METHODOLOGY GUIDE

VALUING OFFICE BUILDINGS IN ONTARIO

Valuation Date: January 1, 2016

AUGUST 2016

MUNICIPAL PROPERTY ASSESSMENT CORPORATION

August 22, 2016

The Municipal Property Assessment Corporation (MPAC) is responsible for accurately assessing and classifying property in Ontario for the purposes of municipal and education taxes.

In Ontario's assessment system, MPAC assesses your property value every four years. This year, MPAC is updating the value of every property in the province to reflect the legislated valuation date of January 1, 2016.

MPAC is committed to provide Ontario property owners, municipalities and all its stakeholders with the best possible service through transparency, predictability and accuracy in values. As part of this commitment, MPAC has defined three levels of disclosure of information in support of its delivery of this year's assessment update. This Methodology Guide is the first level of information disclosure.

This guide provides an overview of the valuation methodology undertaken by MPAC when assessing office buildings for this year's update ensuring the methodology for valuing these properties is well documented and in alignment with industry standards.

Property owners can access additional information about their own properties through aboutmyproperty.ca. Login information for aboutmyproperty.ca is provided on each Property Assessment Notice mailed this year. Additional information about MPAC can be accessed at mpac.ca.

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1.0 Introduction

The Municipal Property Assessment Corporation (MPAC) – mpac.ca – is responsible for accurately assessing and classifying property in Ontario for the purposes of municipal and education taxation.

In Ontario, property assessments are updated on the basis of a four-year assessment cycle. In 2016, MPAC will update the assessments of Ontario's nearly five million properties to reflect the legislated valuation date of January 1, 2016. Assessments updated for the 2016 base year are in effect for the 2017–2020 property tax years.

The last Assessment Update was based on a January 1, 2012, valuation date. Increases are phased in over a four-year period. Any decreases in assessment are applied immediately.

It is important to ensure that the valuation methodology applied is capable of providing a realistic estimate of current value at the relevant valuation date, which, in turn, enables all stakeholders to understand the valuation process and have confidence in the fairness and consistency of its outcome.

This Methodology Guide has been prepared for the benefit of MPAC assessors, property owners and their representatives, municipalities and their representatives, Assessment Review Board members, provincial officials, and the general public.

This guide outlines the valuation process to be followed by an assessor, including steps that require appraisal judgment. It is incumbent upon the assessor to make informed decisions throughout the valuation process when arriving at estimates in current value.

1.1 Properties Covered by This Methodology Guide

This methodology guide applies to office buildings in Ontario. The following MPAC property codes are used to categorize the various types of office buildings in Ontario:

- 402 Large office building (generally multi-tenanted, over 7,500 sq. ft.)

- 403 Large medical/dental building (generally multi-tenanted, over 7,500 sq. ft.)

It should be noted that these are general guidelines that vary depending on the specific circumstances of a particular property.

An assessor may also make reference to additional Methodology Guides for properties that do not fall precisely within the description of one of the property codes listed above.

1.2 Legislation

The main legislation governing the assessment of properties in Ontario for property tax purposes is contained in the Assessment Act.[1]

The Act contains important definitions and states that all property in Ontario is liable to assessment and taxation, subject to some exemptions. Section 19(1) of the Act requires that land be assessed at current value, which is defined to mean, in relation to land, "the amount of money the fee simple, if unencumbered, would realize if sold at arm's length by a willing seller to a willing buyer."

The Minister of Finance filed Ontario Regulation 430/15 on December 18, 2015, which added additional rules affecting the valuation and classification of properties on which a third-party sign (billboard) is located. To comply with the regulation, the income attributable to a third-party sign will not be included in the valuation of any property for assessment purposes.

1.3 Classification

MPAC's role is to accurately assess and classify all properties in Ontario in accordance with the Assessment Act and its associated regulations established by the Government of Ontario. The classification of a property will determine which tax rate will be applied by the municipality or taxing authority. All properties are classified according to their use, and Ontario Regulation 282/98 of the Assessment Act sets out how various property uses are classified.

Office Buildings are included in the Commercial Property Class in accordance with Section 5(1)1 of Ontario Regulation 282/98 as "land and vacant land that is not included in any other property class."[2] The classification of office buildings is covered in Section 11(1) of Ontario Regulation 282/98. The office building property class only applies if the council of a municipality passes a by-law opting to have the optional class apply. Section 11(1) of Ontario Regulation 282/98 requires the council of a municipality to pass a bylaw establishing the tax ratios for the office building property class pursuant to Section 308 of the Municipal Act, 2001.[3] If a municipality does not opt to have the office building property class apply, the property is included in the default Commercial Property Class in accordance with Section 5(1)1 of Ontario Regulation 282/98 .

