PROPERTY VALUATION

(BG3 ALT S6)

Section 16 –

Methods of Valuation – Investment Method Pt 2

Real Estate Business Management Program

Year 3 – Work study program

Présenter: David Hourihan MSc Prop Inv FRICS

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Property Valuation (BG3 ALT S6)

Agenda

1. Investment Method Recap.
2. Investment Method – Valuations.
3. Valuation of Properties not let at market rent (reversionary freeholds).
4. Example of a Term and Reversion valuation.
5. Some issues…
6. Splitting Yields in the Term & Reversion Method.
7. Yield Summary.
8. Notes on Comparable for Valuations.

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1. Investment Method Recap

Investment method is a valuation approach that determines value by capitalising the income stream from the property (the rent).

It can be used for properties where there is a tenant (a true investment) but also for properties that are owner occupied.

- The rent is capitalised at a yield which reflects the risks and potential rewards of that particular type of property.
- The yield is determined by analysis of market sale comparables.
- The yield is then used to calculate the multiplier that should be used to capitalise the rent.

We have looked at the valuation of properties let at market rent.

- The market rent is determined by analysis of market comparables – preferably recent open market lettings of very similar properties to the one being valued.

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2. Investment Method – Valuations

Recap: Valuation of freehold properties let at market rent (rack rented)

- Approach: value the income by capitalising at YP in perpetuity (PV of £1 p.a. in perpetuity).
- YP in perpetuity formula is 1 / i, where i is the capitalisation yield in decimals.

New: Valuation of freehold properties not let at market rent (reversionary properties).

It is relatively rare that properties are let at market rent (rack rented). We will cover the approach to valuing such properties today.

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3. Valuation of Properties not let at market rent (reversionary freeholds)

Reversionary Freeholds

Previously, we looked at the valuation of properties let at a market rent. It is relatively rare that properties are let at market rent (rack rented) due to:

- Changing patterns of supply and demand. As a result, rental levels are constantly changing, *usually upwards, and the market rental for a property can quite quickly become higher than the rent currently payable under the lease.
- The rent being paid does not change until the next rent review (traditionally 5 yearly in the UK).
- At the next rent review or lease renewal, the rent will revert to the full rent obtainable on the market – called either of: the market, full or estimated rental value (MRV, FRV or ERV).

*** UK leases normally have upward only rent review clauses.**

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3. Valuation of Properties not let at market rent (reversionary freeholds)

Reversionary Freeholds

For these properties, we capitalise two income streams:

1. **Term Income:**
   - This is the rent currently being paid under the lease.
   - This rent could have been agreed as an open market letting or might have been agreed as a rent review (if lease has been in place for some time).
   - This rent will continue to be paid until the next rent review or lease end.
   - Rent reviews are traditionally 5 yearly in UK.

2. **Reversion Income:**
   - At the next rent review or lease renewal, the rent will revert to the market rent – called either of: the market, full or estimated rental value (MRV, FRV or ERV).
   - We estimate this market rent, based on the rental levels applying now (at the date of valuation).

