



UCEM Institutional Research Repository

Title	DISCOUNTED CASHFLOWSMaking THEM MAINSTREAM IN REAL ESTATE
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	31 January 2025
Version	
DOI	
Repository link	https://ube.repository.guildhe.ac.uk/id/eprint/203/
Link to publication	

Copyright:

UCEM aims to make research outputs available to a broader audience via its digital [Repository](#). Where copyright permits, full text material held in the Repository is made freely available. URLs from GuildHE Research Repositories may be freely distributed and linked to. Please refer to each manuscript for any further copyright restrictions.

Reuse:

Copies of full items can be used for personal research or study, educational, or not-for-profit purposes without prior permission or charge provided that the authors, title and full bibliographic details are credited, a hyperlink and/or URL is given for the original metadata page, and the content is not changed in any way.

DISCOUNTED CASHFLOWS

MAKING THEM MAINSTREAM IN REAL ESTATE

PART 1 (SECTIONS A – E)

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

Please Note:

Today's workshop has been created for training purposes only and does not constitute legal or other professional advice or guidance.

No liability is accepted to users or any third parties in respect of the use of the content or any errors or inaccuracies.

Professional advice should always be obtained before applying any information in this workshop to particular circumstances.

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

Summary

- 17 years of commercial real estate experience across Ireland and the UK.
- 15 years in academia - Programme Leader for the MSc Real Estate at UCEM.
- Graduated from MSc in Property Investment in 2008.
- Specialist in investment, office agency, retail asset management and valuation.
- RICS Governing Council seat holder - Commercial Property.
- APC Chairman / Assessor for SCSi and RICS.
- RICS Inspire Ambassador.



David Hourihan MSc Prop Invest
FRICS FSCSI

General House Keeping

To get to most from the workshop:

- I will need your full attention during the workshop:
 - Please switch off your mobile phones.
 - Keep your social media accounts closed.
 - Don't monitor your emails or texts.
- I have added 2 comfort breaks to help us maintain our attention levels.
- Please do ask questions during the session.
- Be ready to contribute. I'll be asking for your opinion.
- I will ask for feedback after the workshop.

DISCOUNTED
CASHFLOWS –
MAKING THEM
MAINSTREAM IN
REAL ESTATE

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

Opening Comments

1. Greater transparency now expected in valuations or appraisals of commercial property
2. RICS has called for a much more analytical profession.
3. This is not a class in Microsoft Excel.
4. Instead, lets focus on the key variables and **NPV/IRR outputs** in a DCF model.
5. Look at both the **return** and **risk** aspects of the investment and **categorise** the investment.
6. Use a **fictitious** scenario – 7 Clarges Street, Mayfair, London.
7. Review **5 key variables** relative to market conditions (as at Q4, 2024).
8. Consider DCF on 'Investment Worth' and 'Market Value' basis.

Agenda (10.00am – 1.30pm)

Part 1 (10.00 – 11.00am) (60 mins)

- A. Introduction
- B. Scenario – West End Office Investment.
- C. Basis of Appraisal.
- D. Property & Market assessment using SWOT analysis.
- E. Investment Categorisation.

Comfort Break (30 minutes)

Part 2 (11.30 – 12.45pm) (75 mins)

- F. The DCF Model.
- G. Measuring Returns (NPV and IRR).
- H. Analysing the 5 key variables:
 - 1 ERV - Hierarchy of Rental Comparisons.
 - 2 Hurdle Rate.
 - 3 Exit Yield.
 - 4 Rental growth rate.
 - 5 Purchase Price.

Comfort Break (15 minutes)

Part 3 (1.00 – 1.30pm) (30 mins)

- I. Stress Testing Key Variables.
- J. Conclusions / Recommendation.

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

A. Introduction

Learning Outcomes:

On completing this course participants should be able to:



Evaluate the '**Investment Value**' and '**Market Value**' of a commercial real estate investment using the DCF method, in the context of the UK market.



Look beyond the figures and critically analyse the **systematic** and **specific risks** of an investment.