The office building property class only applies to the portion of the property that exceeds the 25,000 square feet threshold. As a result, the eligible property will always be apportioned between commercial and office building as follows: the commercial classification is applied to

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[1] Assessment Act, R.S.O 1990, c A.31: https://www.ontario.ca/laws/statute/90a31.
[2] Ontario Regulation 282/98, GENERAL: https://www.ontario.ca/laws/regulation/980282.
[3] Municipal Act, 2001, S.O. 2001, c. 25: https://www.ontario.ca/laws/statute/01m25.

the first 25,000 square feet and the office building classification is applied to the portion of the property that is in excess of 25,000 square feet.

For new construction, depending on the percentage increase of the improvement and the building permit issuance date, an office building may be included in the New Commercial Property Class under Ontario Regulation 400/98.

Irrespective of whether the municipality has adopted the optional office building property class, MPAC will still apply the optional class to the portions of the property that meet the legislative requirements.

1.4 The Use of This Methodology Guide

This Methodology Guide is intended to:

- Ensure MPAC's assessed values for these properties are fair, accurate, predictable and transparent.

- Provide direction to assessors and clear explanations to municipalities, taxpayers and Assessment Review Board members.

- Ensure that MPAC's methodology for valuing these properties is well documented and aligns with industry standards.

- Explain the thought process/decision-making process that an assessor should undertake to apply the valuation methodology.

- Ensure a consistent approach to valuing these property types.

- Support MPAC assessors in conducting their due diligence in:

  ➢ applying Ontario's legislation and regulations
  ➢ adhering to industry standards for market valuation in a mass appraisal environment.

It should be noted that this Methodology Guide is not intended to be a substitute for an assessor's judgment in arriving at a market value–based assessment (i.e., current value) for a particular property. However, given that the Methodology Guide explains industry standards for property assessment, conforms to valuation industry norms, and adheres to provincial legislation and regulation, MPAC assessors are expected to follow the procedures in the Methodology Guide and be able to clearly and satisfactorily justify any deviations from it.

1.5 Consultation and Disclosure

MPAC is committed to providing municipalities, taxpayers and all its stakeholders with the best possible service through transparency, predictability and accuracy. In support of this commitment, MPAC has defined three levels of disclosure as part of its delivery of the 2016 province-wide Assessment Update.

- **Level 1** – Methodology Guides explaining how MPAC approached the valuation of particular types of property

- **Level 2** – Market Valuation Reports explaining how the methodology outlined in Level 1 has been applied at the sector level for the purposes of each assessment

- **Level 3** – Property Specific Valuation Information available to property taxpayers, their representatives and municipalities

2.0 The Valuation Process

The valuation process always begins with a determination of the highest and best use of the subject property.

Any reliance upon this guide is made only after the assessor has determined that the highest and best use of the subject property is that of an office building.

Assessors determine the value of a property using one of three different approaches to value:

- the direct (sales) comparison approach

- the income approach

- the cost approach

2.1 Outline

In the **direct (sales) comparison approach**, value is indicated by recent sales of comparable properties in the market. In considering any sales evidence, it is critical to ensure that the property sold has a similar or identical highest and best use as the property to be valued.

In the **income approach** (or, more accurately, the income capitalization approach), value is indicated by a property's revenue-earning power, based on the capitalization of income. This method requires a detailed analysis of both income and expenditure, both for the property being valued and other similar properties that may have been sold, in order to ascertain the anticipated revenue and expenses, along with the relevant capitalization rate.

In the **cost approach**, value is estimated as the current cost of reproducing or replacing improvements of the land (including buildings, structures and other taxable components), less any loss in value resulting from depreciation. The market value of the land is then added.

MPAC primarily uses the income approach to value office buildings. The value of an income property such as an office building is based on the present worth of anticipated future income.

MPAC uses the direct capitalization method to establish current value assessments in a mass appraisal context.

This method estimates the annual fair market rental income and other potential income that can be generated by the office building, deducts operating expenses and then applies a capitalization rate to the net income to arrive at an estimate of current value for the property.

The direct capitalization approach involves the following steps:

1. Determine the potential gross income (PGI) using market rents.

2. Adjust for typical vacancy expense allowance according to the type and quality of office building to determine the effective gross income (EGI).