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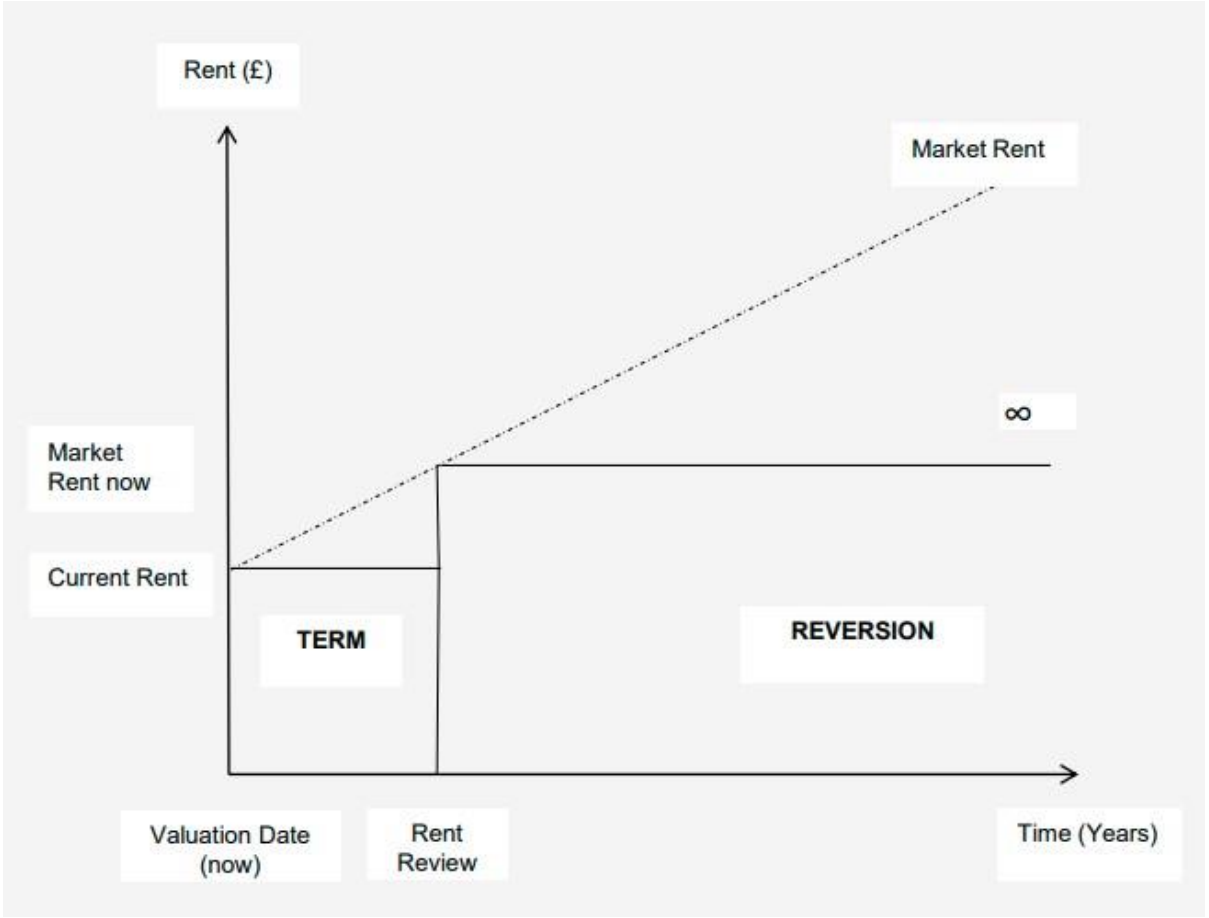
3. Valuation of Properties not let at market rent (reversionary freeholds)

The diagram illustrates the different 'blocks' of income graphically.

In this valuation, we will use the **'Term & Reversion'** method of valuation to capitalise the two blocks and then add the sums together:

- The **Term income** is the income received now (current income) and this is below the market rent that could be achieved.

- The **Reversionary income** is the current market rent and it is assumed that this will be received at the next lease event: usually a rent review but could be the lease end.



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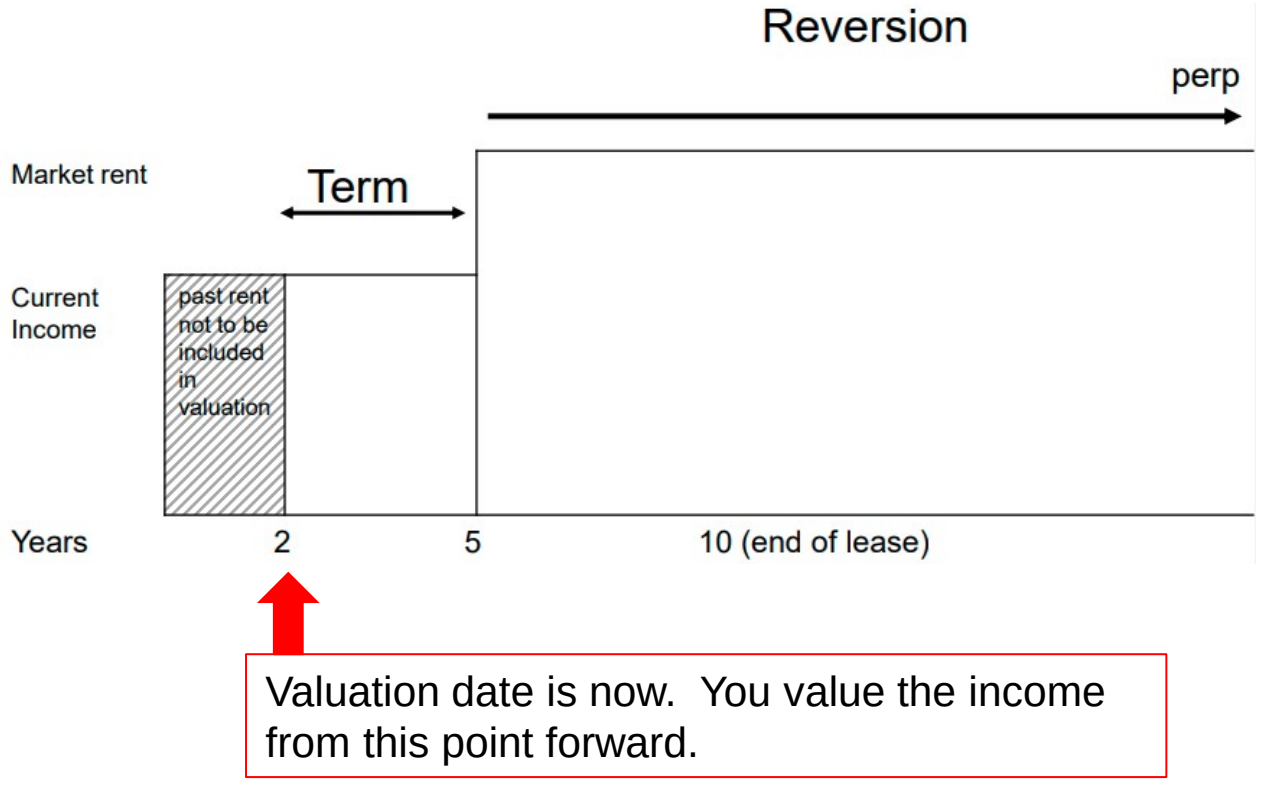

