Valuation of commercial property in turbulent times

Valuations in Ireland's currently frozen commercial property market are problematic, and much clearly depends on them. Frank O'Neill describes the current situation regarding valuations in both investment property and in development land - the two areas of greatest importance to the banking system currently.

We are in turbulent times. The issue of the valuation of property assets is in sharp focus, however, in turbulent times valuation is difficult - a moving target is hard to hit. The stark reality is however commercial property values have plummeted. In this article I do not attempt to estimate with any precision how values have changed by but to explain some of the factors and interrelationships that create value volatility.

There are two broad categories of commercial property; one is investment property and the other is development land. The distinction between the two is self-evident. Investment property is the finished product whether brand new or second hand. Development land is the land upon which the future property can be constructed. Development land consists of brownfield, redevelopment and greenfield sites. Significantly different valuation techniques are used by professional valuers and developers to evaluate investment property and development land assets

Investment property

Investment property values are a function of a pretty simple mathematical calculation – value is the product of the rental income the property produces and the property's 'yield'. Yield is the percentage of a property's cost (including acquisition costs) that its rental income represents. In very simple terms a rental income of €100 with a yield of say 5 per cent would result in the property being valued at €1,845. (the mathematics of this calculation being rent €100 divided by 5 multiplied by 100 = €2,000 gross valuation. This is reduced by the investor's acquisition costs of 8.43 per cent made up of stamp duty 6 per cent and 2 per cent plus irrecoverable VAT at 21.5 per cent for legal/agent fees – to do this we divide the gross value by 1.0843 = €1,845).

This formula is simple and straightforward to apply, all one needs to do therefore is to establish the rent the property generates and the appropriate yield for a property of this nature. The simplicity of the calculation however belies the inherent complexity of property valuations and the skill of valuers.

The yield that a professional valuer applies to value a particular property should reflect all of the specific factors affecting a particular property. There are a myriad of such factors including the condition of the building, the desirability of the location, the financial strength of the tenant, etc., etc., etc. I do not propose to consider these specific issues.

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> *Frank O'Neill, W.K. Nowlan & Associates*

The incredible growth in property value in Ireland over the last decade has been driven to a large extent by decreases in yields this phenomenon is known as yield compression. The decreases in yields have come about primarily as a consequence of the easy availability and relative cheapness of finance to investors to acquire properties, anticipation of rental growth in a booming economy, the voracious appetite of investors for investment property and the relative shortage of product.

The rental shift across the primary property investment sectors of office, retail and industrial has been dramatic. It is the view of my colleague, Bill Nowlan, a long time operator in the property world that the historic 'norms' for these sectors are in the region of 6 per cent for offices, 5 per cent retail, and 9 per cent for industrial. According to figures produced by Jones Lang LaSalle the peak prime initial yields on the sectors in late 2006/2007 were of the order of 3.75 per cent for offices, 2.5 per cent for retail, and 4.75 per cent for industrial. Whilst the JLL figures are not generic sectoral yields they are a good benchmark for the purpose of my illustration of the potential impact of upward yield shifts on value.

In the Table 1 below I set out how the movement in yields from the peak of the market to Bill's historic norm would have on the valuation of €100 of income for each of the principal property market sectors. (I have also shown the impact of Brian Lenihan's recent budgetary decisions to reduce the stamp duty on commercial property transactions from 9 per cent to 6 per cent and increase VAT from 21 per cent to 21.5 per cent)

As you can see, the value implications are staggering with a decrease in values of circa 37 per cent, 50 per cent and 47 per cent for the office, retail and industrial sectors respectively. These decreases have been somewhat offset by the above-mentioned decrease in stamp duty which result in increases of circa 2.7 per cent and 2.8 per cent on the reduced values.

The reality is however that in the current frozen market there is a dearth of transactions on which valuers depend for an informed opinion in relation to the yields in the market. It is however the case that the above-mentioned factors which drove yield compression (easy available and cheap finance, anticipation of rental growth, investor demand and shortage of product) are no longer features of the marketplace indeed the direct converse apply and are now working in reverse.

