



Department of Local Government Finance

2024 Level II Income Approach

Problem and Answer Packet with Audio

Class Problem # 1
Development of Potential Gross Income

You are appraising a neighborhood strip shopping center known as Gateway Shopping Center. The leases with the tenants were entered into at various times over the past five years. The current rent roll follows:

Tenant	Leasable Area	Annual Rent
Kathy's Cards and Gifts	2,500 SF	\$37,500
Sports Galore	2,500 SF	\$40,000
Deuce Hardware	4,000 SF	\$40,000
Palace Restaurant	3,000 SF	\$60,000
Mother Goose Shoes	2,000 SF	\$40,000
House of Beauty	1,500 SF	\$37,500
Safe Insurance	800 SF	\$14,400
Vacant Retail Space	2,500 SF	\$0
	18,800 SF	\$269,400

You have researched the market and found recently negotiated rents for competing shopping centers run \$25.00/SF for space regardless of size or build outs.

What Potential Gross Income (PGI) will you use in your reconstructed operating statement for the Gateway Shopping Center?



Class Problem # 1 Answer
Development of Potential Gross Income

What Potential Gross Income (PGI) will you use in your reconstructed operating statement for the Gateway Shopping Center?

Tenant	Leasable Area	Market Rent	PGI
Kathy's Cards and Gifts	2,500 SF	\$25	\$62,500
Sports Galore	2,500 SF	\$25	\$62,500
Deuce Hardware	4,000 SF	\$25	\$100,000
Palace Restaurant	3,000 SF	\$25	\$75,000
Mother Goose Shoes	2,000 SF	\$25	\$50,000
House of Beauty	1,500 SF	\$25	\$37,500
Safe Insurance	800 SF	\$25	\$20,000
Vacant Retail Space	2,500 SF	\$25	\$62,500
	18,800 SF		\$470,000

OR

18,800	Times	\$25
		\$470,000

The Potential Gross Income is :

\$470,000



Class Problem # 2
Development of Vacancy and Collection Loss

You have researched the properties that compete with the Gateway Shopping Center and have obtained the following information:

Property	Vacant Space	Total Leasable Area	Rents Receivable	Rents Collected
Riverton SC	1,200 SF	20,000 SF	\$475,000	\$469,775
Eagle Ridge SC	1,050 SF	18,000 SF	\$396,000	\$392,440
Chatham SC	1,600 SF	26,000 SF	\$524,000	\$518,760
Hyde Park SC	850 SF	14,000 SF	\$322,000	\$318,780
Gateway SC (Subject Property)	2,500 SF	18,800 SF	\$269,400	\$269,400

What Vacancy and Collection Loss Rate (V & C) will you use in your reconstructed operating statement for Gateway Shopping Center?



Class Problem # 2 Answer
Development of Vacancy and Collection Loss

What Vacancy and Collection Loss Rate (V & C) will you use in your reconstructed operating statement for Gateway Shopping Center?

Property	Vacant Space	Total Leasable Area	Rents Receivable	Rents Collected
Riverton SC	1,200 SF	20,000 SF	\$475,000	\$469,775
Eagle Ridge SC	1,050 SF	18,000 SF	\$396,000	\$392,440
Chatham SC	1,600 SF	26,000 SF	\$524,000	\$518,760
Hyde Park SC	850 SF	14,000 SF	\$322,000	\$318,780
Gateway SC (Subject Property)	2,500 SF	18,800 SF	\$269,400	\$269,400

Vacancy Rate Calculation

Property	Vacant Space	Total Leasable Area	Vacancy Rate
Riverton SC	1,200 SF	20,000 SF	6%
Eagle Ridge SC	1,050 SF	18,000 SF	6%
Chatham SC	1,600 SF	26,000 SF	6%
Hyde Park SC	850 SF	14,000 SF	6%
Gateway SC (Subject Property)	2,500 SF	18,800 SF	13%