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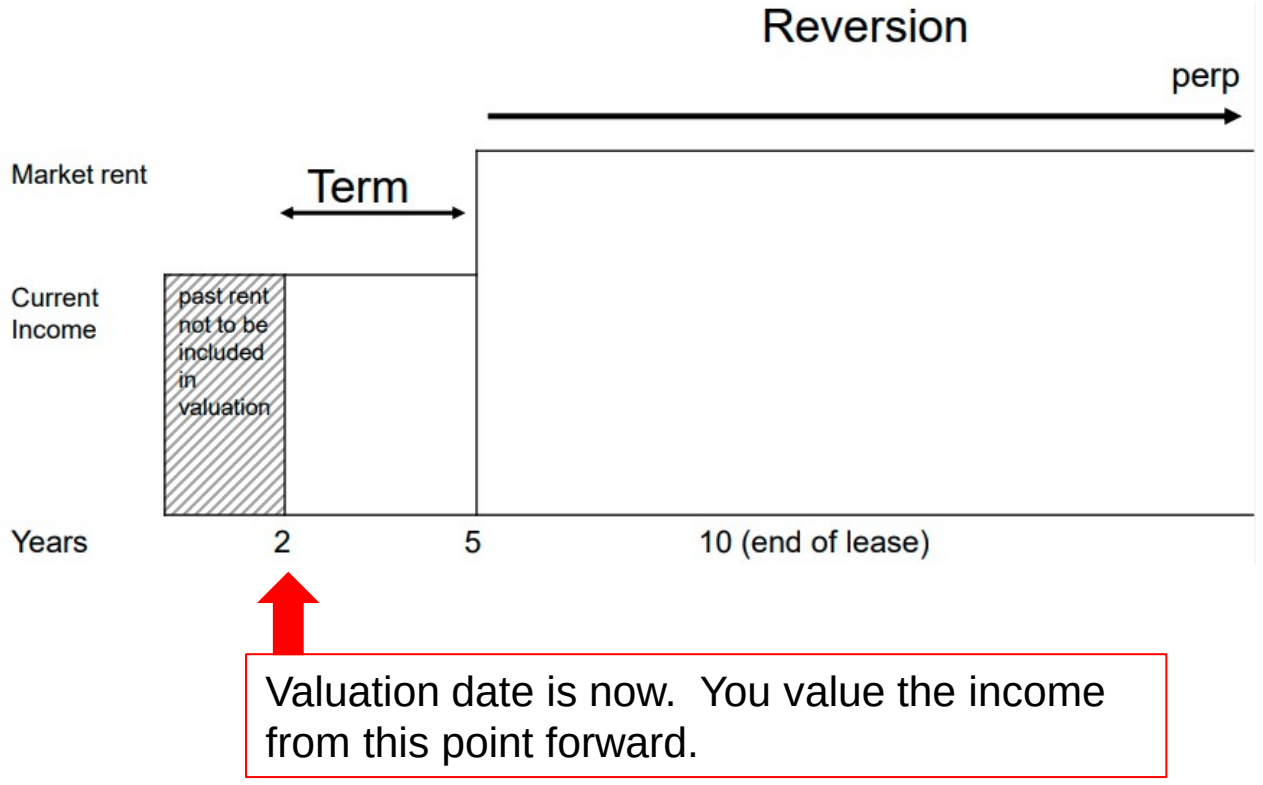