3. Deduct typical non-recoverable expenses to determine the net operating income (NOI).

4. Establish the capitalization rate from sales data.

5. Capitalize the NOI into an estimate of current value.

2.2 Approach

There are four main phases in the process used by MPAC:

- data collection

- analysis of the data collected

- valuation

- property value review

2.3 Data Collection

The data required for office building valuations comes from a number of sources:

- MPAC conducts periodic inspections of office buildings.

- Property owners are required to provide MPAC with details including the actual income and expenses through the Property Income and Expense Return (PIER) forms.

- MPAC also collects information about sales or transfers.

MPAC generally collects the following types of data for office buildings:

- general data (tenant list, occupancy, lease types, etc.)

- financial data (rent, vacancy, expenses, retail sales, etc.)

- property description (site plans, floor plans, etc.)

- sales data (where applicable)

- gross leasable area (GLA)

- further to the above, MPAC will review third party reports from various reputable sources such as CoStar and Altus Insite.

Confidentiality

As outlined above, it is important to be aware that, in order to enable MPAC to produce an accurate valuation of the property concerned, information needs to be obtained from a variety of sources.

This will include information from MPAC's records, from the owner or operator of the property, from the municipality in which the property is located, from the assessor's visit to the property, and from other sources.

All stakeholders in the property assessment system have an interest in ensuring that the current value provided by MPAC is correct; in order to achieve this, it is necessary for all parties to cooperate in the provision of information.

It is appreciated that some of the information outlined above may be of a commercially sensitive nature. MPAC recognizes the need to ensure that any information provided to it is properly safeguarded and only used for the purpose for which it is supplied. Assessors must appreciate the nature of this undertaking and ensure data is treated accordingly.

If, after an appeal has been filed, MPAC receives a request for the release of actual income and expense information, or other sensitive commercial proprietary information, the usual practice is to require the person seeking the information to bring a motion before the Assessment Review Board (ARB), with notice to the third parties, requesting that the ARB order production of the requested information. The release of such information is at the discretion of the ARB and commonly accompanied by a requirement for confidentiality.

The Assessment Act outlines in Section 53(2) that disclosed information may be released in limited circumstances "(a) to the assessment corporation or any authorized employee of the corporation; or (b) by any person being examined as a witness in an assessment appeal or in a proceeding in court involving an assessment matter."

2.4 Data Analysis

For MPAC to gain full value from the data collected, the data has to be organized in such a way that meaningful comparisons can be made and conclusions drawn through statistical analysis.

The analysis process involves several steps. The first task is to vet the data (i.e., check for accuracy) before it is used to help establish the fair market rents and factors that will be used to value the properties. The second step is to enter the data into MPAC's database. Next, MPAC classifies the data so that it can be sorted into appropriate market areas, which reflect conditions where data comparisons can be made and conclusions drawn. Finally, MPAC develops certain valuation parameters through statistical analysis or multiple regression analysis that can be used in the valuation of office buildings. After collecting fair market rent data from property owners, the next steps include:

1. Classify and confirm the types of tenants by market area, property code and occupancy code.

2. Analyze data to reach conclusions for allowances.

3. Establish rents by tenant type for each class of office building through multiple regression analysis.

4. Establish typical market vacancy rates for each class of property.

5. Establish typical non-recovered operating expense allowances.

6. Establish the capitalization rates.

2.5 Grading System for Office Buildings

Office buildings are graded according to physical characteristics and size. Although no formalized industry definitions exist for office buildings, the following classes are typically recognized throughout the real estate industry.

Premium Class

Premier office properties are typically greater than 400,000 square feet in size and are usually 21 storeys or greater. Older office properties may qualify if they have had extensive renovations and upgraded amenities. The offices are generally located in the most desirable areas within an urban area. These properties have a very high quality of construction, materials and finishes.

Class A

Properties tend to be located in large urban centres with easy access to public transportation. They are prestigious buildings, professionally managed, with the most amenities in the best locations. They generally are the most attractive buildings built with the highest quality materials and construction methods.

Class B

These buildings are a grade below Class A. Generally, they are slightly older buildings with good management and quality tenants. Class B buildings are well-maintained overall and quite functional. Class B office buildings commonly have an acceptable curtain wall finish, adequate mechanical, electrical and safety and security systems, and a mid-quality level of interior finish. Class B buildings compete for a wide range of users within their market area.