Vacancy Rate Calculation

6%

Collection Loss Rate Calculation

Property	Rents Receivable	Rents Collected	Uncollected Rents	Rents Receivable	CL Rate
Riverton SC	\$475,000	\$469,775	\$5,225	\$475,000	1%
Eagle Ridge SC	\$396,000	\$392,440	\$3,560	\$396,000	1%
Chatham SC	\$524,000	\$518,760	\$5,240	\$524,000	1%
Hyde Park SC	\$322,000	\$318,780	\$3,220	\$322,000	1%
Gateway SC (Subject Property)	\$269,400	\$269,400	\$0	\$269,400	0%

Collection Loss Rate Calculation

1%

The total Collection and Vacancy Rate is:

7%



Class Problem # 3
Development of Effective Gross Income

Use the information from Problems 1 and 2 and develop an Effective Gross Income (EGI). Also, historically the Gateway SC has miscellaneous income of \$5,000 annually.

What is the Effective Gross Income (EGI) for the subject property?



Class Problem # 3 Answer
Development of Effective Gross Income

What is the Effective Gross Income (EGI) for the property?

Potential Gross Income (Problem 1)	PGI	\$470,000
Less: Vacancy and Collection Loss (Problem 2)	V & C (7%)	-\$32,900
Miscellaneous Income	Misc. Inc	\$5,000
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Effective Gross Income	EGI	\$442,100

The Effective Gross Income for the subject property is: \$442,100



Class Problem # 4
Development of Allowable Expenses

Given below is the statement of expenses for the Gateway SC as prepared by the owner's accountant. They are actual bank withdrawals and are assumed to be correct. In your analysis of the statement for appraisal purposes, you have decided that some items can be used as stated, others need to be eliminated, and some need to be pro-rated. Indicate with an "X" which items you would use as stated, pro-rated (over more than one year), or would eliminate from your reconstructed operating statement.

	<u>As Stated</u>	<u>Pro-Rate</u>	<u>Eliminate</u>
A. Management Fees	_____	_____	_____
B. Advertising	_____	_____	_____
C. Maintenance Personnel Salaries	_____	_____	_____
D. Maintenance Personnel Benefits	_____	_____	_____
E. Debt Service on Mortgage	_____	_____	_____
F. Water and Sewage Fees	_____	_____	_____
G. Electricity	_____	_____	_____
H. Gas for Heating	_____	_____	_____
I. New Roof	_____	_____	_____
J. Miscellaneous Repairs	_____	_____	_____
K. Supplies	_____	_____	_____
L. Casualty Insurance--3 year policy	_____	_____	_____
M. Liability Insurance	_____	_____	_____
N. Snow Removal	_____	_____	_____
O. Income Tax	_____	_____	_____
P. Donation, Christmas Gift Expense	_____	_____	_____
Q. Real Estate Taxes	_____	_____	_____



Class Problem # 4 Answer
Development of Allowable Expenses

Indicate with an "X" which items you would use as stated, pro-rated (over more than one year), or would eliminate from your reconstructed operating statement.

	<u>As Stated</u>	<u>Pro-Rate</u>	<u>Eliminate</u>
A. Management Fees	X		
B. Advertising	X		
C. Maintenance Personnel Salaries	X		
D. Maintenance Personnel Benefits	X		
E. Debt Service on Mortgage			X
F. Water and Sewage Fees	X		
G. Electricity	X		
H. Gas for Heating	X		
I. New Roof		X	
J. Miscellaneous Repairs	X		
K. Supplies	X		
L. Casualty Insurance--3 year policy		X	
M. Liability Insurance	X		
N. Snow Removal	X		
O. Income Tax			X
P. Donation, Christmas Gift Expense			X
Q. Real Estate Taxes			X



Class Problem # 5
Development of Reserve for Replacements

The following are capital items on the Gateway SC that have to be replaced periodically.

The roof costs \$30,000 to replace and typically lasts 15 years.

The HVAC equipment lasts 20 years and costs \$20,000 to replace.