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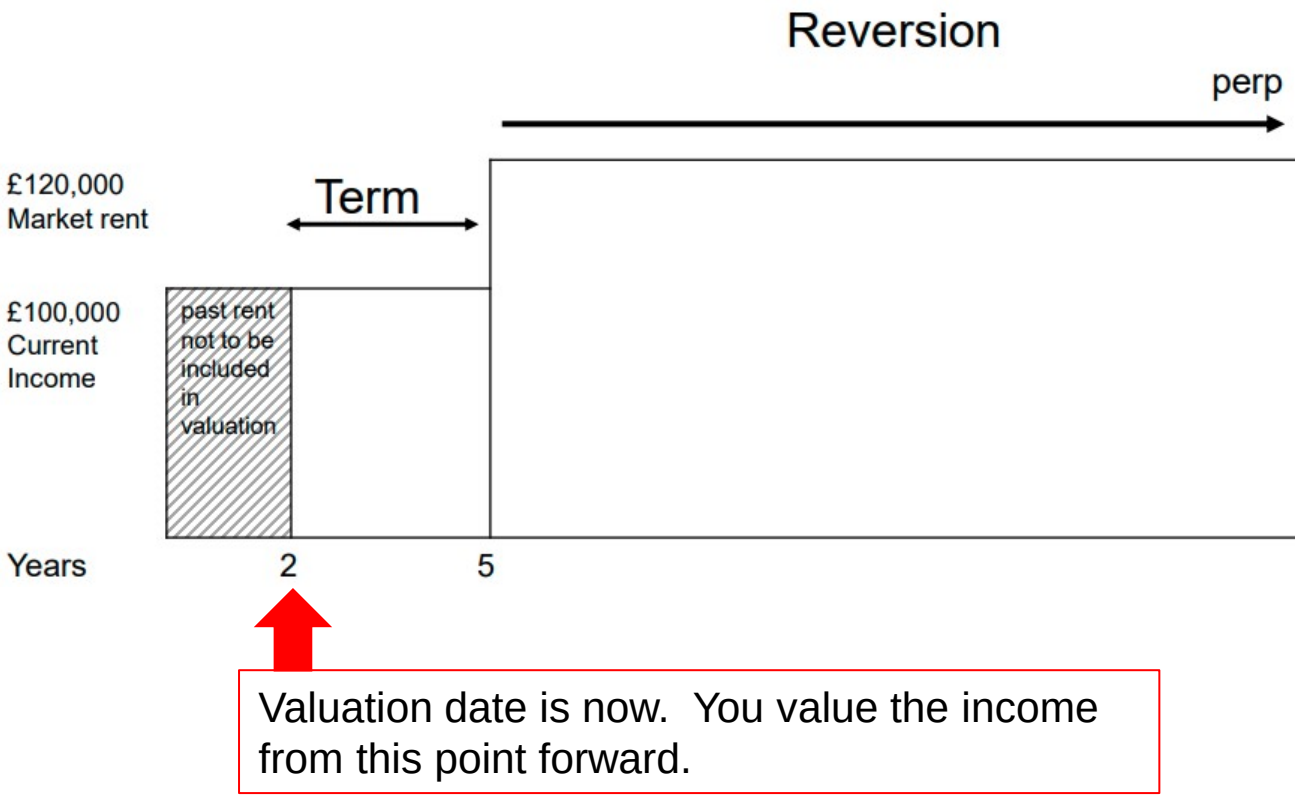
5. Example of a Term and Reversion valuation

- Let us take the example of a property that was let two years ago at a rent of £100,000 per annum.
- It was let on a 10-year FRI lease with 5 yearly upwardly only rent reviews (UORR).
- Since the letting of this property, rents have been rising, and it is estimated that the MRV / FRV (market / full rental value) is now £120,000 per annum.
- Market evidence indicates that the appropriate yield for this type of property is 8%.
- Rent Reviews are every 5 years, but 2 years have passed, so next rent review is after 3 years.



