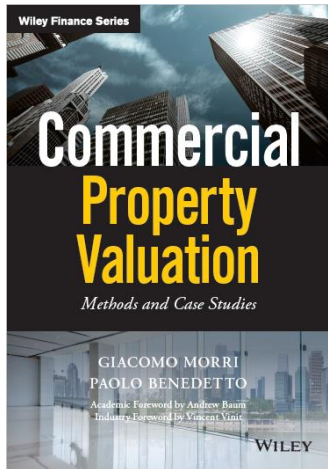


Commercial Property Valuation

Giacomo Morri & Paolo Benedetto

WILEY, 2019



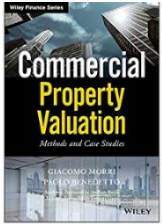
Sales Comparison Approach Methods

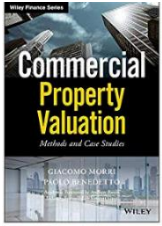
Chapter 5



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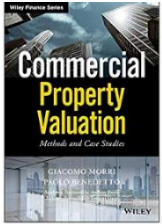
- Approach and Application Criteria
- Direct Comparison Approach
- Hedonic Pricing Model





Approach and Application Criteria

- In the Sales Comparison Methods, the value of an asset is obtained through the identification of prices of comparable transactions
- These methods are based on two main principles:
 1. **Substitution Principle:** the value of an asset is related to the price that should be paid for a perfectly identical asset
 2. **Equilibrium Principle:** the price of an asset depends directly on the market (demand and supply) and is, therefore, the synthesis of the negotiation process

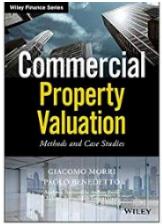


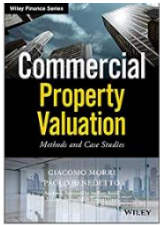
Approach and Application Criteria

- In order to apply the Sales Comparison Methods, one needs a sample of transactions relating to identical assets
- By definition, there are no identical properties because they are all unique, at least in terms of location; however, in practical terms, the flexibility of an asset can be identified based on the main features that contribute to determining its attractiveness
- The Sales Comparison Methods can be divided into two main application criteria:
 1. **Direct Comparison Approach**
 2. **Hedonic Pricing Model**

Direct Comparison Approach

- In order to estimate the value of a property, **the Direct Comparison Approach uses the values of comparables which have been recently sold** by making some adjustments that take into account its specific features
- There are three steps to using this model:
 1. **Selecting the comparables**
 2. **Standardising the transaction price of the comparables**
 3. **Estimating adjustments**

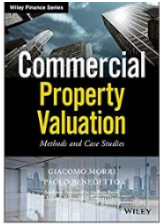




Direct Comparison Approach

1. Selecting the comparables

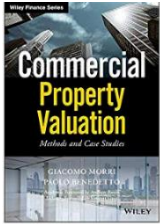
- Assess and verify the existence of similar properties that have been recently sold and their prices
- **Comparability** is determined **based on the physical features of the Building** (age, condition, etc.) **and the Land**, i.e. the location
- The features of the comparable properties must be as similar as possible to those of the subject property and the comparable assets must have been the subject of a recent transaction at a market price
- **There is no time frame that can be defined as valid in all cases.** Its length depends on the type of property, the frequency with which it changes hands and the complexity of the transaction



Direct Comparison Approach

1. Selecting the comparables

- A variety of features need to be considered when defining transactions that are comparable to the subject property:
 - **Physical features**
 - **Regulatory use**
 - **Economic and financial characteristics**
- **There is also no minimum or maximum number of comparables**, although this will obviously depend on the availability of data regarding market transactions. **Ideally, at least three or four comparables** need to be chosen
- Finally, one must exclude all transactions that do not fulfil the normality requirement, meaning those that are not open market transactions