The parking lot has to be re-paved every 10 years at a cost of \$40,000.

The awnings and store fronts need updated every 15 years at a cost of \$50,000.

Set up the Reserve for Replacements Account that you will use in your reconstructed operating statement. Determine the annual expense for these items.



Class Problem # 5 Answer
Development of Reserve for Replacements

Set up the Reserve for Replacements Account that you will use in your reconstructed operating statement. Determine the annual expense for these items.

Item	Cost to Replace	Typical Life	Reserve
Roof	\$30,000	15	\$2,000
HVAC	\$20,000	20	\$1,000
Parking Lot	\$40,000	10	\$4,000
Store Fronts	\$50,000	15	\$3,333

Total

\$10,333

The total Reserve for Replacements would be :

\$10,333



Level II
Class Problem # 6
Development of Expense Ratio

An expense ratio is the total allowable expenses, including reserves, stated as a percentage of Effective Gross Income. (EGI)

You have obtained the following information on properties comparable to the Gateway SC.

Property	EGI	Expenses	Reserve for Replacements
Riverton SC	\$469,775	\$135,330	\$15,000
Eagle Ridge SC	\$392,440	\$117,500	\$12,000
Chatham SC	\$518,760	\$148,000	\$18,000
Hyde Park SC	\$318,780	\$88,020	\$10,800

What expense ratio should you use in your reconstructed operating statement for Gateway SC?



Level II
Class Problem # 6 Answer
Development of Expense Ratio

What expense ratio should you use in your reconstructed operating statement for Gateway SC?

Property	Expenses	Reserve for Replacements	Total Expenses	EGI	Expense Ratio
Riverton SC	\$135,330	\$15,000	\$150,330	\$469,775	32%
Eagle Ridge SC	\$117,500	\$12,000	\$129,500	\$392,440	33%
Chatham SC	\$148,000	\$18,000	\$166,000	\$518,760	32%
Hyde Park SC	\$88,020	\$10,800	\$98,820	\$318,780	31%

The Expense Ratio to use is	32%
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Level II
Class Problem # 7
Reconstructed Operating Statement

Using the information you developed for Problems 1, 2, 3, and 6, reconstruct an operating statement for the Gateway Shopping SC. Then develop its Net Operating Income (NOI).



Level II
Class Problem # 7 Answer
Reconstructed Operating Statement

Using the information you developed for Problems 1, 2, 3, and 6, reconstruct an operating statement for the Gateway Shopping SC. Then develop its Net Operating Income (NOI).

Potential Gross Income (Problem 1)	PGI	\$470,000
Less: Vacancy and Collection Loss (Problem 2)	V & C	-\$32,900
Miscellaneous Income	Misc. Inc	\$5,000
Effective Gross Income	EGI	\$442,100
Less: Expenses (at 32%)	-Exp	(\$141,472)
Less: Reserves for replacements	in expenses	\$0
Net Operating Income	NOI	\$300,628

The subject property's net operating income (NOI) is:

\$300,628



Level II
Class Problem # 8
Land and Building Capitalization Rates

You are given the following information:

Discount Rate		9.0%
Mortgage Rate		6.5%
Recapture Rate		2.5%
Effective Tax Rate		1.5%
Nominal Tax Rate	\$3.00 per \$100 of Assessed Value	

Calculate a Land Capitalization Rate.

Calculate an improvement/building capitalization rate.



Level II
Class Problem # 8 Answer
Land and Building Capitalization Rates

Calculate a Land Capitalization Rate.
Calculate an improvement/building capitalization rate.

Calculate a Land Capitalization Rate.

Discount Rate	9.0%
Plus Effective Tax Rate	1.5%
<hr/>	
Land Cap Rate	10.5%

Calculate an improvement/building capitalization rate.

