CHAPTER 7

Property Return Rates

For the purpose of applying the Income Capitalisation Methods, different rates of return must be used depending on the model adopted. In the Direct Capitalisation Approach, where the reference amount is the income, the formula requires the use of a cap rate, which ideally projects the current income into the future, determining the value of the asset. Differently, in the Discounted Cash Flow Approach (DCFA), where the reference amount is the cash flow, the formula requires the use of a discount rate, which ideally relates future income flows to the present. In order to provide a clear illustration, the two rates will be discussed separately, although they have several points in common.

Both rates are in fact an expression of the amount of return expected by Investors, as more clearly described in the following sections. In particular, given that it is an expected return, they will depend on the implicit risk in the asset or, more accurately, the risk factors associated with its expected income/cash flows.

The methodology for determining Property Return Rates remains, however, one of the most critical elements of the Income Capitalisation Methods and often a source of errors or estimates that are insufficiently supported by empirical evidence. As will be seen more clearly in the Section 'How to Estimate Property Rates', the opportunity to derive the rates directly from the market is limited to the cap rate, while different techniques will have to be used to determine a discount rate.

MEASURING THE RETURN ON A PROPERTY INVESTMENT

Without any claim to be exhaustive on this subject, this section provides a simple description of the most common methods for calculating the return on investments.[1]

When an investment is made, particularly in an asset that generates a regular stream of income and has a residual value, the total return is derived from two return components, as simplified in Figure 7.1:

- Yield or current return (for simplicity just referred to as 'yield'), which is the ratio between the income and the value/price of the asset
- Capital gain return (or 'growth return'), which is the ratio between the increase in value during the period (equal to the difference between the value of the asset at the end of the period – sale or reimbursement value – and the value of the asset at the beginning of the period – purchase price or cost of the asset) and the value of the asset at the beginning of the period.

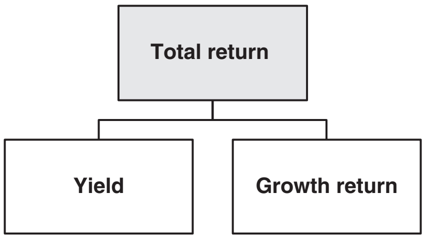

FIGURE 7.1 Return composition