Commercial Property Valuation

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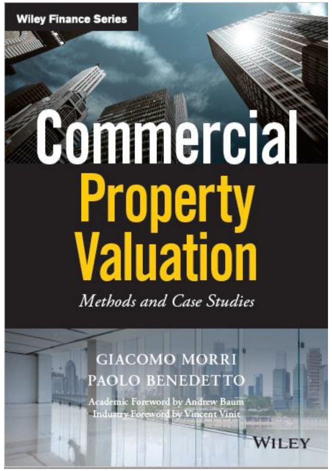
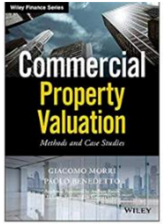


A New Simple Classification of Valuation Methods

Chapter 4

THINK BEFORE YOU PRINT



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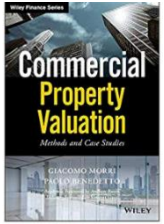


The Traditional Classification of Valuation Methods

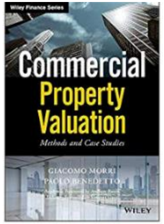
Traditionally, researchers and valuers have identified three approaches:

1. **Market Approach**: *'based on comparing the subject asset with identical or similar assets (or liabilities) for which price information is available, such as a comparison with market transactions in the same, or closely similar, type of asset (or liability) within an appropriate time horizon'*

2. **Cost Approach**: *'based on the economic principle that a purchaser will pay no more for an asset than the cost to obtain one of equal utility whether by purchase or construction'*

3. **Income Approach**: '*based on capitalisation or conversion of present and predicted income (cash flows), which may take a number of different forms, to produce a single current capital value. Among the forms taken, capitalisation of a conventional market-based income or discounting of a specific income projection can both be considered appropriate depending on the type of asset and whether such an approach would be adopted by market participants'*

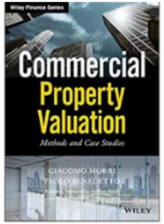
The Traditional Classification of Valuation Methods



Each approach has its methods with different application criteria:

- **Market Approach Methods:**
  - Direct Comparison Approach
  - Hedonic Pricing Model
  - Multipliers and Rules of Thumb
- **(Depreciated) Cost Approach Methods:**
  - Replacement Cost Approach
  - Reproduction Cost Approach
- **Income (Capitalisation) Approach Methods:**
  - Direct Capitalisation Approach
  - Discounted Cash Flow Approach (DCFA)

The Traditional Classification of Valuation Methods

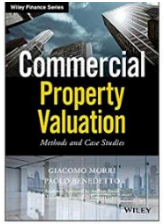


The traditional repartition has at least two limitations:

- **The (Depreciated) Cost Approach Methods**, which are not only severely limited in their applicability but often also **fail to provide a Market Value**, resulting instead, in some cases, in the maximum price obtainable from a potential sale of the property
- **Both the Market Approach and the Income Approach Methods are based on market data, so both should be defined as 'comparative',** with the sole difference being the subject of comparison

- In general, *"comparing historical circumstances that have already taken place with existing ones is the basis for any valuation method. The logical reason for the valuation, as a likely consequence of known causes stemming from experience, is in fact based on an inductive process of comparison"*
- Therefore, there is no significant difference between the two approaches since in both cases the starting point is a piece of information (the price or yield) derived from recent transactions

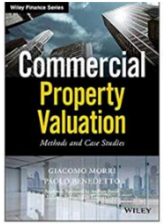
A New Simple Classification of Valuation Methods



Therefore, it is more straightforward to classify Market Value valuation methods as follows:

- **Sales Comparison Approach Methods:**
  - Direct Comparison Approach
  - Hedonic Pricing Model

- **Income Capitalisation Comparison Approach Methods:**
  - Direct Capitalisation Approach
  - Discounted Cash Flow Approach



A New Simple Classification of Valuation Methods

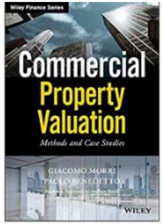
In the new classification, some methods were excluded:

– Multipliers and Rules of Thumb have not been included in the new classification, since, traditionally, being based on direct sales comparison, they are included in the Sales Comparison Methods. On the contrary, since they rely on economic parameters such as EBITDA, they should also be considered as belonging to the Income Capitalisation Methods

– The Depreciated Cost Approach Methods have been excluded from the new classification proposal because they are often inapplicable and misleading when estimating the Market Value

– the Residual Value Methods are not mentioned in the previous classification because, even though they are considered extremely useful, they are viewed merely as a different way of applying the Income Capitalisation Methods

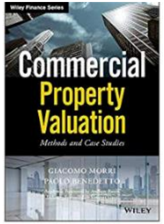
Choice of the Valuation Method



The valuation method choice is fundamental to estimate Market Value correctly.

