estate during the Covid lockdowns coupled with the concern about potential tax rate changes after the 2020 election. Hotels, retail centers, and office buildings had the greatest reduction in value in 2020.

Today, we are experiencing another material reduction in property value due to the significant increase in borrowing rates in 2023 and uncertainty about when these increases may stop. Central Business District ("CBD") office properties are experiencing the greatest decrease in value year-over-year due to the reduction in demand for and use of office space in 2023.

The increase in cost of debt/financing is reflected in an increase in cap rates for real estate which reduces the market value of a property.

	Base Scenario	Cap Rate Increase of 10%	Cap Rate increase of 20%
NOI	$1,000,000	$1,000,000	$900,000
Cap Rate	5.0%	5.50%	6.0%
Value	$20,000,000	$18,181,818	$15,000,000
$ Change		($1,818,182)	($5,000,000)
% Change		-9.1%	-25.0%
Total Value Loss: 5% to 6% cap rate		$5,000,000	25.0%



And Now the Good News

With revenues declining and expenses growing, there is little a property owner can do to retain value in a cycle like this. The silver lining is that property owners can take advantage of the market driven decrease in value and meet their wealth transfer goals by gifting/transferring equity in their real estate investments. Keep in mind the federal lifetime gift exemption will be cut from $12.92 Million in 2023 to approximately $6 Million after December 31, 2025.

Property values will most likely be higher in the future than they are today, so the best course of action is to see your estate tax attorney and make that gift soon. We are happy to assist with the real estate and financial valuations you require for your gift tax filings.

For those who enjoy digging deeper into the numbers …

Cap rate, or capitalization rate, is a metric used in real estate to determine the value of an income-producing property. It represents the rate of return that an investor can expect to earn on their investment, based on the property's **net operating income (NOI).** The formula to calculate the value of a property using cap rate is:

Value = NOI / Cap rate

Assuming the property's NOI remains the same, if the cap rate increases from 5.0% to 5.5%, the value of the property decreases. This is because a higher cap rate means that investors require a higher rate of return to justify their investment.

To illustrate this, let's say that a property generates $100,000 in NOI. If the cap rate is 5.0%, the value of the property would be:

Value = $100,000 / 0.050 = $2,000,000

Now, if the cap rate increases to 5.5%, the value of the property would be:

Value = $100,000 / 0.055 = $1,818,181, a loss in value of 9.1%

As you can see, the value of the property decreases by almost 10% when the cap rate increases by 0.5%. This means that if an investor was willing to pay $2 Million for the property at a 5.0% cap rate, they would only be willing to pay $1,818,181 at a 5.5% cap rate, assuming the NOI remains the same.

A cap rate increase from 5.0% to 6.0% and the Net Operating Income (NOI) decline from $1,000,000 to $900,000 decreases the value by 25% Here's how to calculate the change in value:

First, calculate the current property value using the following formula:

Property Value = NOI / Cap Rate

At a cap rate of 5.0% and an NOI of $1,000,000, the current property value would be:

$1,000,000 / 0.05 = $20,000,000

Next, calculate the new property value using the same formula, but with a cap rate of 6.0% and an NOI of $900,000:

$900,000 / 0.06 = $15,000,000 reflecting a loss in value of 25%

The new property value would be $15 Million. This represents a decrease in property value of $5 Million or 25% from the original value of $20 Million. This calculation assumes that all other factors remain constant and that the change in cap rate and NOI is the only factor impacting the property value. In reality, changes in market conditions, property conditions, or other factors can also impact the value of a property.

Commercial Property Price Discovery Challenges in 2023

1. **Lack of comparable data**: The lack of transparency in the commercial real estate market can make it difficult to find reliable, comparable data for similar properties. This can lead to a lack of confidence in the accuracy of property valuations and can make it challenging for buyers and sellers to agree on a fair price.

2. **Market volatility**: Commercial property prices can be affected by a wide range of economic and market factors, such as interest rates, supply and demand, and geopolitical events. These factors can cause significant fluctuations in prices, making it difficult for buyers and sellers to accurately predict market conditions.

