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How to construct a Hurdle Rate for DCF appraisals



How to construct a Hurdle Rate for DCF appraisals

Professor Colin Lizieri

Summary

- Professor Emeritus of Real Estate Finance.
- Professor of Real Estate Finance, Cambridge.
- Director, Lizieri Real Estate Consultants.
- Professor of Real Estate Finance, University of Reading.
- Senior Research Fellow / Reader in International Real Estate Markets.
- Doctor of Philosophy from The London School of Economics.
- Bachelor of Arts, Geography from University of Oxford.
- Consultant and investment advisor to central banks, sovereign wealth funds, institutional investors and listed real estate firms.
- Expert witness on commercial and residential property in the UK and Australian courts.



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.



How to construct a Hurdle Rate for DCF appraisals

Introduction

- When an investor undertakes a DCF appraisal they set a target (hurdle) rate of return that they require from the investment.
- This hurdle rate of return reflects levels of risk that the investor is prepared to accept.
- It is common to build-up a hurdle or target rate of return that is based upon 'specific' risks associated with the property being appraised and 'systematic' risks from the wider markets.
- A frequent criticism of this approach is that these allocations for risk are often arbitrary or subjective, and at the very best, based on experience and past performance, rather than this being an objective, criteria-based approach.
- $\text{Hurdle rate} = \text{risk free rate} + \text{risk premium}.$

'An investigation of Hurdle Rates in the Real Estate Investment Process'.

- This report focused on the hurdle rate variable in the Discounted Cashflow method of valuation.
- The hurdle rate – The minimum, required or target rate of return.
- A hurdle rate is applied in the DCF model to reflect the investor's weighted average cost of capital (WACC).

How to construct a Hurdle Rate for DCF appraisals

‘An investigation of Hurdle Rates in the Real Estate Investment Process’.

Key Findings:

- 1 It is common practice among commercial real estate investors in the UK to use non-cashflow decision-making tools (eg payback, profit-on-cost) in the investment process,
- 2 There is significant evidence of discretionary behaviour being exhibited by real estate investors in the measurement process which has resulted in inconsistencies in the use of key metrics in the decision-making process, and;
- 3 There is also a reluctance to adopt more sophisticated quantitative modelling applications.



Example: Hurdle Rate for Q1 2024 West End Office appraisal

Based on historic data 1980-2023: all institutional-grade property

	Delivered return; source MSCI	8.9%
Less	Average 10 Year Gilt Yield	<u>5.2%</u>
	Delivered Risk Premium	3.7%
	Current 10 Year Gilt Rate	4.1%
	Implied Real Return	<u>7.8%</u>

What's in the risk premium?

- Volatility relative to Government gilt yields
- Liquidity relative to Government gilt yields
- Risks: depreciation, obsolescence, locational risk
- Structural change: working patterns and demand shifts

Should you adjust required return for individual property characteristics?

- Prime versus secondary – critical in current market
- Tenant covenant strength
- WAULT?
- Building characteristics and quality (including ESG factors)
- Micro -locational factors
- Lease terms

Example: Hurdle Rate for Q1 2024 West End Office appraisal

Thinking about yields

Over that 1980-2023 period:

	ERV growth averaged	3.33%
Less	Inflation averaged	<u>4.08% p.a.</u>
	Implies real rental growth of	-0.75%
	Current anticipated inflation	<u>3.15%</u>
	Implies expected growth of	2.4% p.a.

Implies “rational” yield of $7.8\% - 2.4\% = 5.4\%$

MSCI average equivalent yield end 2023: 5.2%

- But agents reporting prime yields 4.0% to 4.5%?
- How much transaction activity is there?

Thinking about structural change

- Has market changed structurally 1980-2023?
- Does pandemic imply new working practices and reduced long-run demand, higher costs?
- If so, real rental growth likely to be lower (unless supply adjustment)?
- Do new ESG pressures make assets vulnerable (stranded assets, retrofit costs)?
- How do you value potential change of use?



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