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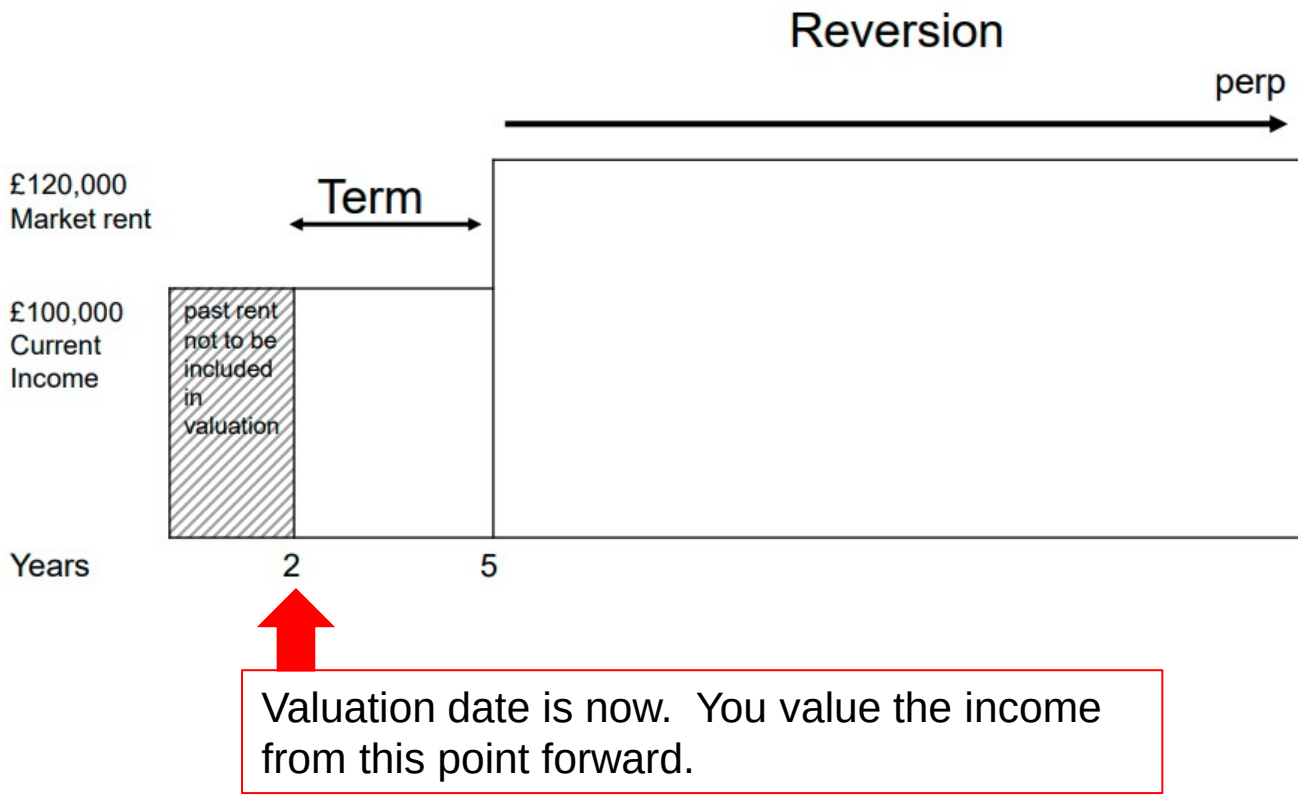
5. Example of a Term and Reversion valuation

- End of lease at end of year 8.
- 10-year lease but 2 years have passed.
- **Term income** = Current income for 3 years.
- **Reversionary Income** = MRV thereafter.
- The valuation assumes cash flow into perpetuity (forever).
- The market rental should continue to increase and as such rents would be increased at each rent review.
- Also: reality is that at re-letting, lease renewal – there might be a break / void in the income flow whilst a new tenant is found.