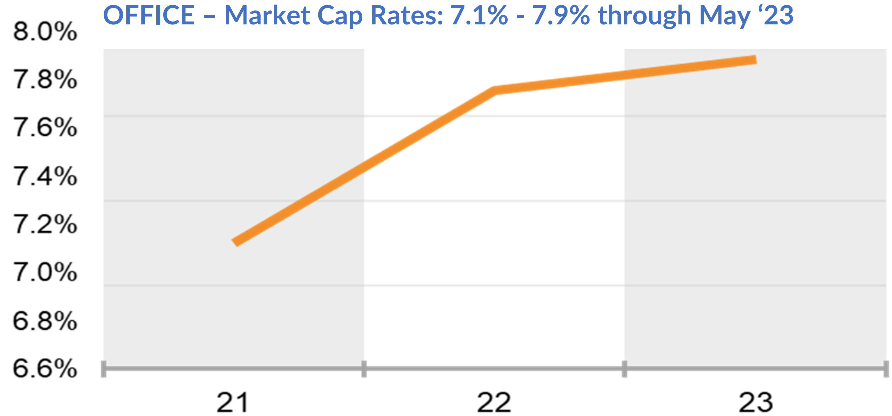
3. **Limited access to capital**: Access to financing can be a significant challenge for many commercial real estate investors, particularly in the current economic climate. A lack of available capital can limit the number of potential buyers and make it difficult for sellers to find a suitable buyer at a fair price.

4. **Changing investor preferences**: Investor preferences and market trends can shift rapidly, making it difficult to accurately predict the demand for certain types of commercial properties. For example, the rise of remote work and e-commerce has led to a decrease in demand for traditional office and retail spaces, while increasing demand for industrial and logistics properties.

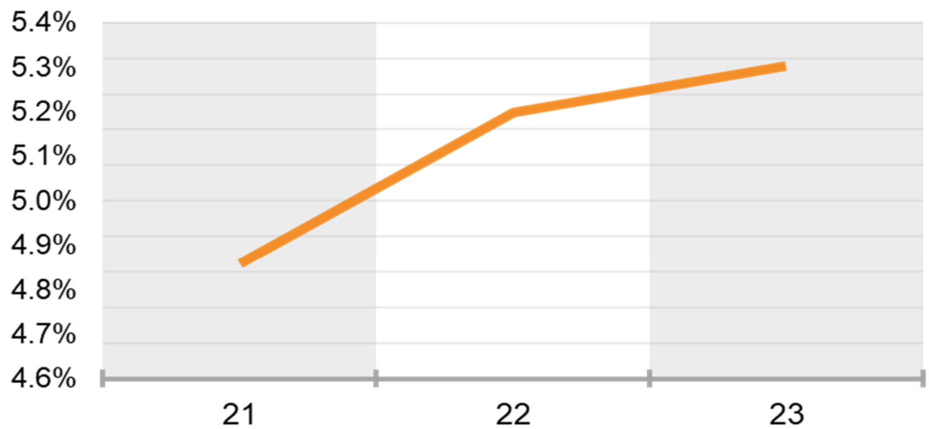
Overall, commercial property price discovery can be challenging in today's market due to a range of factors that can affect demand, supply, and financing. To mitigate these challenges, it is important for buyers and sellers to work with experienced professionals who can provide well contemplated valuations including access to reliable data and insights into market trends and conditions.

Here are a few graphs from Costar to illustrate the general cap rate environment:

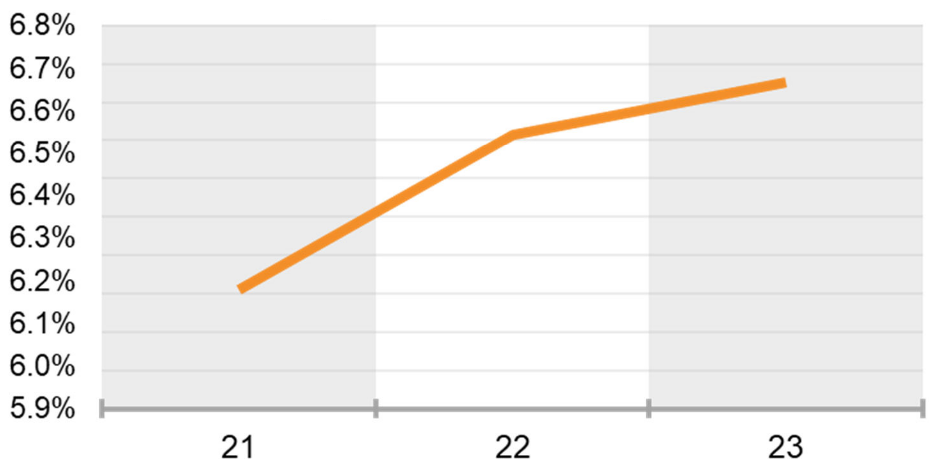
OFFICE – Market Cap Rates: 7.1% - 7.9% through May '23



MULTIFAMILY – Market Cap Rates: 4.9% - 5.3% through May '23



INDUSTRIAL – Market Cap Rates: 6.2% - 6.7% through May '23



Ralph Consola
Executive Managing Director
National Practice Leader
Business Development
213.233.1511
rconsola@marshall-stevens.com

Patrick T. Craig, MAI, MRICS
Executive Managing Director
National Practice Leader
Real Estate Valuation
212.897.9481
pcraig@marshall-stevens.com