- It is essential to note that, while in some cases several criteria can be applied at the same time, in other situations some models may not work appropriately and may contribute to mislead the correct value
- **Care should therefore be taken if, when applying different models at the same time, significant differences emerge in the estimated value**. In these cases, it is likely that (at least) one of the models is not suitable because:
  - It does not reflect the operation of a specific market
  - The data required to apply it are not easily and correctly obtainable
- **In these situations, the use of an average value would only contribute to deviating from the correct value**

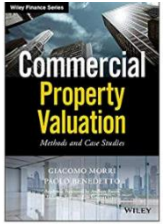
Choice of the Valuation Method



Although it is fundamental to analyse each case separately, it is possible to identify some general rules:

- **Residential Properties -> Sales Comparison Methods**
  - User = Owner
  - High number of transaction, easy to find the data
  - Relatively uniform properties
- **Commercial Properties -> Income Capitalisation Methods**
  - Owner ≠ User
  - Low number of transaction and heterogeneous properties

- If the characteristics outlined above for Residential properties are respected, it is possible to use Sales Comparison Methods also for commercial properties such as small shops, offices, garages, etc..
- At the same time, Residential Buildings developed and managed for lease only, should be treated as Commercial real estate



Choice of the Valuation Method

The choice of the valuation method is based also on the flexibility of a commercial property:

- **Flexible Commercial Property**

  In practice, it is simpler to gather information about the income and expected yield rather than to search for the sale price of properties:

  – Income Capitalisation Methods

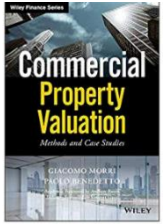
- **Non-Flexible Commercial Property**

  It is difficult to find information about the sale price of similar assets (possible no transactions) and to identify a new User, in these case the valuation methods should be:

  – Or the Depreciated Cost Method

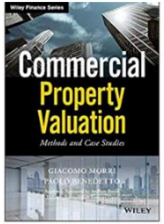
  – Or the asset could be valued based on the rent that could be earned during the period in which the current User could continue its activity

Choice of the Valuation Method



- **Trade-related Properties -> Income Capitalisation Methods**
  - **It is also essential to perform a careful analysis of the economic sustainability** (EBITDAR) **of the rent for the User**
  - The choice of other methods, notably the Direct Comparison Approach, may, however, be acceptable when there are comparable standardised properties (hotel in medium/large cities)
  - Typically for similar properties an value for room can be used (not use the value for square meter)

Choice of the Valuation Method



- **Land and Brownfield sites**
  - The asset is not generating any income, but its value depends on the future utility
  - The properties are very heterogeneous

  - **If the are comparables** -> **Sales Comparison Methods**
    - The method should be not based on the asset in its current state but on what can be achieved in terms of size and intended use

  - **In case of no comparables** -> **Income Capitalisation Methods** (precisely the Multiple Periods Residual Value Approach)

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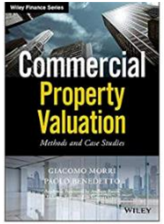
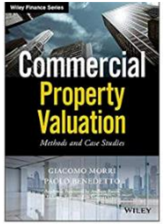
Choice of the Valuation Method



- **Property Portfolio:**
  - **The sum of the value of the individual units is not the value of the portfolio**, as this will have a different level of liquidity and different potential buyers
  - Two solutions can be applied:
    1. Apply a discount to the sum of the values of the individual units. (not objective)
    2. Use the Discounted Cash Flow Approach (requires many assumptions)
  - The DCF can be used also for the valuation of a development scheme, already built but in which some of the units remain unsold

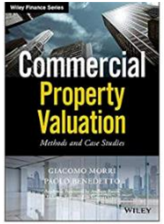
In practise, combinations of different valuation models are often appropriate such as in the case of a Residential Development Project (Direct Comparison Approach for the single units + DCF for the portfolio)