Class C

These office buildings are generally older and may be located on less desirable streets in the city. Many of these buildings usually have higher than average vacancy rates for their market and are defined by older, less desirable architecture, limited infrastructure and antiquated technology. For these reasons, Class C buildings offer low rental rates and can be more difficult to lease. The curtain walls, mechanical, electrical and security systems are generally dated, and the quality of finish is often below average. These buildings attract tenants who sign short-term leases for functional space at below-average rental rates.

Class D

Typically, these office buildings are in need of major renovations. Electrical and mechanical systems are very outdated. Class D buildings lack amenities to attract long-term tenants and may suffer from economic obsolescence.

3.0 The Valuation

3.1 Determining Potential Gross Income (PGI)

In determining the potential gross income (PGI) for an office building, MPAC reviews open market rents taken from current rent roll information for the property provided by the property owner. In establishing the PGI, it is assumed there is typical and competent management and leases were established by a willing lessor and lessee who were both knowledgeable and free from duress. This data is analyzed through statistical analysis using multiple regression analysis to arrive at an estimate of fair market rent (FMR).

It is important to note that when the assessor is developing FMRs from actual rental information, a thorough review of the rent rolls is conducted to ensure rents are reflective of current market conditions.

Items to consider and review:

- overall economic circumstances of geographical area and property type

- whether rents reflect existing market conditions

- the length and time of the lease transactions

- rents paid for other similar-sized office spaces

- full floor office rents to that of partial floor office rents

As per the Assessment Act, when valuing office properties as unencumbered, it is imperative that the assessor estimate FMR, reflective of the marketplace as of the effective valuation date and inclusive of all interests in the real property. The FMRs are applied to the office gross leaseable areas (GLA) to arrive at an overall PGI for the property.

The nationally recognized standard and approach to measuring office building FMRs and determining GLA has been established by the Building Owners and Managers Association (BOMA).

Additional income generated from the property for such items as parking or storage fees should also be added to the PGI. This additional income should reflect the same market considerations as the office generated revenue (i.e., should be determined from open market rates).

In estimating the properties PGI, the property should be considered as though fully leased and occupied and operating at its maximum potential.

In instances where current rent roll information has not been supplied, is not complete or is not available for an office building, typical market rents can be established by analyzing the rent roll returns from similar properties in the vicinity. The assessor may stratify properties by location, age, classification, etc. in the vicinity. The resulting stratified FMRs are then applied to similar or comparable properties to determine the PGI for those properties.

Figure 3.1 – Example of PGI

Suite	Type of Space	GLA	FMR	Income
100	Office	5,000	$18.00	$90,000
101	Office	5,000	$18.00	$90,000
105	Office	5,000	$18.00	$90,000
200	Office	10,000	$18.00	$180,000
205	Office	5,000	$18.00	$90,000
300	Office	15,000	$18.00	$270,000
400	Office	15,000	$18.00	$270,000
B-100	Storage	10,000	$16.00	$160,000
Monthly parking rate		100 Spaces	$200.00	$240,000
			Total PGI	**$1,480,000**

It should be noted that rates and other information shown are for illustrative purposes only.

3.2 Establishing Effective Gross Income (EGI)

Once the PGI from a property has been established, the next step is to determine an effective gross income (EGI). EGI is the amount of income the owner expects to receive over the long term; this is the EGI reduced as a result of expected vacancy and bad debt.

Effective Gross Income = Potential Gross Income – Vacancy and Collection Loss

Market Vacancy

Market vacancy reflects the amount of space that is typically vacant in a particular type of office building. Three issues arise when considering vacancies:

• A vacancy estimate is intended to reflect the likely average for a property type over a typical holding period and recognizes that, because of economic cycles, there will be periods when demand is good and periods when demand softens.

• Vacancy rates at individual office buildings may differ from the norm.

- The vacancy and collection loss is an allowance for reductions in PGI attributable to vacancies, tenant turnover and non-payment of rent.

Establishing the Typical Market Vacancy Rate

MPAC assessors approach the vacancy rate using the percentage of loss of income typically lost due to vacant tenancies. When calculating vacancy based on lost income, the assessor will calculate the loss of income as a percentage of the total potential rental income that was reported on a property's income and expense return.

Once lost revenue has been converted into a percentage of the PGI, the properties are then stratified by location, age and quality to produce ranges of vacancy percentages. The mean vacancy rate is then selected and applied to the entire inventory of similar properties.

Bad debt represents rental and other payments that the landlord cannot collect from the tenants. It is typical to include vacancy and bad debt as a single blended rate.

Determining EGI

To determine the EGI, the assessor starts with the PGI and deducts vacancy and collection loss allowance. The result is the EGI.