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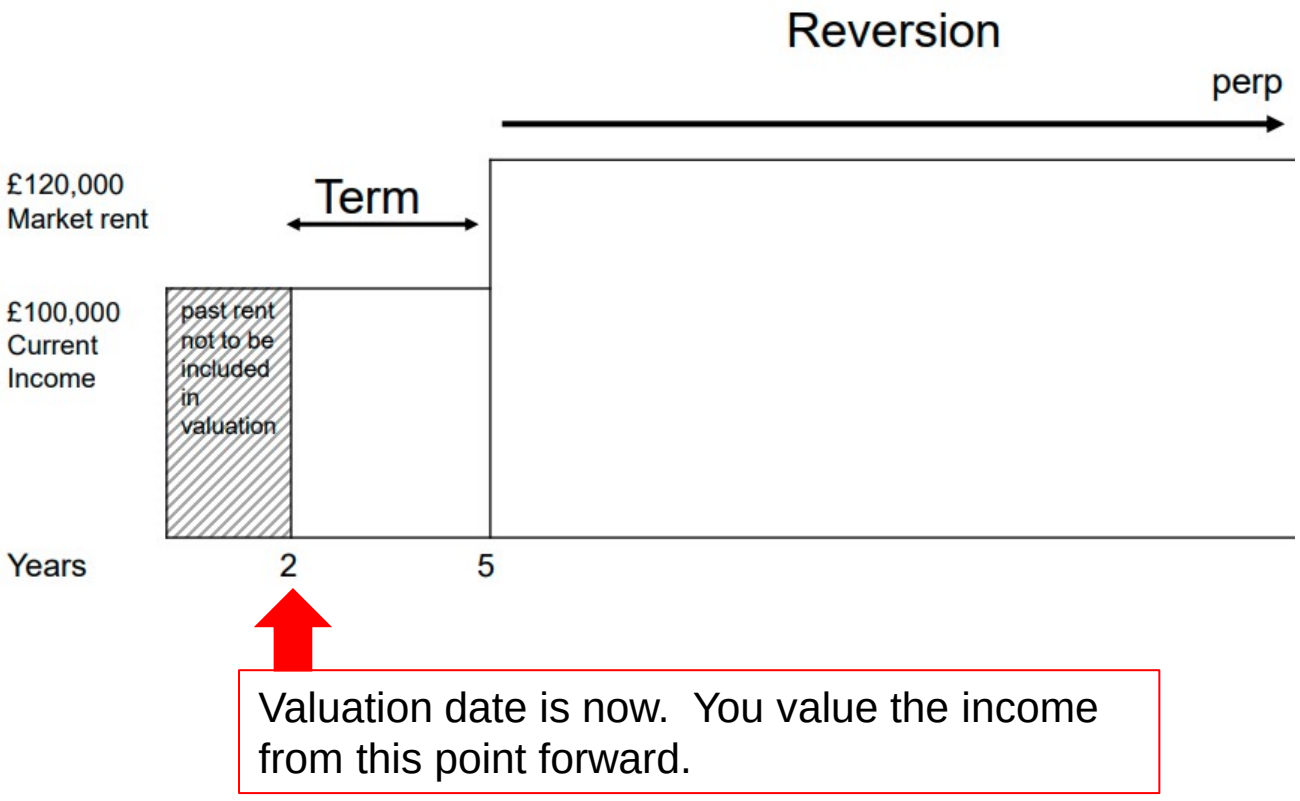
5. Example of a Term and Reversion valuation

- This method does not forecast income growth, so we use the current rent and current market rental value in the valuation.
- So, the MRV is applied for the first and any subsequent rent changes – we only consider the current rent and the current market rent (reversionary rent) – the latter being applied at the first rent event – rent review (in this case) and onwards to Perpetuity.



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5. Example of a Term and Reversion valuation

Having identified the income flows: how do we capitalise the income flows (the property)?

We use the all risk yield of 8% from comparable analysis. The valuations is a 2-stage process.

1. Term income

As this is an income for a fixed period, we capitalize it using the Present Value of £1 p.a. formula (YP) = $\frac{\left(1-\left(\frac{1}{(1+i)^n}\right)\right)}{i}$

This formula will give us our multiplier, which we apply to the term income to give us the 'value' of the term income.

Yield: Traditionally the term part of the income has been capitalised at a lower yield (say, 7%) to reflect the perceived better security of this income relative to the security of the reversionary rent.

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5. Example of a Term and Reversion valuation

2. Reversionary income

The reversionary income is capitalised in perpetuity at 8% (the appropriate All Risks Yield for this type of property) and we also have to take account of the fact that we do not receive this revised income for 3 years. We do this by deferring this reversionary income. To do this we require two formula:

- The YP in perpetuity (PV of £1 p.a. in perpetuity) to capitalise income = 1 / i (the multiplier)

- The Present Value of £1 (PV of £1) to defer the capitalised income back to today = $\frac{1}{(1+i)^n}$

We multiply these and the reversionary income to get the 'value' of the reversionary income.

