**Executive Summary**

Address: 2610-18 NE 55th Street, Seattle, WA, 98105

Property Type: 2 story mixed use retail/residential building, zoned for NC2P-40

Property Description: Income producing property with 9,728 net square feet divided between 3 retail spaces on ground floor and 8 residential units above. Built in 1928, renovated in 1990.

Market Overview: Located in the mostly residential Ravenna Neighborhood. Prime location for accessibility within the neighborhood with connections to the UW campus, U District, and Downtown. Demographic and market trends such as a young and growing population, neighborhood wealth, low vacancy, and high rents indicate strong demand for retail and rental space. The Seattle market is beginning to slow down, however, the stability of tenants and continued demand for retail space bode well for the long term viability of the site.

Appraisal: Assessed value of the site using the income valuation approach. Using a market capitalization rate of 5% and the anticipated income for 2018, the estimated value of the property stands at $2,942,619,70. This value was used to simulate purchasing the property and holding it for 20 years, drawing income from it before selling it in year 20. All assumptions used for the appraisal are shown and explained.

Conclusion: Overall, this property is not an optimal investment at the current moment. The analysis run on the site yielded an after tax IRR of 6.16% over 20 years. The property does not return a positive after-tax cash flow until year 14 and is thus not suitable as a short term investment. The current market conditions in the Seattle area are not optimal for buyers due to a rapidly expanding real estate market. However, as the market slows, there may be more opportunities to invest in real estate to take advantage of rising property values once growth picks up again.

**Introduction**

This paper seeks to achieve two main goals. Firstly, to conduct a market analysis on the area surrounding the study site to better understand the economic and demographic factors that go into determining the real estate market. The second aim of the project is to assess the value of the specific site I have decided to focus in on, which I plan to undertake using the income valuation approach. Once I have completed the assessment, I will be able to determine a preliminary estimate of the property value and will simulate purchasing and operating the property over the next twenty years, through the lens of a real estate investor and manager.

 I was drawn to this site for several reasons. First of all, it hosts a charming, historic building which has served as a key piece of the Ravenna neighborhood commercial district since its construction in 1928. The main building is a mixed use development, with retail space on the ground floor and residential dwelling units on the second. This presents the interesting condition of having two main sources of income, commercial and residential rents, while hosting both commercial and residential tenants. The current commercial tenants are all small local businesses operating a variety of different services. Developers often idealize having these sorts of tenants in their buildings to show their connection to their neighborhood, however I would like to determine whether hosting these tenants is financially viable in the case of this specific property. Overall, this property seems ideal in terms of its tenant makeup, role in the neighborhood, and overall charm, but I want to look further into its feasibility as a real estate investment.

**Location Overview**

The study site is located at 2610 NE 55th St in the Ravenna area of North Seattle. Ravenna is a neighborhood dominated by single family residential development, with a couple major commercial and mixed-use clusters along its main arterials such as 25th Ave NE, NE 65th St, and NE 55th St, along which the study site is located. It is at the crossroads of 27th Ave NE, two blocks east of one of the major commercial nodes of the neighborhood at NE 55th St and 25th Ave NE, but is still in a quiet location with much less street traffic than the other main arterials of the neighborhood. The site is an 11 minute walk south of NE 65th street, the main commercial strip of the Neighborhood. It is also located directly north of the University Village shopping center and the Burke Gilman trail, the main bike and pedestrian thoroughfare of North Seattle. The number 72 bus stops directly in front of the site while the 372 stops just two blocks away, connecting the site to the nearby UW campus and University District, the two most defining features of the surrounding area. Costar scores the site as an 87 (very walkable) for walk score and a 66 (good transit) for transit score. Additionally, I-5 is only a five minute drive away along Ravenna Boulevard, providing access to Downtown Seattle and SeaTac Airport. Overall, the site is highly accessible, through a variety of means, to and from many of the key locations in the area.