Depreciated Cost Approach Methods

- In many cases, the **Depreciated Cost Approach Methods are not appropriate for estimating the Market Value** of a property because there is not always a direct relationship between the cost incurred for the construction and the utility the market attributes to the asset

- In particular, if ‘wrong’ properties have been built, i.e. properties for which there is little or no demand of use, the Depreciated Cost Approach is unlikely to be even close to their (actual low) Market Value



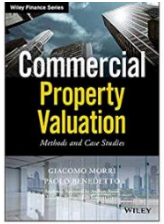
Depreciated Cost Approach Methods: Description

- The Depreciated Cost Methods are based on the substitution principle, where the potential buyer chooses between buying a property and constructing a building with the same features on a similar plot of land, considering the depreciation of the existing asset

- **An Investor will not pay the price for a property that is above the value of the land on which it was built and the cost of constructing the building, net of any depreciation**

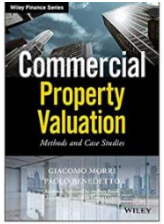
- The Depreciated Cost Methods consist of the sum of the following elements:
    1. The cost of constructing the Building from new, including the cost of capital (+)
    2. The depreciation of the Building (-)
    3. The cost of the Land (+)

Depreciated Cost Approach Methods: Description



The cost of constructing the new building

- **The cost of the Building is estimated by multiplying the number of square metres (surface) by the average cost of construction per square metre**
- The various components of a property do not have the same cost per square metre and to avoid excessive distortions, the total square metres of the main elements (garage, office areas, commercial premises, etc.) can be subdivided and each one multiplied by the respective construction cost
- Another cost element to be included is the cost of capital, including both the amount of equity used by the developer and the amount of debt borrowed from banks

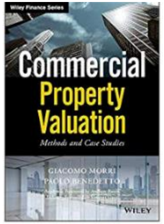


Depreciated Cost Approach Methods: Description

The depreciation of the Building

Three main factors need to be estimated:

1. **Material wear and tear**: depends on the age of the Building, the quality of construction, the ordinary and extraordinary maintenance and the actual use of the property
2. **Functional obsolescence:** the lack of a particular function compared to a property built today that complies with modern building quality standards and fulfils market requirements
3. **Economic obsolescence:** absence of real demand for a particular type of property

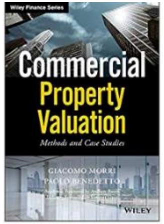


Depreciated Cost Approach Methods: Description

The depreciation of the Building

- The depreciation can be determined as:
  1. Considering a linear annual depreciation rate, e.g. a rate of 2% if the estimated useful life of the building is 50 years
  2. Considering a non-linear depreciation of the building, choosing lower rates in the first few years of life and subsequently adopting higher rates
  3. Estimating the refurbishing cost required to ensure the property is equivalent to a standard new property (**Best Choice**)

Depreciated Cost Approach Methods: Description

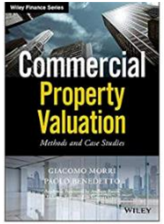


The cost of the Land

- It could be determined using information on recent sales of comparable plots of land, resorting to the Direct Comparison Approach

- **However, in the majority of the cases there is not an active market for land, and each plot of land has not only a different location but also different building rights**

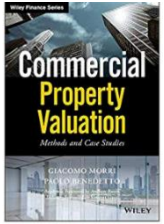
Depreciated Cost Approach Methods: Use, Advantages, and Limitations of the Depreciated Cost Approach



- The main two limitations of the Depreciated Cost Approach are:
  - It is difficult to determine the value of the land
  - The depreciation has to be quantified as the loss of economic value resulting from the obsolescence of the building and its physical deterioration, which is difficult to measure objectively

- **The Depreciated Cost Approach allows to estimate:**
  - **The insurance value of a building (**not necessary to determine the value of the land and the depreciation)
  - **The market value only in few cases** (there is no direct relationship between the realisable cost of an asset and the usefulness attributed to it by Users and Investors)

Depreciated Cost Approach Methods: Use, Advantages, and Limitations of the Depreciated Cost Approach



- Therefore, the Depreciated Cost Approach can not be used for estimating the value of properties where:
  - There is a market of Owners/Users (Sales Comparison Methods)
  - There is a market of Space (Income Capitalisation Methods)

- **It also questionable the use of the Depreciated Cost Approach when there are no comparable transactions nor information about rents** since this could be an indication that there is no market at all (the estimation of the Market Values is meaningless)

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