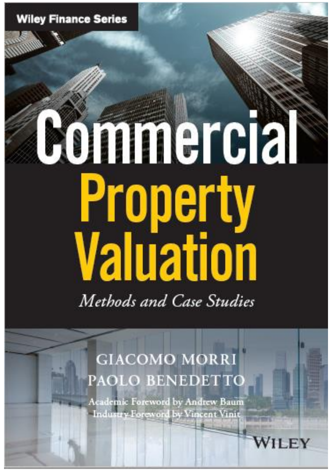
Commercial Property Valuation

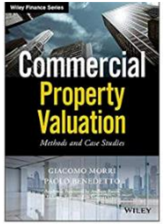
Giacomo Morri & Paolo Benedetto

WILEY, 2019



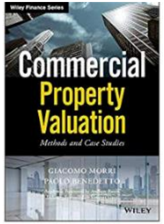
High Street Retail Unit Appraisal

Chapter 10



Index

- Description of the Property
- Choice of the Valuation Method
- Market Analysis
- Valuation

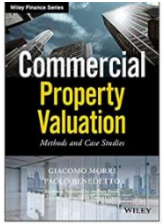


Description of the Property

- **The property**, currently rented to a restaurant business (whose lease agreement is expiring in 24 months), **is located on Alexandria Street**, **adjacent to one of the most prestigious worldwide luxury retail locations in the centre of one of the main European cities**

- The property is facing Alexandria Street from the front side; the opposite side is facing a minor street, while lateral sides adjoin other properties

- The property is a low-rise building composed of 3 floors (underground, ground and mezzanine) for a total Weighted Lettable Area of 1,413 square metres



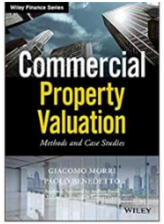
Description of the Property

- **Surface layout is rather efficient for retail business**, with approximately 50% of the total Weighted Lettable Area placed in the ground floor, suitable storage space and numerous shop windows, on average approximately one each 100 m2 of Weighted Lettable Area

- The property has a mezzanine floor characterised by high ceilings and wide windows

- Despite its relevant size, it can only be leased to a single tenant because a series of physical constraints do not allow a rational and economically efficient surface if split in more than one unit.

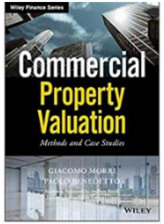
Description of the Property



Floor	Destination of use	Net Lettable Area (sq.m.)	Weighting factors	Weighted Lettable Area (sq.m.)	Weighted Lettable Area (% of total)	# shop windows
Mezzanine	Retail	489	60%	293	21%	6
Ground	Retail	673	100%	673	48%	8
Basement	Retail	750	50%	375	27%	-
Basement	Storage	240	30%	72	5%	-
	Total	**2.152**	**66%**	**1.413**	**100%**	**14**

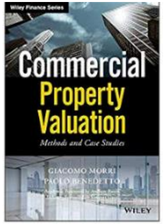
Retail surface efficiency indicators	**on Net Lettable Area**	**on Weighted Lettable Area**
Ground surfaces on total surfaces	31%	48%
Storage on total surfaces	11%	5%
Surface per shop window [sq.m]	154	101

Description of the Property



- **Maintenance conditions are substandard**, with an ancient and old-fashioned façade and not properly maintained windows fixtures
- The internal layout might be transformed to fulfil the requirements of a modern retail unit
- Accessibility and visibility are granted by the eight shop windows at the ground floor
- **At the valuation date, however, the current layout does not properly leverage the full potential of the shop windows at ground level[1]**

[1]In fact, while one is used as restaurant entrance, the remaining seven are used as standard walls without enhancing restaurant visibility and appeal



Choice of the Valuation Method

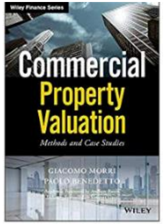
- Due to its location, balanced surface distribution across ground and other floors and architectural features, **the restaurant business does not represent the HBU for the property**

- **Being a Trade-Related Property, the most appropriate valuation method is deemed to be the Discounted Cash Flow Approach**

