Title	Lectures (20 hours) to international students in 2023 for Ecole Supérieure des Professions Immobilières, Paris Campus.
Author(s)	David Hourihan, David Hourihan, David Hourihan and David Hourihan
ORCID	https://orcid.org/0000-0003-1405-3130; https://orcid.org/0000-0003-1405-3130; https://orcid.org/0000-0003-1405-3130; https://orcid.org/0000-0003-1405-3130
Type	Conference or Workshop Item
Publication title	
Publisher	
ISSN/ ISBN	
Publication Date	6 November 2023
Version	
DOI	
Repository link	https://ube.repository.guildhe.ac.uk/id/eprint/198/
Link to publication	

PROPERTY VALUATION

(BG3 ALT S6)

Section 11 –

Methods of Valuation – Profits Method

Real Estate Business Management Program

Year 3 – Work study program

Présenter: David Hourihan MSc Prop Inv FRICS

7 November 2023

Property Valuation (BG3 ALT S6)

Agenda

1. Profits Method of Valuation - What is it?
2. Profits Method of Valuation - When is it used?
3. Profits Method of Valuation - Overview of the Method.
4. Trading Performance.
5. Profits Method of Valuation – A Worked Example.
6. Summary.

Property Valuation (BG3 ALT S6)

1. Profits Method of Valuation - What is it?

The profits method is based on the premise that certain specialist properties are **not capable of valuation according to comparative principles** owing to their unique location and characteristics.

Where such properties are identified as revenue earning, an annual value (a rental value) can be determined based on their earning capacity.

- The value is estimated from the amount of trade or business conducted on the premises.
- Sometimes known as the ‘Accounts method’ or ‘Income method’.

Property Valuation (BG3 ALT S6)

1. Profits Method of Valuation - What is it?

Hotels and public houses are examples of where comparison with other properties is difficult - as the value primarily depends on the property’s earning capacity.

Other examples of properties valued using this method:

- Pubs
- Hotels
- Cinemas
- Theatres
- Petrol filling stations
- Racecourses
- Golf courses
- Country clubs
- Marinas
- Bingo halls
- Nightclubs
- Fairgrounds

2. Profits Method of Valuation - When is it used?

The profit method is used mainly to estimate rental value where there is an element of monopoly and there is no direct comparative evidence of rents.

A licence is needed

It can arise from a situation where a license is needed to operate:

- Pubs.
- Casinos.
- Licensed restaurants.

Location

Or the monopoly arises from location.

- Motorway service areas.
- One newsagent in a railway station.
- One petrol station in a town.

2. Profits Method of Valuation – When is it used?

Consider, as an example, a cinema with ten screens located in a town centre. Whilst there may be comparable evidence of other town centre cinemas sold in the marketplace, the building characteristics, location and, most importantly, the trading potential is unlikely to be similar. The valuer works on the premise that it is sales per annum that will be the major determinant of an offer for rent. Any purchaser in the market (with a few exceptions) can only bid for rent that the business can afford, and this must ultimately depend on profit.

Summary

- The profits approach is used for those properties where competition is restricted.
- It is based on the principle that the rental value will usually be proportional to the volume of trade carried on.
- Earning capacity will depend on gross earnings which, in turn, will depend on the volume of trade.
- Profits method does not value a property in isolation.
- Profits method values business in conjunction with the property.
- These specialised properties bought and sold as operational entities.

3. Profits Method of Valuation - Overview of the method.

The first step in the Profits Method is to obtain at least the three previous years' accounts for the business.

From this, it is possible to estimate the Net Profit from the **annual gross earning**, as follows:

Estimated gross earnings	£
Less	
Purchases	£ ________
Gross profit	£
Less	
Working expenses	£ ________
Divisible balance (**Net Profit**)	£

Property Valuation (BG3 ALT S6)

4. Trading Performance.

Trade related properties are valued on the assumption that the business will be effectively and competently managed, operated and promoted.

The profits generated (if any) will be shown in the company accounts.

- The accounts need to be analysed.
- Valuers using the Profit Method need to be able to understand and to interpret financial accounts.
- Usually, 3 to 5 years accounts is required.
- The reason for looking over a number of years is to determine trends and even-out discrepancies in the data.
- The net profit is adjusted to reflect the trading of a reasonable efficient operator.

