

## Income (Capitalization) Approach Job Aid

The income (capitalization) approach is used to determine a value that supports income and expenses (i.e., providing support for rents, expenses, and capitalization rates). This approach allows an appraiser to measure the present value of future benefits. The analysis for this approach is done at the “time of sale.” There are nine key steps involved in completing a detailed analysis for the income (capitalization) approach.

1. Collect sales.
2. Verify all sales and the information/data regarding these sales.
3. Classify the comparable sales into improved and unimproved.
4. Compute cap rates for similar sales.
5. Analyze and compute rents – vacancy rate [percentage estimate that the rental will be vacant]\* and other income.
6. Analyze and compute expenses.
7. Compute net operating income (NOI);  $\text{NOI} = \text{income} - \text{expenses}$ .
8. Select cap rate based on similarities.
9. Compute value;  $\text{subject NOI} / \text{selected cap rate} = \text{subject value}$ .

\* Rents – vacancy rate is referred to as Effective Gross Income.

The following are some key terms and concepts that an appraiser must understand in order to use the income (capitalization) approach. These terms and concepts are helpful for reviewers to understand as well, in order to determine if the appraiser used the approach properly and accurately.

Key Term/Concept	Description/Explanation
Direct income capitalization technique	<p>This technique:</p> <ul style="list-style-type: none"> <li>• Is the most commonly used for the income (capitalization) approach.</li> <li>• Assumes a relatively stable market.</li> <li>• Capitalizes 1 year worth of income into perpetuity.</li> </ul>
Rents	Rents are derived from market data; the appraiser must get to know the area, farm plans, and lease data.
Expenses	Expenses are derived from the market area; the appraiser must use consistent application if the expenses are estimated.
Net operating income (NOI)	NOI is derived from rental and/or other income minus expenses (i.e., $\text{rental and/or other income} - \text{expenses} = \text{NOI}$ ).
Cap rates	Cap rates are derived from the market

*For additional information on this approach, contact your supervisor/mentor.*