Stress test the impact of changes in key variables on the '**Net Present Value**' and '**Internal Rate of Return**'.

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

A. Introduction

Background - Discounted Cash Flows (DCF)

- ▶ DCF analysis gained popularity as a valuation of stocks in 1930s.
- ▶ The United Kingdom (UK) real estate investment sector has not yet adopted into standard practice the capital budgeting techniques commonly used in other investment sectors.

This research found that there is/are:

1. Many investors in the UK to use non-cashflow decision-making tools.
2. Inconsistencies in the use of key metrics.
3. A reluctance to adopt more sophisticated quantitative modelling applications.



A. Introduction

Challenges to making DCF mainstream in real estate

1. Fear of change
2. Inconsistency of use
3. Lack of transparency on risk
4. Future Rental Growth not factored in
5. Analytic tools are too basic

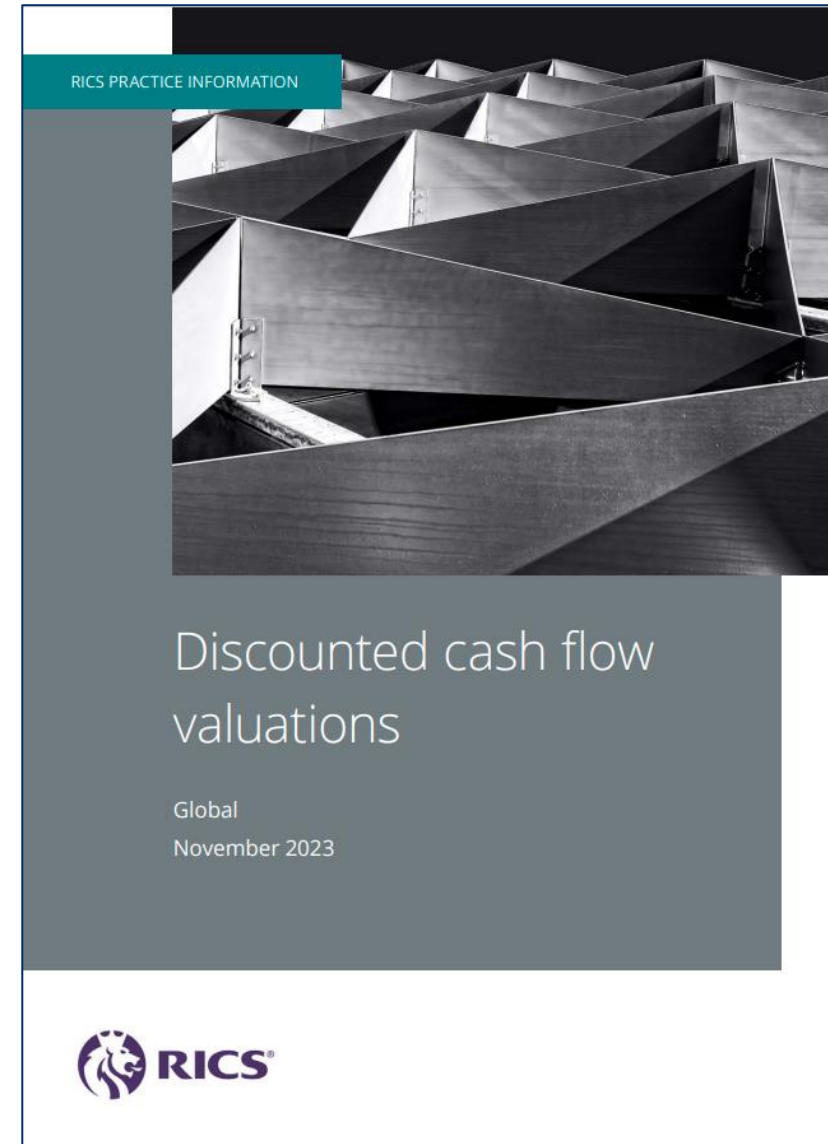
DISCOUNTED
CASHFLOWS –
MAKING THEM
MAINSTREAM IN
REAL ESTATE

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

A. Introduction

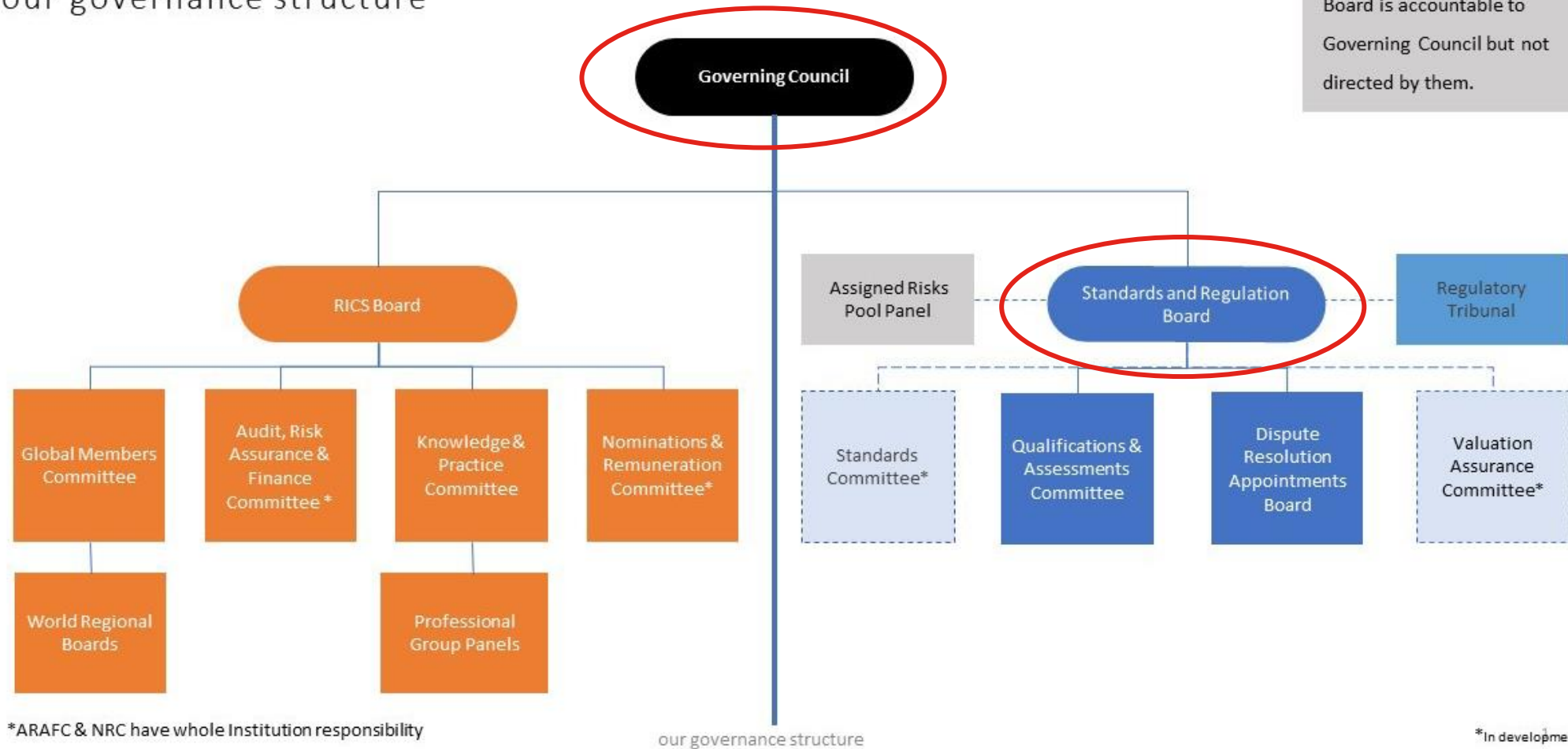
Background – Key steps at RICS

- Dec 2021 - The *Independent Review of Real Estate Investment Valuations* review was undertaken.
- April 2022 - the RICS established Valuation Review Implementation Committee (VRIC).
- March 2023 - VRIC carried out a consultation specifically regarding the use of Discounted Cash Flow (DCF) within valuations.
- November 2023 – RICS issued a global practice information paper entitled 'Discounted cash flow valuations'.



DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

Independent professional regulation is guaranteed through our governance structure



• *ARAFC & NRC have whole Institution responsibility

our governance structure

*In development

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

B. Scenario

- ▶ You are an investment surveyor employed at 'Wilde & Collins Real Estate', a London 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' 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 client report giving recommendations on the possible acquisition of 7 Clarges Street, Mayfair, London .

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

B. Scenario - 7 Clarges Street, Mayfair, London

Asking Price: £140,000,000

Description:

- The subject property is a prime six story office development with the three uppermost levels incorporating private terraces with views across Green Park to Buckingham Palace.
- Fully occupied by Reuters on a 10 years lease.
- The Property comprises 49,500 sq ft (4,599 sq. m) of office accommodation.
- Flexible column free floor plates.
- 7 Clarges benefits from strong transport links, located less than a five-minute walk from Green Park station with connections to London City Airport in less than 30 minutes and St Pancras International Station in 10 minutes. Crossrail also provides access to Heathrow in 27 minutes and Paddington in 3 minutes.
- The total annual rent: £5,500,000 per annum exclusive of service charge, rates, insurance etc.
- The asking price is exclusive of VAT reflecting a net initial yield of 4.05%.

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

B. Scenario - 7 Clarges Street, Mayfair, London

Building Specification:

- ▶ Smart building designed.
- ▶ Large ground floor reception area.
- ▶ Raised access floors.
- ▶ Suspended ceilings.
- ▶ Passenger lifts.
- ▶ Air conditioning.
- ▶ Accessible WCs.
- ▶ Male and Female WCs.
- ▶ Excellent natural light.
- ▶ Designated commuter entrance and facilities:
 - ▶ 55 cycle spaces.
 - ▶ 39 Cycle Lockers for folding bicycles
 - ▶ Staff shower amenities



Source: <https://www.commercialnewsmedia.com/archives/57182>

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

B. Scenario - 7 Clarges Street, Mayfair, London

Investment Appraisal Details:

- Current rental income: £5,500,000 pax (£111 psf).
- Tenant: Reuters.
- Unexpired lease term: 9.41.
- The building has been independently measured in accordance with the latest IPMS standards for office buildings.
- 7 Clarges Street is held under freehold title.
- For the purposes of your calculations the appraisal date is the 1 January 2025.
- Reliable information on the local office market has shown that there has been an annual rental growth rate of 1.5% per annum over the last three years.
- Client's hurdle rate of return is 4.25%.
- 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.
- You will appoint an agent for the day-to-day management of the property under a new contract. Their annual management fee is £100,000, which will be subject to a 5% increase in management fees in year 5.
- 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. Assume an exit yield of 4.25% for 7 Clarges Street.
- Rents are collected quarterly in advance. Rent reviews occur every 5 years and affect rental levels thereafter.
- Acquisition fees will be at 6.79%. (i.e. 4.99% stamp duty, 1% plus VAT at 20% for agent's acquisition fees and 0.5% plus VAT at 20% for legal fees).
- Disposal fees will also be at 1.5% (i.e., 0.75% plus VAT at 20% for agent's disposal fees and 0.5% plus VAT at 20% for legal fees).
- Rent review fees will be at 7.5% of the revised rent.
- The EPC rating for the building is currently B.
- Rents collected in the latest quarter (ie Dec 24) 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.)