- This valuation approach takes into account the current humble maintenance status

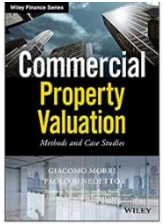
- A Direct Comparison Approach is not suitable since the current use of the property is suboptimal

Market Analysis:
Estimating the ERV

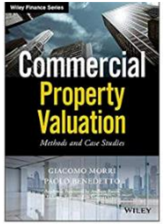


- **On average, data show a market timing effect in the previous 16 years**, with ‘older’ contracts closed between years ‘–15’ and ‘–13’ characterised by higher ERV and key money paid for all store sizes. Later on, the leasing market has slowed down with the first transaction occurring in year ‘–9’ and registering, despite the limited contract size, a low ERV and no key money
- Recovery started in year ‘–6’, with a series of transactions closed at increasing ERVs. Starting from year ‘–4’ the leasing market was back on track registering closing terms in line with the previous cycle both in terms of ERV and of key money payment
- Intuitively, **the slightly lower ERV per m2 of ‘Jewellery’ vs. ‘Women’s clothing’ and ‘Watches’ is due to the relatively significant total rental amount of ‘Jewellery’**

Market Analysis:
Estimating the Cap Rate



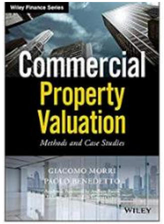
- The cap rate estimation for the subject property takes into consideration a series of operating risk factors (ERV sustainability, vacancy, tenant market strength and investor's appetite)
- Since the subject property has a value add potential because it is not currently expressing its HBU, **the valuer should estimate a going-out cap rate coherent with the new lower risk profile and higher income potential after the completion of valorisation process and related CapEx**



Market Analysis:
Estimating Vacancy and Leasing Time

- **For luxury HSR valuation, under normal market conditions, their vacancy can be assumed close to none**
- Historically retail properties in Alexandria Street have registered on average less than two-month vacancy at lease expiration with only very few lease agreements not being renewed at natural expiration
- In addition, the key money market practice that is peculiar to HSR properties shows that there exists some reward for tenants having the ‘privilege’ to rent in such locations

Market Analysis:
Estimating Refurbishment Costs



- **Complexity in refurbishment costs estimation is limited** since:
  - Costs are parametric/proportional to the size of the Building (estimates by contractors are typically in line with effective costs)
  - Specific/more complex costs are directly managed and borne by the tenant, thus reducing the risk for the Owner
  - Refurbishment costs represent a low percentage of the overall property value
- Although fit-out works are usually managed and paid directly by the tenant, it is market practice for the Owner to grant a CapEx/ fit-out contribution to the tenant. It can be delivered either as a cash contribution or as a free rent equivalent and its amount depends on the market conditions, length of the lease agreement and type of refurbishment works to be realised