Figure 3.2 – Example of EGI Calculation

Total PGI		**$1,599,100**
Vacancy	-7.0%	-$111,937
Total Effective Gross Income		**$1,487,163**

Note that unless there are extenuating circumstances, which will be noted by the assessor, market vacancy rates should be used as opposed to actual vacancy rates in order to derive the appropriate deduction for vacancy.

It should also be noted that rates and other information shown above are for illustrative purposes only.

3.3 Establishing Net Operating Income (NOI)

The objective of the income approach is to determine a property's net operating income (NOI). The process begins by establishing the expected PGI, then determining the effective income by making a deduction for typical vacancy. The final step is to adjust the income for expenses that cannot be recovered from the tenants.

Net Operating Income = Effective Gross Income − Non-recoverable
Operating Expenses

Non-recoverable operating expense is the difference between the total operating expenses and the total income recovered from tenants.

Non-recoverable Operating Expenses

Non-recoverable operating expenses are expenses to the property owner that are not recovered from tenants in order to maintain and generate an income stream. In a typical office, tenants are on net leases and the operating costs, such as real property taxes, heating, air conditioning, and cleaning, are collected from the tenant, independent of the rent paid for the occupied space.

There are typically two areas where the property owner has to cover expenses:

- non-recoverable operating expenses, which are not passed on to the tenants, such as legal and audit fees, advertising and promotional fees; and

- expenses associated with operating any vacant space.

It is possible to express all non-recoverable operating expenses as a percentage reduction from the EGI. A study of the typical difference between operating recoveries and operating expenses produces the expected difference between EGI and NOI. If this difference is fairly uniform and consistent, then it is applied as a one-time deduction, much like the vacancy deduction.

Excluded Expenses

There are several expense items that are typically excluded from any operating expense study, as they do not form part of the day-to-day operation or ongoing maintenance of a property. These items include:

- income tax and taxes associated to the business

- mortgage or debt service

- depreciation on the book value of the building

Note that structural repairs and capital cost items (not regular building maintenance) are typically excluded from lease arrangements made with tenants.

The determination of NOI should not be unduly distorted by large, one-time or infrequent expense items, such as major structural repairs or capital costs. However, if a deduction is determined appropriate for such expenses, the assessor may prorate the expense amount over the life expectancy of the item.

Figure 3.3 – Example of NOI Calculation

Total effective gross income		$1,487,163
Total non-recoverable expenses	−5%	$74,358
Net operating income		$1,412,805

It should be noted that rates and other information shown are for illustrative purposes only.

3.4 Capitalizing NOI into Value

Once the NOI has been established, the final step for the assessor is to apply the appropriate capitalization rate to convert the income into a present value. The assessor will establish the capitalization rate by studying sales of properties that present similar investment opportunities and therefore similar income profiles. An income profile is the degree of risk, as well as the potential for growth, associated with the income stream.

Selecting an Appropriate Capitalization Rate

Selection of an appropriate capitalization rate is essential to the production of an accurate and equitable value for a property. Selecting an appropriate rate considers such factors as age, state of repair and location of the property, in comparison to the average or typical property.

Figure 3.4 – Capitalization of Net Income into Value (V = I / R)

Net Operating Income (I)	$1,373,083
Capitalization Rate (R)	8.0%
Income Valuation (V)	$17,164,000 (Rounded)

It should be noted that rates and other information shown are for illustrative purposes only.

3.5 Current Value Assessment

The final step in the process is to consolidate a current value assessment for the property. Once the determination of income value has been completed, the assessor will consider whether there is any other value in the real estate that has not been captured by the analysis of income.

Excess Land

Excess land is undeveloped land that is surplus to current needs. This land is not captured by the income approach, as the rents and other payments made go to support all the real estate elements needed to operate the offices. Land that is not required to operate the office building is surplus or excess to current needs. The value of excess land depends on its location within the site and how well it suits future developments or expansion.

3.6 Post Valuation Review

Having arrived at the value of the office building through the above process, MPAC assessors will conduct a detailed review of the valuation and address any anomalies through a process called *post valuation review*. Through this process, the assessor will review the property specific data to ensure accuracy, compare results to similar properties and ensure the value is reflective of local market conditions.

3.7 Conclusion

This guide sets out how MPAC assessors approach the valuation of offices for property assessment purposes.

Although it outlines the general approach adopted, it does not replace the assessor's judgment and there may be some cases where the assessor adopts a different approach for justifiable reasons.

For further information about MPAC's role, please visit mpac.ca.