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

C. 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

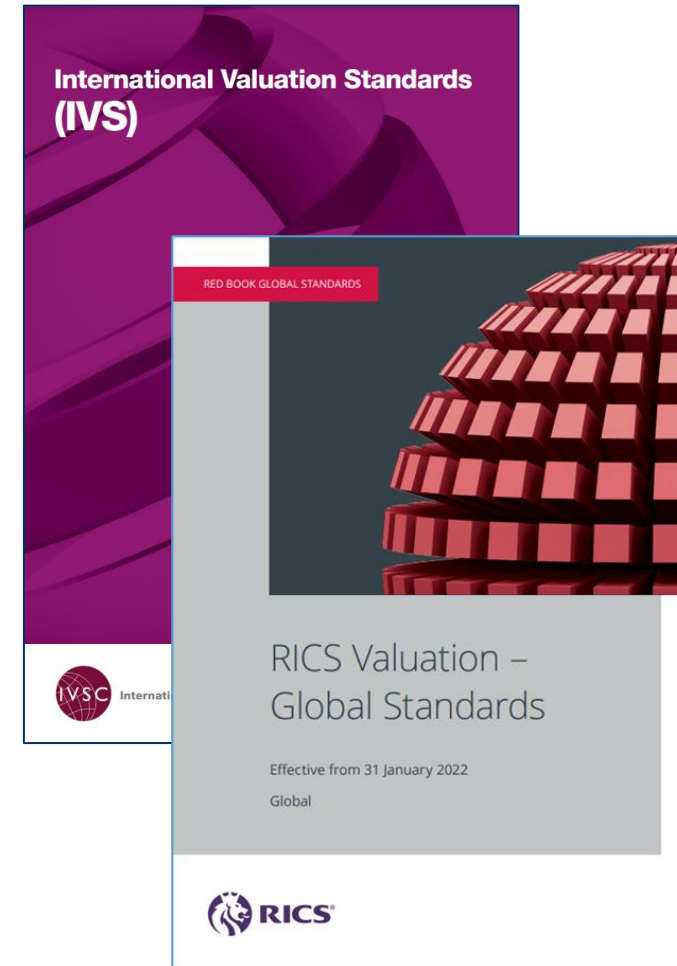
‘Market Value’

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.



DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

D. Property & Market assessment using a SWOT analysis

	STRENGTHS		WEAKNESSES
1	GRETl 2024 – UK ranked no 1 out of 89 countries and territories.	1	The subject property is a single-let. There is a major impact on rental income from the property if the tenant vacates.
2	Mayfair is a leading sub-market within Central London with restricted development pipeline in the West End.	2	Large lot size of investment will limit the range of active investors who would bid for it.
3	Polarisation of the office market has spurred demand for best quality, well located buildings.	3	Flatlining UK and European economies.
4	Vacancy rates are low and levels of occupier demand in West End has remained stable despite volatile market conditions.	4	Lack of market transparency. Many West End deals happen 'off market'.
5	The subject property has a high EPC rating.	5	The large government spending plans as part of Labour's Budget plans is currently unsettling market sentiments. UK bond market surge, pound weakness.
	OPPORTUNITIES		THREATS
1	Changing work patterns: many employees working remotely 2-3 days a week.	1	Ongoing global conflicts eg Ukraine and Middle East.
2	The continued 'flight to quality' will spur even further demand for high quality offices by investors.	2	Changing work patterns and the greater need for flex space. Landlords need to be more proactive.
3	The availability of 'Core' type investments in the West End is rare.	3	The new Westminster government is settling in.
4	War on talent. Occupiers want best in class space to attract the most talented staff.	4	UK economic constraints including tight labour markets and concerns over inflation.
5	Occupiers have a much greater awareness of the environment and want best in class space with high green credentials.	5	Uncertainty regarding the global impact of the new US presidency.

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

E. Investment Categorisation

Core

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;
- ▶ and assets with a modest level of leverage (40.0% to 50.0%) relative to value.

Core Plus

The core plus segment is a variation on core investing, offering slightly higher overall returns. 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,
- and/or higher levels of leverage (50.0% to 60.0%).