Property Valuation (BG3 ALT S6)

4. Trading Performance.

What can the accounts tell us?

- How well is the business performing relative to the operating costs.
- How well does the business keep its costs down.
- How does it compete with others in the same business.
- How well is it doing in terms of return on capital compared to different investments available.
- The actual accounts might be unreliable. Knowledge of similar businesses might be preferred to actual accounts.

Property Valuation (BG3 ALT S6)

5. Profits Method of Valuation – A Worked Example.

Using the Profits Method, calculate the rental value of this pub:

Summary

Gross Sales:	£250,000
Purchases / Cost of sales:	£140,000
Working Expenses:	
Electricity	£ 2,000
Gas	£ 500
Advertising	£ 650
Wages	£ 25,000
Insurance	£ 3,500
Motor Costs	£ 4,000
Telephones	£ 1,750
Tenant's capital	£50,000 (more on this later)

Assume a return on capital of 10% on any working capital the tenant has invested in their business.

Stage 1

Gross Sales:	£250,000	
Less		
Purchases / Cost of sales:	£140,000	
Gross Profit		£110,000
Less		
Working Expenses:		
Electricity	£ 2,000	
Gas	£ 500	
Advertising	£ 650	
Wages	£ 25,000	
Insurance	£ 3,500	
Motor Costs	£ 4,000	
Telephones	£ 1,750	£ 37,400
Net Profit (Before Rent)		£72,600

Property Valuation (BG3 ALT S6)

5. Profits Method of Valuation – A Worked Example.

Having calculated Net Profit what's next?

Now make two more steps to adjust the Net Profit to determine the tenants share.

These are:

1. A sum to represent return on the working capital in the business.

   This sum is calculated using the interest rate that is applied to borrowed money.

   This is deducted from the net profit to give us the Divisible Balance.

2. An allowance that represents the tenants Risk and Enterprise.

   The sum used to represent the tenant's risk and enterprise is usually 50% of the Divisible Balance.

Property Valuation (BG3 ALT S6)

5. Profits Method of Valuation – A Worked Example.

Using the Profits Method, calculate the rental value of this pub:

Summary

Tenant's capital	£50,000

- Assume a return on capital of 10% on any working capital the tenant has invested in their business – this can cover a variety of items.
- Also assume the tenant's reward for risk and profit is 50% for this business.

Stage 2

Net Profit (Before Rent)	£72,600
Less	
Interest on Working Capital £50,000 @ 10%	£ 5,000
Divisible Balance	£67,600
Tenant's share	
Tenants Share of Divisible Balance @ 50% x £67,600	£33,800
Landlord's Share (Market rent)	£33,800 p.a.

The rental value (per annum) for the property is £33,800 per annum.

This rental value can be capitalised at the appropriate yield (YP perp) for the type of property.

5. Profits Method of Valuation – A Worked Example.

To estimate the capital value of the property, the annual rent (£33,800) would be capitalised using the appropriate yield.

If appropriate yield was 8%, then the investment / capital valuation would be:

Market Rent	£ 33,800 p.a. (from previous calculation)
x YP perp. @ 8%	12.5
Capital Value	**£422,500**

Issues:

- What is the appropriate yield. How do we determine this?
- Remember the objective is to determine a fair value for the property.
- This method require considerable knowledge of the sector being valued and experience of valuing these types of properties.

Property Valuation (BG3 ALT S6)

6. Summary.

The profits or accounts method:

- Is used to find rental value of properties where:
  - there is some element of monopoly and/or
  - annual value is dependent upon turnover and there is no general market for the kind of property in question.
- Is commonly applied to valuations of hotels, public houses, petrol stations, cinemas, though often in a shortened form, e.g., petrol stations where rental value is based on £x per 1,000 litres / gallons per annum sales.
- Rental value is calculated based upon the earning capacity of the associated business – information found in the accounts,
- Consists of deriving net profit and apportioning the resultant amount between interest on the tenant’s capital, tenant’s remuneration and rent.
- Requires skill and judgement from the valuer.
- Capital Value can be found by capitalising the rent at an appropriate yield.
- The share of the final figure between tenant and landlord will not always be 50:50 but that is sufficient for our purposes.
- If possible, check with value e.g. per barrel for pubs, per bedroom for hotels, per seat for cinemas.

Next Lecture

Section 12 – Methods of Valuation – Contractors Method