Discount Rate	9.0%
Plus Effective Tax Rate	1.5%
Plus Recapture Rate	2.5%
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Building Cap Rate	13.0%



Level II
Class Problem # 9
Overall Capitalization Rate
and
Weighted Land and Building Cap Rates

You are given the following information:

Discount Rate	8.0%
Recapture Rate	2.0%
Effective Tax Rate	2.0%
Land to Building Ratio	1:3

Calculate an overall capitalization rate (OAR)



Level II
Class Problem # 9 Answer
Overall Capitalization Rate
and
Weighted Land and Building Cap Rates

You are given the following information:

Discount Rate	8.0%
Recapture Rate	2.0%
Effective Tax Rate	2.0%
Land to Building Ratio	1:3

Calculate an overall capitalization rate (OAR)

Step 1) Calculate a Land Cap Rate:

Discount Rate	8.0%
Plus Effective Tax Rate	2.0%
Equals Land Cap Rate	10.0%

Step 2) Calculate a building capitalization rate.

Discount Rate	8.0%
Plus Effective Tax Rate	2.0%
Plus Recapture Rate	2.0%
Equals Building Cap Rate	12.0%

Step 3) Weight the land and building cap rates by the land to building ratio.

Land	1 part	1/4	25.0%
Building	3 parts		75.0%
Total	4 parts		100.0%

Land Cap Rate	10.0%	X	25.0%	2.5%
Building Cap Rate	12.0%	X	75.0%	9.0%
Total Overall Capitalization Rate				11.5%

Level II
Class Problem # 10
Overall Capitalization Rate From the Market

Property	EGI	Total Exp. And RR	Sale Price
Riverton SC	\$469,775	\$150,330	\$2,778,000
Eagle Ridge SC	\$392,440	\$129,500	\$2,307,000
Chatham SC	\$518,760	\$166,000	\$3,065,000
Hyde Park SC	\$318,780	\$98,820	\$1,895,000

Calculate an overall capitalization rate.



Level II
Class Problem # 10 Answer
Overall Capitalization Rate From the Market

Calculate an overall capitalization rate.

Property	EGI	Total Exp. and RR	NOI	Sale Price	OAR
Riverton SC	\$469,775	\$150,330	\$319,445	\$2,778,000	11.5%
Eagle Ridge SC	\$392,440	\$129,500	\$262,940	\$2,307,000	11.4%
Chatham SC	\$518,760	\$166,000	\$352,760	\$3,065,000	11.5%
Hyde Park SC	\$318,780	\$98,820	\$219,960	\$1,895,000	11.6%

The Overall Capitalization Rate is:

11.5%



Level II
Class Problem # 11
Direct Capitalization and Overall Cap Rate

Use the answers from Problems 7 and 10 and calculate the value of the Gateway Shopping Center using direct capitalization in the income approach to value.



Level II
Class Problem # 11 Answer
Direct Capitalization and Overall Cap Rate

Use the answers from Problems 7 and 10 and calculate the value of the Gateway Shopping Center using direct capitalization in the income approach to value.

Answer from Problem # 7:

The subject property's Net Operating Income (NOI) is: \$ 300,628

Answer from Problem # 10:

The Overall Capitalization Rate (OAR) is: 11.5%

Apply the Direct Capitalization Method IRV Formula

$$V = I/R$$

Net Operating Income/Over All Rate = Market Value

$\$300,628/11.5\% =$ \$ 2,614,157



Level II
Class Problem # 12
Direct Capitalization Vs. Gross Income Multiplier

Using the EGI arrived at in Problem # 3 and the chart below from problem # 10, calculate a Gross Income Multiplier (GIM) and determine the value of the subject property using Direct Capitalization in the Income Approach.

Then compare this answer to the one you arrived at in Problem # 11.

Property	EGI	Total Exp. And RR	Sale Price
Riverton SC	\$469,775	\$150,330	\$2,778,000
Eagle Ridge SC	\$392,440	\$129,500	\$2,307,000
Chatham SC	\$518,760	\$166,000	\$3,065,000
Hyde Park SC	\$318,780	\$98,820	\$1,895,000



Level II
Class Problem # 12 Answer
Direct Capitalization Vs. Gross Income Multiplier

Using the EGI arrived at in Problem # 3 and the chart below from problem # 10, calculate a Gross Income Multiplier (GIM) and determine of the value of the subject property using Direct Capitalization in the Income Approach.