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

E. Investment Categorisation

Value Added

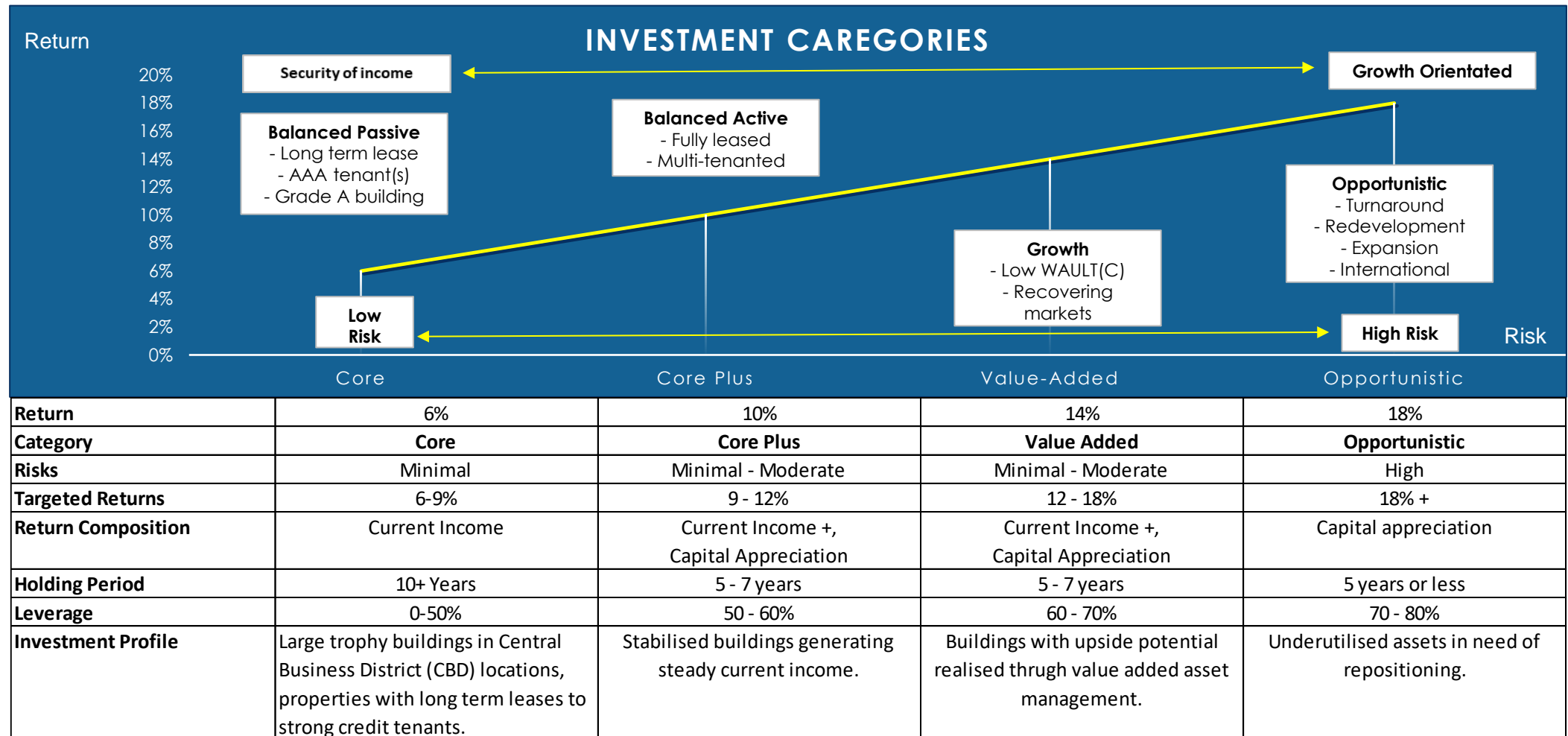
Investments of this type offer opportunities for a mix of current cash flow and future appreciation. They may be in recovering primary markets, secondary or tertiary markets. They often require re-engineering of the tenant mix in order to improve cash flow and often benefit from a change in marketing, operating, or leasing strategy; physical improvements; and/or a new capital structure.

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.

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

E. Investment Categorisation



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)

DISCOUNTED CASHFLOWS – MAKING THEM MAINSTREAM IN REAL ESTATE

E. Investment Categorisation - Quick Recap

- ▶ 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?

DISCOUNTED CASHFLOWS

MAKING THEM MAINSTREAM IN REAL ESTATE

31 January 2025