Direct Comparison Approach

2. Standardising the transaction price of the comparables

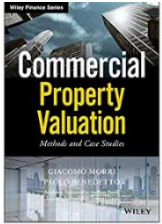
- Since the surface area has a direct effect on the value of properties, in order to standardise in most cases **the unit considered is the Net Lettable Area**
- For some property types, the unit considered can vary depending on the income 'generating' unit drawn from the sample of comparables analysed (i.e. price per square metre in the residential sector, per seat in multiscreen cinemas, per hotel room, etc...)
- **For properties where there is a separation between Owner and User** (i.e. commercial), **it may not be appropriate to use this unit of measurement** (or generally the Direct Comparison Approach)

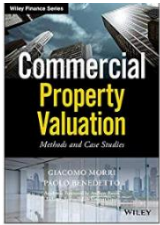
$$\text{Value of the asset} = \text{Average value drawn from the market} \times \text{Quantity of the asset to be valued}$$

Direct Comparison Approach

3. Estimating adjustments

- Fundamental to make adjustments because the subject property may not be exactly the same as the comparables, owing to its age, condition, or accessibility
- This model should never be applied to properties which, by their nature, are effectively unique in every respect
- In practice, it is often felt that **two properties are not comparable if an adjustment needs to be made that exceeds a certain percentage (20%)** of the value of the unit of measurement
- The reliability of the information obtained must be considered carefully

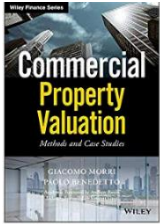




Direct Comparison Approach

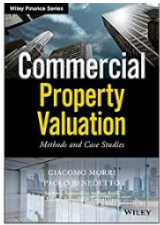
Final Considerations

- **The Direct Comparison Approach** is particularly **appropriate** for valuing fairly ‘standard’ properties, i.e. **standardised types in which there is an Investment Market with Owners who are also Users**
- This method works efficiently the more uniform the properties and the more frequent the transactions
- The model is sometimes used to estimate the value of Land, where buildability (a type of construction and whether it can be built) are considered in addition to the quality of the location when selecting comparables. However, comparing plots of Land is very difficult, as the value is influenced not only by the size of the plot and the area on which buildings can be erected, but also by the intended use and the actual size of the building that may be developed



Hedonic Pricing Model

- The Hedonic Pricing Model is used to estimate the rental value of primarily residential properties, as well as to determine residential property market indexes
- The Hedonic Pricing Model is based on the idea that the supply and demand for heterogeneous goods include supply and demand for each characteristic of such goods
- Provided that these elements are observable, **an implicit price in each characteristic** (i.e. the presence of a lift) **will emerge from a comparison between the supply and demand for each characteristic**
- **The final price of the property will be the sum of the theoretical prices of its components**

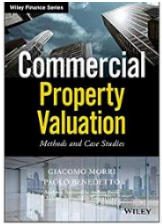


Hedonic Pricing Model

- Implicit prices are measured using multiple regression models:

$$\frac{P}{m^2} = \alpha + \beta_1 C_1 + \beta_2 C_2 + \dots + \beta_m C_m + \varepsilon$$

- Where:
 - α : constant
 - β : price of the characteristic
 - C : characteristic
 - ε : error
- Information on the price of the transaction and the values of the characteristics considered in the regression model need to be collected for a sample of properties sold in a specific period of analysis



Hedonic Pricing Model

The Hedonic Pricing Model presents two major advantages:

1. Significant reduction in subjectivity

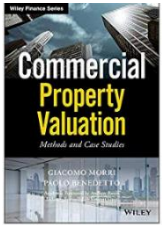
- Various qualitative characteristics can be measured through quantitative elements
- Subjectivity in the measurement of some parameters cannot, however, be eliminated entirely, because it arises from the fact that various attributes are qualitative

2. Definition of the impact of every attribute on the value of the property

- The Hedonic Pricing Model can be used to isolate the impact of any characteristic on property prices, such as the value of a sea view and distance from the city

Hedonic Pricing Model

- The Hedonic Pricing Model have limitations as **it only provides reliable estimates if the subject property is relatively standard**, and consequently, there is a sufficient number of transactions involving similar assets
- The Hedonic Pricing Model is useful for a better application of the most commonly adopted Direct Comparison Approach. In fact, the latter is based on a major single element (i.e. the value per unit, e.g. €/m²), while the Hedonic Price Model relies on the value of each characteristic of the property





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