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PROPERTY VALUATION

(BG3 ALT S6)

Section 18 –

Methods of Valuation (DCF) Pt 2

- Scenario

Real Estate Business Management Program

Year 3 – Work study program

Présenter: David Hourihan MSc Prop Inv FRICS

10 November 2023

Methods of Valuation – Investment Method (DCF)

Agenda

A. Scenario.

B. Basis of Appraisal.

C. Property & Market assessment using SWOT analysis.

D. Investment Categorisation.

Methods of Valuation – Investment Method (DCF)

A. Scenario

You are an investment surveyor employed at ‘Wilde & Collins Real Estate’; a Dublin based investment advisory firm. Your day-to-day responsibilities include the strategic management of several client investment portfolios for international private investors.

Your client, ‘Provincetown Investments’ is based in 425 Park Avenue, New York, USA. They are long-term investors and are generally risk averse regarding their real estate investments. As a result, they generally only acquire Core or Core plus type investments.

You have been instructed by your client, ‘Provincetown Investments’, to prepare a fully referenced client report giving recommendations and conclusions on the possible acquisition of Phoenix House, 1100 Bayside Office Park, Dublin.

Here you should:

- Confirm of the basis of valuation you have adopted in your appraisal and a detailed explanation that clarifies the differences between the expressions ‘Market value’ and ‘Investment worth’.
- Analyse the outputs from the Discounted Cash Flow (DCF) appraisal model supplied with this client brief for this investment. Provide clear conclusions and recommendations on whether the investment is a suitable acquisition for your client.
- Assess the level of risk associated with this investment by analysing the sensitivity and probability tables provided with the Discounted Cash Flow (DCF) appraisal model to determine if there are acceptable levels of risk in this investment proposal for your client.

Methods of Valuation – Investment Method (DCF)

A. Scenario - Phoenix House, 1100 Bayside Office Park, Dublin

Asking Price: **€15,000,000**

Location:

- Bayside Office Park is a low-rise development located in close proximity to the IFSC. Occupiers in this park include leading international companies in the TMT sector.
- The business park has a dedicated shuttle bus service linking the park to LUAS and DART rail networks.
- Amenities on the park include a gym, cafes, bars, restaurants, convenience stores, creche and sports facilities.

Description:

- The Property comprises 40,000 sq ft (3,716 sq m) over four floors of Grade A office accommodation.
- Stand-alone office building with full height atrium.
- Floorplates are c-shaped averaging 10,000 sq ft.
- 58 car spaces.
- Construction of Phoenix House was completed in early 2015.

Methods of Valuation – Investment Method (DCF)

A. Scenario - Phoenix House, 1100 Bayside Office Park, Dublin

Building Specification:

- Large ground floor reception area.
- There is a central core and excellent levels of natural light.
- Meeting rooms on each floor.
- Tea stations/small kitchens on upper floors with canteen style facilities at the rear of the ground floor.
- Staff facilities include: 4 Showers, Lockers, Bike racks, large storerooms and secure parking (60 car spaces).
- Modern air conditioning.
- Fully accessible raised flooring.
- Suspended ceilings incorporating diffused lighting.
- Average floor to ceiling height of 2.7m.
- Two 8-person passenger lifts.
- Male, Female and disabled WC's on each floor.
- Double glazed windows.
- Accessible WCs.
- Male and Female WCs.
- Designated commuter entrance and facilities:
  - 235 cycle spaces.
  - Cycle Lockers.
  - Showers.

Methods of Valuation – Investment Method (DCF)