Overall Valuation

Combining the 'values' for the term and reversionary elements gives us the overall capital value of the property.

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5. Example of a Term and Reversion valuation

Term

Current Rent	£100,000	
PV of £1 pa (YP) 3 years at 7%	x 2.6243	£ 262,430

$$\frac{1-\left(\frac{1}{(1+0.07)^3}\right)}{0.07}$$

Reversion

Market Rental Value	£120,000	
PV of £1pa (YP) in perp at 8%	x 12.5	
PV of £1 for 3 years at 8%	x 0.7938	+ £1,190,700
	Capital Value	**£1,453,130**

$$\frac{1}{(1+0.08)^3}$$

- The formula for PV of £1 per annum for a fixed term (YP) is $\frac{\left(1-\left(\frac{1}{(1+i)^n}\right)\right)}{i}$
- The formula for PV of £1 per annum (YP) in perp is 1/i.
- The formula for PV of £1 is $1/(1+i)^n$.

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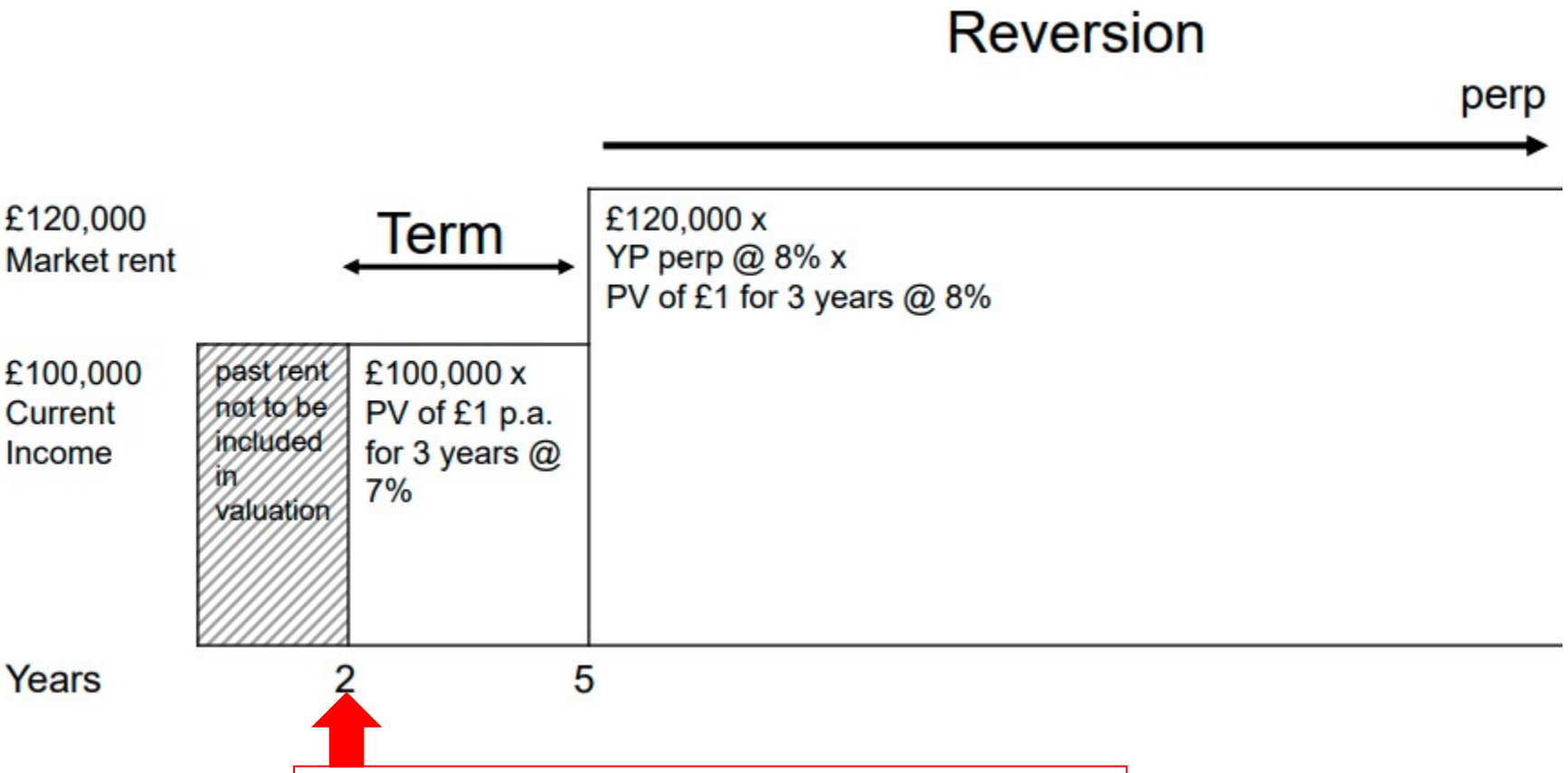
5. Example of a Term and Reversion valuation