Property	EGI	Total Exp. And RR	Sale Price
Riverton SC	\$469,775	\$150,330	\$2,778,000
Eagle Ridge SC	\$392,440	\$129,500	\$2,307,000
Chatham SC	\$518,760	\$166,000	\$3,065,000
Hyde Park SC	\$318,780	\$98,820	\$1,895,000

Calculation of Gross Income Multiplier (GIM): $GIM = \text{Sale Price} / \text{Annual EGI}$

Property	Sale Price	EGI	GIM
Riverton SC	\$2,778,000	\$469,775	5.9
Eagle Ridge SC	\$2,307,000	\$392,440	5.9
Chatham SC	\$3,065,000	\$518,760	5.9
Hyde Park SC	\$1,895,000	\$318,780	5.9

The Gross Income Multiplier in this problem would be 5.9

Now apply the VIF formula:

EGI Times GIM = Market Value

\$442,100 times 5.9 =

\$2,608,390

Now compare this answer to the one arrived at in Problem # 11:

\$2,614,157



Practice Problem # 1

PGI-EGI-NOI

You have obtained the following information:

A building has total of 40,000 Square Feet. There is 8,000 Square Feet of common area. Market rent is currently \$20.00 per square foot of net leasable area. The Vacancy and Collection Loss Rate is 6%. The Operating Expense and the Reserves for Replacements is at 18%. The Overall Capitalization Rate is 10%.

You are to develop the Potential Gross Income (PGI), the Effective Gross Income (EGI), and the Net Operating Income (NOI). Once you have done that, calculate an estimate of value for this property.



Practice Problem # 1
PGI-EGI-NOI Answer

You are to develop the Potential Gross Income (PGI), the Effective Gross Income (EGI), and the Net Operating Income (NOI). Once you have done that, calculate an estimate of value for this property.

Potential Gross Income	\$640,000
Vacancy and Collection Loss	-\$38,400
Misc Income	0
Effective Gross Income	<u>\$601,600</u>
Operating Expenses & RR	-\$108,288
Net Operating Income	<u><u>\$493,312</u></u>

COMPUTATION OF PGI, EGI, AND NOI FOR ABOVE PROBLEM

PGI	32,000	\$20	\$640,000
V and C	\$640,000	6%	-\$38,400
Misc Income	\$0		0
Effective Gross Income			<u>\$601,600</u>
Operating Expenses & RR	\$601,600	18%	-\$108,288
Net Operating Income			<u><u>\$493,312</u></u>

THE INCOME FROM ABOVE IS	<u>\$493,312</u>
Overall Capitalization Rate	10%
Estimate of value using the IRV formula	<u><u>\$4,933,120</u></u>



Practice Problem # 2
Development of NOI and Overall Cap Rate

Potential Gross Income	\$150,000
Vacancy and Collection Loss	10%
Operating Expense	\$25,000
Christmas Gift	\$2,500
Property Value	\$800,000
Loan to value ratio	0.4

The above is given to you. Develop the NOI and the Overall Capitalization Rate.



Practice Problem # 2 Answer
Development of NOI and Overall Cap Rate

Potential Gross Income	\$150,000
Vacancy and Collection Loss	10%
Operating Expense	\$25,000
Christmas Gift	\$2,500
Property Value	\$800,000
Loan to value ratio	0.4

The above is given to you. Develop the NOI and the Overall Capitalization Rate.

Net Operating Income	\$110,000
Overall Cap Rate	13.8%

DEVELOPMENT OF NET OPERATING INCOME

PGI	\$150,000
V & C Loss	-\$15,000
Misc Inc	\$0
Effective Gross Income	\$135,000
Operating Expense	-\$25,000
Net Operating Income	\$110,000



Practice Problem # 3
Expense Ratio Problem

You have obtained the following information. Develop an Expense Ratio for the subject property based on this market information. What expense ratio will you use for your subject property?