A. Scenario - Phoenix House, 1100 Bayside Office Park, Dublin

- Current rental income: €1,031,200 / Average rent €23.75.
- Tenants: Adobe, Texas Instruments, SAP, Verizon Communications Inc.
- WAULT: / WAULTc: 14.10 / 10.39.
- The building has been independently measured in accordance with the latest IPMS standards for office buildings.
- Phoenix House is held under freehold title.
- For the purposes of your calculations the appraisal date is the 26 October 2023.
- Reliable information on the local office market has shown that there has been an annual rental growth rate of 2% per annum over the last three years.
- Client's hurdle rate of return is 7.00%.
- The holding period for this investment is 10 years, after which the investment will be sold.
- The leases in the investment are on an effective 'Full Repairing and Insuring' basis.
- The disposal value will be assessed on the basis of the expected rental value at the date of the disposal and subject to a capitalisation rate, which would reflect the age and obsolescence of the building.
- Rents are collected quarterly in advance. Rent reviews occur every 5 years and affect rental levels thereafter.
- Acquisition fees will be at 9.96% (i.e. 7.5% stamp duty, 1% plus VAT at 23% for agent's acquisition fees and 1% plus VAT at 23% for legal fees).
- Disposal fees will be at 2.46% (i.e. 1% plus VAT at 23% for agent's disposal fees and 1% plus VAT at 23% for legal fees).
- Rent review fees will be at 7.5% of the revised rent.
- The BER rating for the building is currently B2.
- Rents collected in the latest quarter (i.e. Sept 23) assumed to transfer to purchaser at date of appraisal.
- Cashflows in this DCF model are unleveraged.
- Cashflows in this DCF model exclude any possible tax liabilities.

(Disclaimer: The property is entirely fictitious. Any resemblance to real properties is coincidental.)

Methods of Valuation – Investment Method (DCF)

B. Basis of Appraisal

What is the basis of appraisal? Price, Value and Worth

'Investment Value' or 'Investment Worth' is not 'Market Value'. It is not used in a 'Red Book' valuation.

'Investment Value'
The value of an asset to the owner or a prospective owner given individual investment or operational objectives (may also be known as worth).

IVS 20.11

'Market Value'
The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

IVS 20.14

The Investment Method of Property Valuation

- This method of valuation is used to establish the capital value of a property based on its income.
- It is the most widely used method to value commercial property and is based on the relationship between capital and rental value.
- The method uses two approaches: the traditional approach ('Term & Reversion' or 'Hardcore' methods) and Discounted Cashflow method.
- The DCF method is a form of valuation that calculates an investment's value based on the ability to receive a predicted future cash flow.

Methods of Valuation – Investment Method (DCF)

C. Property & Market assessment using a SWOT analysis

	STRENGTHS		WEAKNESSES
1	GRETI 2022 – Ireland ranked no 7 out of 94 countries and territories.	1	Open Economy.
2	Mature economic structure.	2	Loss of low corporation tax rate (12.5%). Now at 15%.
3	12th most competitive economy in the world (IMD World Competitiveness Yearbook 2020)	3	Stamp Duty at 7.5%.
4	Post Brexit - Now only English speaking capital city within the EU.	4	Rent Reviews (cap/collar, index linked) v Upward Only.
5	Greater diversity of investor type.	5	Dominance of tech companies as occupiers.
	OPPORTUNITIES		**THREATS**
1	Changing work patterns.	1	Labour shortages.
2	Repurposing of older office buildings.	2	High cost of living.
3	Sustainability.	3	Higher energy prices.
4		4	Higher building environmental standards.
5		5	Political tensions post Brexit.

Methods of Valuation – Investment Method (DCF)

D. Investment Categorisation

'**Core**' and '**Core Plus**' are terms which carry with them judgements about property risk, including leverage, and expected returns.

Core investments tend to appeal to longer term, strategic investors, including many international institutional investors as well as some individual investors. Investors in core assets typically seek a secure return, largely generated from ongoing current property cash flow. Representative core investments include:

- Properties let to strong credit tenants.
- First class or "trophy" office buildings in major urban markets, with intermediate to longer term leases;
- Premier multi-tenant buildings with limited lease rollovers.
- Assets with a modest level of leverage (40.0% to 50.0%) relative to value.

While overall returns (IRRs) in the core category can be below 10.0% in the current market, investors view these returns as offering an attractive premium relative to other asset classes, including stocks and bonds.

Core plus investments are a variation on core investing, offering slightly higher overall returns that typically range between 9.0% and 12.0%. Core plus investments often derive a somewhat lower percentage of their overall return from current cash flow and a correspondingly higher percentage from residual value. The higher returns from core plus investments relative to core investments may reflect such factors as:

- Somewhat higher releasing risk.
- Lesser credit leases.
- Higher levels of leverage (50.0% to 60.0%).

Methods of Valuation – Investment Method (DCF)

D. Investment Categorisation

Value Added

Investments of this type offer opportunities for a mix of current cash flow and future appreciation. They may be in recovering primary markets, secondary or tertiary markets. They often require re- engineering of the tenant mix in order to improve cash flow and often benefit from a change in marketing, operating, or leasing strategy; physical improvements; and/or a new capital structure. Overall returns from properties n this sector range from 12.0% to 18.0%. Such investments tend to attract to knowledgeable institutional and individual investors seeking an enhanced return in exchange for somewhat higher levels of operating risk.