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5. Example of a Term and Reversion valuation

Recap Notes:

The term part of the income.

The Present Value of £ 1 per annum formula is used (YP) to capitalise the term income. This is the formula we use to capitalise income for a fixed time period.

$$\frac{\left(1-\left(\frac{1}{(1+i)^n}\right)\right)}{i}$$

The reversionary income.

The Present Value of £1 per annum in perpetuity (YP perp) formula is used to capitalise the reversionary income. This is the formula we use to capitalise an income to be received in perpetuity (forever).

$$\frac{1}{i} \times \frac{1}{(1+i)^n}$$

This capital sum calculated is also discounted for three years and the Present Value of £1 formula has been used here. [this is to reflect the fact that the PV of £1 in perp (YP perp) formula capitalises this block of the income stream as if it starts now, whereas in reality it does not start until the next rent review in three years' time].

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5. Example of a Term and Reversion valuation

Recap Notes:

Having undertaken the valuation, we can analyse the yields that the investor would achieve if he paid the price of £1,453,130.

- The **initial yield** is the current rent (income) / price.
- The **reversionary yield** is reversionary rent / price.

Yield analysis

1. Initial yield	£ 100,000 / £1,453,130	=	6.88%
2. Reversionary yield	£ 120,000 / £1,453,130	=	8.26%

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6. Splitting Yields in the Term & Reversion Method

There are differing views on the yield adjustments in the valuations.

Conventionally these are:-

Term and Reversion:

The convention is to apply the 'All Risk Yield' (ARY) to the Reversion and then use lower yield for the fixed Term income because this income is not subject to an uncertain level of rental growth (perceived as more secure).

[Note it does not grow at all – it is fixed under lease].

Also the tenant is less likely to default as they are paying a rent below the market level of rent.

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7. Yield Summary

- Conventional valuations use yields in a similar manner to dividend yields and PE rations (price/earnings) in equities markets.
- Conventional valuation yields are taken from comparables (observed sales and letting transactions).
- **All Risk Yield** = rent on rack rented building / market price.
- **Initial Yield** = rent passing/market price.
- **Reversionary Yield** = market rental value / market price.
- Split yields apply to the term and reversion.

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8. Notes on Comparable for Valuations

- Before undertaking a valuation, you are required to undertake a degree of analysis of some comparable properties.
- In the marketplace this will involve looking at all recent transactions, selecting the most comparable five or six recent lettings and the same number of recent sales evidence), and then analysing these.
- After the analysis of these deals, you will then adjust the MRV/FRV's derived from the analysis of recent lettings to reflect the differences from each comparable to your subject property.
- You will then do the same to each of the recent sales to derive the appropriate capitalisation rate (ARY).
- Find the market rental value per m2, then the market rental value (£ per annum) and the yield.
- From the information gained above, you will decide on the appropriate MRV/FRV and ARY for the property that you are valuing.
- (Do not average the figures gained above – you may have a range of values and you have to decide where the subject property fits within this range).

8. Notes on Comparable for Valuations

When setting out your analysis of comparables - Keep it simple:

1. Set them out in a neat and logical manner so the client can follow your thinking and your argument.
2. Provide clear annotations and state assumptions. Ideally, these should follow immediately after the calculation.
3. It is also a good idea to highlight or underline the final answer so that it stands out on the page.

Unless calculating right through on a calculator, you should calculate any valuation formula rounded to a minimum of 4 decimal places or if taking from the valuation tables, again the figure you set down on paper should be a minimum of 4 decimal places (rounded to).

Next Lecture

Section 17 – Methods of Valuation – DCF Pt 1 - Introduction