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Using DCF for 'Red Book' valuations – A discussion with a Professional Valuer



Using DCF for 'Red Book' valuations

Matthew Dichler MRICS



Summary

- Partner at Knight Frank Valuation & Advisory.
- Over 15 years of real estate experience.
- Member of the Royal Institution of Chartered Surveyors and RICS Registered Valuer
- Specialist in valuation of assets across the main sectors plus residuals and development appraisals.
- Further interests in the Prime Investment Yield Guide and Out of Town rental values.
- Clients include: abrdn, AEW, Aviva Investors, LGIM and Swiss Life.
- **Previous roles include:**
 - Commercial Valuations at Colliers, Dubai.
 - Head of Residential Valuations, Cavendish Maxwell, Dubai.
 - General Practice Surveyor at Wilks Head & Eve LLP.
- Graduated with MSc Real Estate from UCEM in 2011.

David Hourihan



Summary

- Programme Leader for the MSc Real Estate at UCEM.
- 17 years of commercial real estate experience across the UK and Ireland.
- Specialist in investment, office agency, retail asset management and valuation.
- Previous positions with international firms including JLL and Colliers International.
- Acquisition and asset management instructions for clients including Société Générale, Metzler Bank, Mobil Oil, Scottish Widows, Aviva and British Land.
- Fellow of the Society of Chartered Surveyors Ireland and Royal Institution of Chartered Surveyors.
- RICS Governing Council geographical seat holder for the UK and Ireland.
- Visiting Professor, Ecole Supérieure des Professions Immobilières (Paris Campus).
- Graduated with an MSc in Property Investment from UCEM in 2008.
- APC Chairman / Assessor for SCSi and RICS.
- RICS Inspire Ambassador.

Using DCF for 'Red Book' valuations

Bases of Valuations

Key definitions are defined in Red Book:

'Market Value'

- Basis of Value in most jurisdictions
- Not forward or backward looking – at date of valuation

'Investment Value'

- Calculation of worth
- Used to assess price investor might pay compared against expected Market Value

'Market Rent'

- Different from Estimated Rental Value
- Used interchangeably...

Using DCF for 'Red Book' valuations

Investment Valuation - *Traditional vs DCF*

Traditional Valuation Method

- Relies on comparable inputs.
- Capitalisation and Analysis yields are implicit.
- Rarely used for Worth calculations.

Discounted Cash Flow Method

- Allows for wider range of inputs and assumptions.
- Valued with regard to time value of money (discount rate).
- Can be used for Value and Worth.

Best practice is to adopt the accepted approach in the market and then review or 'sense check' using other methods where appropriate.

The increased number of input variables within DCF are its greatest strength...and its greatest weakness.

Using DCF for 'Red Book' valuations

1 Fear of change

Valuers in the UK market have traditionally used the 'Hardcore' (or 'Layer') method or the 'Term & Reversion' method to carry out Red Book valuations or non-Red Book appraisals.

2 Inconsistency of use

Models used can vary in complexity eg annual in arrears versus quarterly in advance.

3 Lack of transparency on risk

The traditional methods apply risk implicit adjustments, which are problematic for non-real estate investors who are used to more transparent adjustments for risk. Risk in context of property can be defined as either specific or systematic. The drive to net zero carbon is highlighting specific risk in the form of obsolescence in buildings while systematic risk is currently very evident in the form of volatility in local markets and global economies. Geo-political risk also impacts on the valuation as a form of systematic risk. The DCF model can more explicitly address these various forms of risk.

4 Future Rental Growth not explicitly factored in

A DCF model of appraisal or valuation differs from the traditional methods of valuation as it adopts the market's assessment of future growth in an explicit way. This future income stream is then discounted back at a discount rate (Hurdle Rate) to establish market Value. The traditional methods only use today's rental values and discounts the income at a rate based on analysis of comparable transactions.

5 Analytic tools are too basic

'Stress testing' techniques have also been heuristic in nature. Scenarios used but other forms of risk analysis (sensitivity, probability) should be more widely adopted.

6 Confusion between IV and MV

Typically used for IV rather than MV in many markets and the two bases can get confused.

7 Lack of supporting data

Market data for variables such as estimated rental growth (ERV), rental growth and yield growth data can be difficult to source.

Using DCF for 'Red Book' valuations

➡ **Examples** of where we use the DCF method in the marketplace.



Upcoming Property Webinars:

- **How to construct a Hurdle rate for DCF Appraisals**

24th April 2024 | 11:00am BST

- **Benefits of Upskilling Employees with MS Excel Modelling Skills, as a Recruitment Expert**

14th May 2024 | 13:00pm BST



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