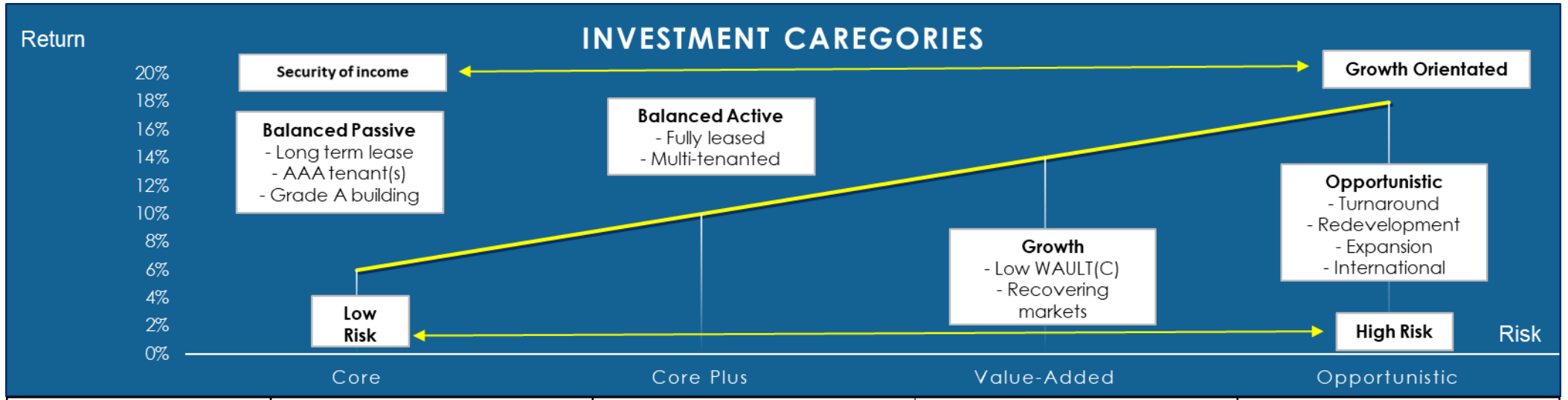
Opportunistic

Property Investments in this category often involve the commitment of significant capital and have a higher risk profile than ‘Core’ and ‘Core Plus’ properties because they have higher vacancy levels, lower weighted average unexpired lease terms (WAULTS), have secondary or tertiary location and/or require redevelopment /refurbishment. They typically have high overall returns (18.0% and above).

Such properties often require intensive input by the investor to ‘rescue’ or ‘turn them around’ and returns tend to be “back-end loaded” and only achieved upon the disposal or refinancing of the asset.
Opportunistic investors tend to be well capitalized investors and are comfortable with the higher levels of leverage that are typical in this segment.

Methods of Valuation – Investment Method (DCF)

D. Investment Categorisation



Return	6%	10%	14%	18%
Category	**Core**	**Core Plus**	**Value Added**	**Opportunistic**
Risks	Minimal	Minimal - Moderate	Minimal - Moderate	High
Targeted Returns	6-9%	9 - 12%	12 - 18%	18% +
Return Composition	Current Income	Current Income +, Capital Appreciation	Current Income +, Capital Appreciation	Capital appreciation
Holding Period	10+ Years	5 - 7 years	5 - 7 years	5 years or less
Leverage	0-50%	50 - 60%	60 - 70%	70 - 80%
Investment Profile	Large trophy buildings in Central Business District (CBD) locations, properties with long term leases to strong credit tenants.	Stabilised buildings generating steady current income.	Buildings with upside potential realised thrugh value added asset management.	Underutilised assets in need of repositioning.

Note: Suggested rates of return per category here are for guidance purposes and will vary by investor and market

Source: The Prescott Group LLC (2017)

Methods of Valuation – Investment Method (DCF)

D. Investment Categorisation

- Having now reviewed the details of the subject property and carried out a SWOT analysis of the property and wider market - What investment categorisation would we give the subject property?

- Can the categorisation of an investment change?

- Does the categorisation align with the investor’s requirements?

Next Lecture

Section 19 - Methods of Valuation – Investment Method (DCF) Pt 3 – Key Variables