Real Estate Valuation

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Soft Factors of Real Estate Valuation

Summary

- Make sure to significantly adjust your valuation for the property's location
- Make sure that you have checked important factors such as the building permit, the technical standard of the property before you sign the purchase agreement
- Always make a common sense check of your valuation
- Stay cool when the market values are deviating from the Akelius value – there is money to make!

Introduction

What we'll basically learn during this calculation course is that valuation of real estate, or actually any asset such as stocks or bonds, is done through discounting future cash flow with an appropriate discount rate reflecting the risk of the asset. Depending on the characteristic of the investment, we will learn to use different models.

- For assets with a really long life span, or actually an eternal life span, and stable growth in the cash flow we will learn that we can value them as a growing perpetuity. This is what we normally call the 1-year calculation.
- For assets or investments that do not fulfil the characteristics of an eternal life span and/or stable growth in the cash flow, we basically need to discount each year's projected cash flow.

It's really important to know when to use which model. This chapter however, will focus mainly on risk, or the denominator in our calculations, and some tips when monitoring your calculations – the common sense check – and what to do when the market value is deviating from the Akelius value.

Risk and Location

As you will learn during this course: investors demand higher returns for higher risk. When buying properties the investor will encounter two risks in the main:

1. The Cash Flow Risk

The more the cash flow varies over time, the higher the risk. This could be illustrated by a property with just one tenant with a three year lease. When looking at this investment the investor can only guess whether the current tenant will stay or if he/she will terminate her lease after three years. If she terminates, the investor can only speculate how long it will take him to find a new tenant, hence, how long he/she will have to pay operational costs, maintenance out of his/her own pocket. If the investor has financed a part of the property externally and is not able to pay the interest rates, the risk is that the financier will take the property and the investor will lose the equity.

2. The Value Risk

The more the value varies over time, the higher the risk. When the value falls, the investor is losing equity, and when, if externally financed, the value goes down below the value of the external financing the financier might want to have more securities to secure the financing. If the investor isn't able to hand over more securities, the financier might be able to take over the property.

The value risk is of course connected to the cash flow. All else being equal, when the cash flow decreases, the value will decrease as well. However, the value can also vary due to factors far beyond the control of the owner. When the interest rate shifts, for example, there will also be a shift in property values. The same is true when there is a shift in the property risk premiums.

So what factors determine the cash flow risk and the value risk? Location, location and location is a beloved expression in the real estate sector. And this is actually true. Probably 80 to 99 percent of a property's risk, which can be controlled before one buys a property, can be derived from the location of the property. For many other industries the location is also very important, however most of them can move their business elsewhere when things are running bad in one location. A property owner cannot.

The MACRO Location

The first thing most property investors look at is probably the country the property is situated in. Take Akelius as an example. Akelius currently makes direct investments in properties in Sweden and Germany only. Both locations offer: low political risk (it is hard to imagine governmental expropriation); have functional financial markets; a liquid transaction market (it's possible to buy and hence sell properties); and a legal environment ensuring property owners a high level of security. Furthermore, both countries have historically shown economical growth and growth in rental levels. Hence, both countries must be characterized as low risk countries and thus offer a low risk premium on properties.

The Macro Location

When Akelius is looking at properties in Germany, for example, we have very carefully chosen the cities or the regions we have invested in. Even if the country presents very low risk, different regions or cities within a country represent different risk levels. The demographic development, the industrial structure, the labour market and the transaction market are important risk indicators in a region or a city. When the population is declining, the industrial structure is obsolete and not producing new jobs it will be hard finding tenants for the properties located in that region or city. Hence, there will, or at least should be a difference in risk premiums in different regions or cities within a country.

The Micro Location

Breaking a region or a city down even further, there are varying locations within a region/city. You have the bumper areas in the suburbs which are the first locations experiencing vacancy when population is decreasing and the last experiencing low vacancies when population is increasing. And you have the stable inner city locations which always have low vacancy. An area's demand within a city normally does depend on architecture, infrastructure, rumour, etc. Hence, even within a city there will be, or should be different risk premiums depending on the location.

Since the location is the dominant risk factor for properties, there has to be a significant difference in the risk premiums being offered. If not, we should not buy the property offering a too low a risk premium.

Other Factors to be Considered

If the location decides 80 to 99 percent of the property risk, there are still some factors left. Let us look at three of them briefly:

- The product
  Is the property attractive when comparing with current standards? Does the property have attractive layouts? Changing layouts of apartments can be very expensive.
- Contaminated soil
  Make sure that the property is not on top of a pile of toxic waste.
- Building permit

Make sure that there is a building permit. It could be very unpleasant to be responsible for someone’s death through fire, or be forced to tear down a part of the building, losing rental income.

The above-mentioned factors are just a few factors to be considered when calculating a property's value, or setting the risk premium.

The common sense check

Probably one of the most important and one of the most forgotten steps in a valuation is the common sense check. Does the calculation make sense? Are the assumptions realistic? Some of the most important common sense checks you should do are:

- Market rent – compared with our properties in the same area, check out the web. Is your assumption realistic?
- Fluctuation – is sometimes desirable when the market rent is higher then the current rent in the property. But it is also associated with costs. Make sure it is realistic.
- Vacancy – is 0.5 percent realistic when all other properties in the neighbourhood have 3 percent?
- Rental growth – is a rental growth of 5 percent realistic, when the expected inflation rate is 2 percent?
- Maintenance – does your calculation cover the costs, are they too high?
- Risk premium – is it reasonable with a discount rate of 6 percent, when the interest rates are 6 percent? You might want to have a risk premium…
- Square meter price – is the resulting square meter price reasonable compared with other transactions and with the prices for condominiums?

Remember that we want to do realistic calculations. If we are too pessimistic, we will not be able to buy any properties and we will lose good deal-making opportunities. If we are too optimistic, we will buy properties that are too expensive and will have problems with our profitability.

Market Value vs. Akelius Value

Sometimes there will be a difference between the market value of properties and the value we are willing to pay. The reason is, of course, that we are making other assumptions about the future regarding cash flow and/or other assumptions regarding the discount rate. In these situations it is important to stay cool as then, good possibilities for earning money will turn up – ie, paying more than the market value when the market value is lower than the Akelius value. And not buying or selling properties when the market value is higher than the Akelius value.