CHAPTER 2

Economic Characteristics and Elements of Risks of Properties

This chapter provides an economic interpretation of properties, illustrating their characteristics and providing a preliminary classification for valuation purposes. In order to estimate the value of an asset correctly, it is essential to start by assessing the economic characteristics that determine the demand from potential users and buyers. These economic characteristics are also fundamental for choosing the correct valuation method, as they identify which market data is required to allow the value of the asset to be estimated.

Property Valuations or investment analyses based on Income Capitalisation Methods rely on the expected yield to be identified which, in a nutshell, depends on the risk associated with the asset being analysed. For this reason, it is fundamental to give the reader some food for thought on the subject of real estate risk. As we shall see, no definitive answer is given to the problem of quantifying risk. Despite a large amount of financial literature on the subject, measuring the risk involved in direct real estate investment presents specific implementation difficulties.[1] Furthermore, even though it would be more correct to distinguish between the concepts of risk, where the likelihood of an event can be measured statistically, and uncertainty, which cannot be measured,[2] in this book the two terms will be used synonymously. Finally, despite the fact that the term ‘risk’ is often interpreted with a negative connotation, and this is how the factors that can impact on the value of a property will be presented in this chapter, one must not forget that the *ex-post* return might actually be lesser or higher than expected.

Real estate investment decisions are often taken with a ‘fundamental uncertainty about the future’.[3] The problem, in fact, is that often there is not enough information and the available data are not normally distributed,[4] which means that statistical models and probability analysis are not very useful, although they have been used in research for many years.[5]

Furthermore, the property market is characterised by relatively long cycles, with periods of price contraction followed by periods of price rise. This cyclical behaviour can be explained by the lengthy production process, which leads to periods of excess supply alternating with periods of scarcity (availability of Space) and consequent variations in income (rent), and by rate variations in the capital market and consequent variations in the expected cap rates.[6] Periods of increasing values, which may last several years, can lead some Investors to underestimate the risk of property investment: in almost all real estate markets, in fact, there have been prolonged periods of sustained growth in value, albeit followed by periods of negative performance. Given this dynamic, many Investors, primarily private individuals, believe that the current yield is the ‘basic’ return, which will be further increased by a ‘definite’ capital gain return in the medium- to long-term.

Even though the myth of bricks and mortar being a safe investment may have waned recently, it is worth describing the main types of risk involved in the real estate sector so that the risk of property investment can in some way be adequately considered. In this chapter an attempt will be made to provide the reader with a description of the main elements of risk, although it would be better to refer to these as uncertainty, in order to identify an overall risk that can be associated with a particular subject property, for which an expected return rate may need to be estimated.