The site itself contains a two star mixed use retail/residential storefront building on a 0.15 acre plot. Built in 1928 but renovated as recently as 1990, the building boasts a charming masonry exterior and has storefront entries along its southern face. The building is divided equally across 2 stories, each with a floor area of 5,477 square feet. The ground floor is entirely retail space and is fully occupied with four businesses renting out the five storefront spaces. The upper floor is entirely residential space, consisting of 5 studio and 3 one bedroom units. As a mixed use development, this site is unique in the Ravenna neighborhood and thus occupies a vital role in the community through the uses it accommodates in addition to its prime location.

**Market Analysis**

*Demographic Features:*

According to information gathered by Costar, there are roughly 40,397 people living within a one mile radius of the study site, making up a large portion of the Ravenna, Bryant, and University District neighborhoods. The area is expected to increase in population 7.08% in the next five years, with an average yearly growth rate of a strong 1.416%. The average age of residents living within one mile is only 32 years old, reflecting the relative youth of the area. This feature in addition to the strong projected population growth bodes well for viability of the site, as a young, growing population is likely to be established enough financially to provide a stable retail consumer base without having the means to purchase a home, especially within the city of Seattle, thus creating demand for the rental market as well. Because of the relatively young population and large numbers of students, the median household income within one mile is only $65,000, lower than the $83,000 median income within the city as a whole (Balk, 2017). However, when expanded to include all areas in a three mile radius, the median annual household income of the area rises to almost $98,000, demonstrating the ability of consumers in the area to afford higher end retail services.

 *Market Trends:*

While I have so far described it as being in the Ravenna neighborhood, the study site is officially located in the Ballard/U district submarket. This submarket is one of the strongest markets in Seattle, as indicated by data gathered by Costar. It has an extremely low commercial vacancy rate of 1.2%, reflected in the fully occupied status of the retail space of the study site. The average rent is over $27 per square foot, which is higher than the Seattle market overall. With a strong average market capitalization rate of 4.2%, the Ballard/U district submarket remains a good place to invest in real estate. However, it should be noted that this value has been steadily declining since 2010 and is projected to continue to do so. The regional real estate market has been slowing down since its peak in 2016, however in my estimation, it remains a strong sellers’ market, evidenced by low vacancy and high rents, and may not be the best time to invest in new property. The overall wealth of the Ravenna area and driving economic force of the nearby University of Washington signal sustained growth in the area’s real estate market regardless of larger trends.

*Commercial Analysis:*

I was able to contact the property owner of the site and discuss some of the questions that I had come up during my site analysis. One interesting finding from this conversation was an explanation regarding the makeup of commercial tenants currently occupying the site, all of which are small, local businesses. The owner told me that this was not a conscious effort on his part but rather a reality of the market and the small size of retail spaces at the site. He explained that only smaller local businesses were interested in locating in the building when he first was seeking to rent it out. The fact that all three have remained as stable tenants for more than 10 years shows their success operating in the local market. While it is important not to jeopardize the commercial stability the property owner currently enjoys, it may be a wise decision to attract higher end service businesses or restaurants to cater to the large number of wealthier residents in the area. This could possibly replace the less lucrative interior design studio or upholstery shop currently present to maximize the revenue generated from the commercial space in the building.

*Site Comparisons:*



 For comparison, I gathered data from Costar on several properties in the Ballard/U District submarket with features comparable to 2610 NE 55th St. The above sites are all small retail and mixed use developments that were all sold in the past year and were originally build in the early part of the 20th century. Despite a range of floor sizes, all of which are smaller than the study site, the price per square foot of their sales occupy the same range of $300-$500. Once I calculate the property value, I can compare the resulting value/per square foot to see if the site falls within this same range. While these sites are broadly similar, it is important to consider the different locations, building conditions, amenities, and other factors that may affect this analysis.

**Assumptions**

Before conducting the appraisal, I must first lay out and explain the assumptions I will be making regarding values key to the income approach process. Below is a list of key assumptions upon which I will base my analysis.



