CHAPTER **6**

Income Capitalisation Comparison Approach Methods

This chapter provides a detailed description of the Income Capitalisation Comparison Approach Methods (also referred to, for simplicity, as the Income Capitalisation Methods) and of its two main application criteria: the Direct Capitalisation Approach and the Discounted Cash Flow Approach (DCFA). It also includes the Residual Value Methods, based on the same criteria and which allows for the value Land and, in general, all properties at the end of their life cycle.

APPROACH AND APPLICATION CRITERIA

The Income Capitalisation Methods are based not only on the principles of substitution and equilibrium between supply and demand set out above, but also on the principle of anticipation, according to which a rational buyer will not pay a price higher than the Present Value of the economic benefits that the property will be able to generate during its lifetime, implicitly also suggesting that it will not be possible for this price to exceed the purchase cost of similar properties which present the same degree of usefulness.

They are often presented as economic and financial methods because they are based on principles that are applicable and applied to all other types of investment assets and therefore differ from the other methods introduced in the previous chapters, which are more common in real estate. The Income Capitalisation Methods allow to express the value of a property according to the same factors that determine the value of any other asset: the expected income and the risk associated with its achievement.

As previously mentioned, it would be even more correct to use the 'Income Capitalisation Comparison Approach Methods' definition, which is still a market comparison, although one that, unlike the Sales Comparison Methods (which analyse the Owners/Users market), is based on an indirect comparison of two economic variables in two different markets: the expected economic benefits (income or cash flow), derived from the Space Market, and a required (immediate or total) rate of return, derived from the Investment Market.

The Income Capitalisation Methods, therefore, assume to identify an economic benefit and a time adjusting factor (cap rate or discount rate) based on the risk of the previous economic benefit.

The economic benefit of an Income-producing Property is, primarily, its rent net of operating costs. The economic principle also remains valid if the User is also the Owner of the property: in this case, the economic benefit consists of the alternative cost of buying the Use of the Space in the market or the opportunity cost of choosing to use the property himself (rental

expenses). In order to estimate the economic benefit, it is essential to identify the amount of income the Property can generate by analysing a sample of Comparables in the Space Market, while also considering the actual rent from the lease agreement currently in place.

The time correction factor based on the risk associated with the economic benefit (cap rate or discount rate) is instead a measure of the rate of return required by the potential buyers/Investors to invest in an asset whose expected return presents a specific level of risk. In order to identify this parameter, a valuer has therefore to analyse the Investment Market; in other words, the market in which Owners trade the ownership of properties (i.e. the right to receive their future economic benefits) based on their expected returns. This element is often hard to quantify due to the complexity of measuring risks and returns. This subject will be addressed in greater detail in Chapter 7.

Recently, the practice and theory of Property Valuation have quite rightly focused on the Income Capitalisation Methods, which are well-suited to the valuation of properties that generate a regular income (e.g. Income-producing Properties, such as shopping centres, hotels, offices). However, these methods, with the appropriate approaches described in the Section 'Residual Value Methods', are also applicable to the valuation of Land and Development Projects, giving rise to the Residual Value Methods.

The Income Capitalisation Methods provide two application models[1] based on different measurements of expected economic benefits and return:

- Direct Capitalisation Approach: This is used in order to convert the forecast of an expected income of a single period in an indication of value through a direct passage, by dividing the estimated income at an appropriate cap rate (one income and one rate).
- Discounted Cash Flow Approach (DCFA): This is used in order to convert all the future cash flows in a Present Value, by discounting all the expected economic benefits (several cash flows) at an appropriate discount rate.