Office Bldg.	EGI	Expenses	Reserves	Total Exp	Exp Ratio
Uptown	\$468,230	\$134,220	\$15,000		
River Edge	\$393,450	\$118,200	\$12,000		
East Lake	\$522,030	\$147,500	\$18,000		
Forest Glen	\$319,500	\$88,120	\$10,800		



Practice Problem # 3 Answer
Expense Ratio Problem

What expense ratio will you use for your subject property?

Office Bldg.	EGI	Expenses	Reserves	Total Exp	Exp Ratio
Uptown	\$468,230	\$134,220	\$15,000	\$149,220	31.9%
River Edge	\$393,450	\$118,200	\$12,000	\$130,200	33.1%
East Lake	\$522,030	\$147,500	\$18,000	\$165,500	31.7%
Forest Glen	\$319,500	\$88,120	\$10,800	\$98,920	31.0%

Total Expense Ratio 31.8%



Practice Problem # 4 (A)
Gross Rent and Gross Income Multipliers

Gross Rent Multiplier Problem

The subject property is a single family dwelling which is rented for \$475 per month. The market rent is also \$475 per month. Develop a GRM from the following data and use it to calculate a possible indication of value.

	<u>Sales</u>					
	1	2	3	4	5	6
Sale Price	\$60,000	\$72,000	\$65,000	\$62,000	\$68,000	\$70,000
Monthly Rent (EGI)	\$425	\$520	\$460	\$450	\$490	\$500
GRM						



Practice Problem # 4 (A) Answer
Gross Rent and Gross Income Multipliers

Gross Rent Multiplier Problem

The subject property is a single family dwelling which is rented for \$475 per month. The market rent is also \$475 per month. Develop a GRM from the following data and use it to calculate a possible indication of value.

	<u>Sales</u>					
	1	2	3	4	5	6
Sale Price	\$60,000	\$72,000	\$65,000	\$62,000	\$68,000	\$70,000
Monthly Rent (EGI)	\$425	\$520	\$460	\$450	\$490	\$500
GRM	141	138	141	138	139	140

GRM = Sales Price divided by the Monthly Rent (EGI)

Median is 140

Possible indication of value: Market rent of \$475 times 140 = \$66,500



Practice Problem # 4 (B)
Gross Income Multiplier Problem

The subject property produces Gross Annual Effective Gross Income of \$72,000. Analysis of rents and, sales of comparable properties rendered the following. Based upon this information calculate a Gross Income Multiplier (GIM) and then calculate an indication of value for the subject property.

Sale	Sale Price	EGI	Gross Income Multiplier	Range
1	\$675,000	\$75,000		
2	\$600,000	\$68,000		
3	\$720,000	\$85,700		
4	\$750,000	\$87,500		
5	\$650,000	\$73,000		

Estimated value of subject property:

Value using Median

Value using Low range

Value using High range



Practice Problem # 4 (B) Answer
Gross Income Multiplier Problem

The subject property produces Gross Annual Effective Gross Income of \$72,000. Analysis of rents and, sales of comparable properties rendered the following. Based upon this information calculate a Gross Income Multiplier (GIM) and then calculate an indication of value for the subject property.

Sale	Sale Price	EGI	Gross Income Multiplier	Range
1	\$675,000	\$75,000	9.0	8.4
2	\$600,000	\$68,000	8.8	8.6
3	\$720,000	\$85,700	8.4	8.8
4	\$750,000	\$87,500	8.6	8.9
5	\$650,000	\$73,000	8.9	9.0

GIM = Sale Price divided by the median EGI

Possible indicated range of value:

Subject property EGI of \$72,000 times low range =

Subject property EGI of \$72,000 times high range =

Subject property EGI of \$72,000 times median range 8.8 =

\$604,800
\$648,000
\$633,600