The building value and land value were both assessed by the King County Department of Assessments and displayed as data points on the site’s report in the King County Parcel Viewer. The metrics related to floor area including lot size, FAR, Gross Building Area and Rentable building area were also taken from this source. The State of Washington does not collect an income tax, thus rendering that value at 0%. The loan to value ratio, interest rate of 8%, term of 20 years, and monthly payment structure are all standard features of commercial real estate loans offered through a conventional bank (Wessell, 2018). This would be the most likely financing option for purchasing this property as an investor rather than a business owner, which would allow one to qualify for a variety of small business loans or commercial bridge loans. Assumptions made regarding depreciation, capital gains tax rate, depreciation recapture, and sales costs are all standard values for real estate investment. Finally, the inflation rate of 3% is based on the current rate of 2.2% and standard projections into the near future (Consumer Price Index, 2018).

My discussion with the property owner gave me the information I needed to determine the rest of my assumptions. He provided me with figures for the property’s income, expenses, and floor area breakdown, shown below:





Using this information, I was able to calculate the operating expenses as a percentage of Effective Gross Income by dividing the sum total of all operating expenses by the combined income, arriving at a value of just under 40%. The property owner also told me that the site experiences very little turnover in terms of both commercial and residential tenants. Of the three commercial tenants, both Manning and Son’s Upholstery and Altstadt Interiors have been in the building for over 20 years while Frank’s Oyster House has existed for over 10 and all three intend to remain in the space for the foreseeable future. Due to the impressive stability of tenants occupying the building, I decided to project a vacancy rate of 0%. I felt comfortable assuming this value for the residential spaces of the building as well because of factors such as the area’s young median age, comfortable wealth, proximity to the University and Downtown, and projected population increase that will maintain high rental demand.

**Appraisal**

In order to effectively appraise a mixed use property that draws value from both residential and commercial revenue sources, I decided to adopt the Income Valuation Approach for the purposes of this project. According to Ling and Archer, this method is the best for estimating the value of income producing property, as it views the current value as a function of the income strem it is expected to produce. As an investor concerned with drawing revenue from this investment, the income approach seems like the most relevant valuation method to employ. Having already calculated the total revenue from the property and all operating expenses, I was able to determine the Net Operating Income, the difference between the two. With a market capitalization rate of 5%, the estimated value of the property stands at $2,942,619,70. This equates to a property value/square foot of around $308.38, which is in a similar range to several of the price per square foot values for the comparable properties in the area.



 I arrived at a 5% market cap rate based off the current average rate of 4.2% for the Ballard/University District submarket according to Costar. The property owner also advised me to use a value of 5%, which he uses for his purposes regarding the property. Arriving at an estimate for the property value allowed me to determine an asking price, and as a result the loan amount through the loan to value ratio.

**Analysis**

With all the information necessary, the next step of the project involved simulating buying and operating the study property for a period of 20 years. I approached this from the perspective of real estate investor to focus on the profitability of the endeavor. I also simulated the sale of the property after 20 years, a point in time where it will be needing renovations. I assumed a sale price of $4.5 million, a 50% increase in value over the next 20 years, which is a quite conservative estimate, equivalent to just below projected annual inflation rate of 3%. The entire Discounted Cash Flow analysis is shown in the charts below:







**Conclusion:**

Based on the variables I used in my analysis, the property does not begin turning a profit until Year 14. The return on equity reaches just above 5% at Year 20, indicating significant profitability. However, by this time, the cost of repairs needed on the building, which was last renovated in 1990 may start to outweigh the revenue generated. If the project is able to be sold for a price at or above $4.5 million, a realistic estimate, the investor stands to gain an after tax IRR of 6.16% over the course of the entire 20 year term, a solid but not spectacular value. This also assumes no issues with vacancy, which is difficult to gauge over a period as long as 20 years. While the growth in the area seems sustainable, any major shifts that occur during this time period could alter the profitability as well. Overall, I would say that the relatively modest gains derived from this property are not worth the risk over such a long period of time. The property is not suitable at all for short term investment either, so I would caution against investing in it for any reason at this point in time. The best strategy I see is to either wait for a major slowdown in the market that would drop the price significantly or to purchase the property at a point in the future where major repairs are needed, probably 10 or 20 years down the line. An investor could use this opportunity to quickly improve and flip the property or purchase it for a reduced price or begin renovation and hold it as a long term investment.

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