Valuation

			semester 1	2	3	4	5	6	7	8
Rents										
Current tenant (restaurant)	1.811	*€/mq*	€ 1.280.000	€ 1.280.000	€ 1.299.200	€ 1.299.200	€ 1.318.688	€ 1.318.688		
New tenant	3.500	*€/mq*							€ 2.624.845	*€ 2.624.845*
Potential Gross Income			**€ 1.280.000**	**€ 1.280.000**	**€ 1.299.200**	**€ 1.299.200**	**€ 1.318.688**	**€ 1.318.688**	**€ 2.624.845**	***€ 2.624.845***
Effective vacancy			€ 0	€ 0	€ 0	€ 0	€ 1.318.688	€ 1.318.688	€ 0	*€ 0*
Effective Gross Income			**€ 1.280.000**	**€ 1.280.000**	**€ 1.299.200**	**€ 1.299.200**	**€ 0**	**€ 0**	**€ 2.624.845**	***€ 2.624.845***
Operating costs										
Property taxes	256.000	*€/year*	€ 128.000	€ 128.000	€ 130.560	€ 130.560	€ 133.171	€ 133.171	€ 135.835	*€ 135.835*
Property insurance	12.000	*€/year*	€ 6.000	€ 6.000	€ 6.120	€ 6.120	€ 6.242	€ 6.242	€ 6.367	*€ 6.367*
Stamp duty	1,00%	*% on rents*	€ 12.800	€ 12.800	€ 12.992	€ 12.992	€ 0	€ 0	€ 26.248	*€ 26.248*
Extraordinary maintenance	0,50%	*% on reconstruction cost*	€ 10.601	€ 10.706	€ 10.813	€ 10.920	€ 0	€ 11.139	€ 11.249	*€ 11.361*
Property & Facility Management	1,50%	*% on rents*	€ 19.200	€ 19.200	€ 19.488	€ 19.488	€ 0	€ 0	€ 39.373	*€ 39.373*
Total Operating costs			**€ 176.601**	**€ 176.706**	**€ 179.973**	**€ 180.080**	**€ 139.414**	**€ 150.552**	**€ 219.072**	***€ 219.184***
Net Operating Income			**€ 1.103.400**	**€ 1.103.294**	**€ 1.119.227**	**€ 1.119.120**	**-€ 139.414**	**-€ 150.552**	**€ 2.405.773**	***€ 2.405.661***
Investments										
Capex & Capital contribution	2.000	*€/mq*	€ 0	€ 0	€ 0	€ 0	€ 1.470.501	€ 1.485.134	€ 0	*€ 0*
Leasing fees	10,0%	*% headline rent*	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 524.969	*€ 0*
Total Investments			**€ 0**	**€ 0**	**€ 0**	**€ 0**	**€ 1.470.501**	**€ 1.485.134**	**€ 524.969**	***€ 0***
Intermediate Cash Flow			**€ 1.103.400**	**€ 1.103.294**	**€ 1.119.227**	**€ 1.119.120**	**-€ 1.609.915**	**-€ 1.635.686**	**€ 1.880.804**	***€ 2.405.661***
Terminal Value										
Exit value (on net GOCR)	3,00%	*net GOCR*	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 160.377.377
Brokerage fees	0,50%	*% Terminal Value*	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 0	€ 801.887
Final Cash Flow			**€ 0**	**€ 0**	**€ 0**	**€ 0**	**€ 0**	**€ 0**	**€ 0**	**€ 159.575.49**
Total Cash Flows to be discounted			**€ 1.103.400**	**€ 1.103.294**	**€ 1.119.227**	**€ 1.119.120**	**-€ 1.609.915**	**-€ 1.635.686**	**€ 1.880.804**	**€ 161.981.15**
Time factor			*0,25*	*0,75*	*1,25*	*1,75*	*2,25*	*2,75*	*3,25*	*3,5*
Discount factor	*5,20%*	*discount rate*	*0,9874*	*0,9627*	*0,9386*	*0,9151*	*0,8922*	*0,8699*	*0,8481*	*0,8374*
Discounted Cash Flows			**€ 1.089.504**	**€ 1.062.134**	**€ 1.050.506**	**€ 1.024.116**	**-€ 1.436.374**	**-€ 1.422.842**	**€ 1.595.116**	**€ 133.632.19**
Sum of Discounted Intermediate Cash Flows	*2,2%*	**€ 2.962.161**								
Discounted Final Cash Flow	*97,8%*	**€ 133.632.194**								
Market Value		**€ 136.594.355**								
Market Value (rounded)		**€ 136.600.000**								

Property Finance
Real estate books, resources and links
http://www.propertyfinance.it/it/home-english/

Giacomo Morri, *Ph.D.*
giacomo.morri@sdabocconi.it
www.linkedin.com/in/giacomo-morri-0596b2

Associate Professor of Practice & Faculty Deputy of Corporate Finance & Real Estate
SDA Bocconi School of Management

Professor of Real Estate Finance, Finance Department
Bocconi University
Milano – Italy

Paolo Benedetto
paolo.benedetto@unibocconi.it
www.linkedin.com/in/paolobenedetto

SDA Fellow of Corporate Finance & Real Estate
SDA Bocconi School of Management

Academic Fellow of Real Estate Finance, Finance Department
Bocconi University
Milano – Italy

www.sdabocconi.it/realestate