The correction in values that the confirmation of yield shift back to historic norms would entail would present a serious problem for both investors and the funding banks.

Development land

Development land is evaluated in a completely different way to investment property. The methodology used by rational developers in assessing development land coming on the market is called residual valuation.

In essence the residual valuation technique involves the calculation of the

value of finished development that the land will, or is expected to, accommodate from which all of the costs of development, including the provision for a developer's margin are deducted. This calculation generates the residual value i.e. the amount that a developer is prepared to pay.

Clearly there is considerable amount of market knowledge and judgement required to assess the amount of development that a site can accommodate and the likely value of that finished development. Issues such as sales values for residential units and investment values/sales values for commercial units require careful consideration. In addition issues of planning constraints, geo-technical conditions, construction complexity, specification, local authority levies etc., all need to be taken into account. It is not my intention in this article to go into any of the latter matters. I will by using by a simple example attempt to illustrate the non-linear relationship between development values of the finished product and the residual valuation of development land.

Set out below in Table 2 is a simple example showing the inordinate impact on the value of land that a decrease in the value of the finished development can have. For this example I have used actual market information on the value 3-bedroom semi-detached houses on a specific estate in a North Dublin suburban development just outside the M50. Our market information reveals that houses in this estate have fallen from €425,000 to €350,000 – an 18 per cent fall- since the peak of the market in mid 2006.

In the residual valuation I have provided for building costs and other development costs. I have assumed that building costs have decreased by some 7 per cent. As you can see I conclude that an 18 per cent decrease in the sales price of the house would result in a 54 per cent decrease (from €59,000 to €27,000) of a site's residual value. Bearing in mind that the later figure does not take attempt to quantify the significant issues of the increased cost of funding –if funding is available at all- and the higher margin a developer would seek in more difficult market, our estimated decrease is, if anything, on the conservative side.

Again, like the investment property valuation it was this process (residential sales values falling) in reverse that fuelled the inordinate increases in development land over the last ten years.

TABLE 1: Valuation of €100 of Rental Income

		Office	*Retail*	*Industrial*
Market Peak Yields (Acquisition Costs 11.42%)	Yield	3.75 %	2.50 %	4.75 %
	Value	€2,393	€3,590	€1,889
Historic Norm Yields (Pre Budget Acquisition Costs 11.42 %)	Yield	6.0 %	5.0 %	9.0 %
	Value	€1,496	€1,795	€997
Decrease		**-37 %**	**-50 %**	**-47 %**
Historic Norm Yields (Post Budget Acquisition Costs 8. 43%)	Yield	6.0 %	5.0 %	9.0 %
	Value	€1,537	€1,845	€1,025
Increase		**2.7 %**	**2.8 %**	**2.8 %**

TABLE 2: Residual Valuation of a Site for Residential Unit

	Peak of Market *€'000*	*Now* *€'000*
House Sales Value Incl. VAT	425	350
House Sales Value Excl. VAT	374	308
Decrease in Value		**-18 %**
Development Costs		
Construction Costs	175	163
Other Development Costs	50	50
Acquisition & Sales Costs	13	7
Financing	24	19
Developer's Margin	53	42
Total (000s)	315	281
Residual Value of Site	€59	€27
Decrease in Value		**-54 %**

The real winners in the development land world have been the seasoned developers who acquired land on the periphery of the city at values which represented a modest premium over agricultural values and who have enjoyed the benefit both rocketing residential unit values and a transformed planning environment where higher number of units were allowed per acre. These developers have realised enormous fortunes. The losers have been the late developers who acquired development land on the assumption of residential sales values that were far in excess of the market prices today. Indeed during the feeding frenzy of the Celtic Tiger years not only were residual valuations being done based on the basis of significantly increased residential sales values but on the assumption that such increases would continue over the development phase of the project. Anecdotally we are aware of situations in parts of Dublin where a rational residual analysis would now result in a nil residual values for development land – i.e. development is no longer viable and developers who have started, if they can sell, will realise significant losses.

The negative value volatility in commercial property is a fact in turbulent times. Highly geared investors and illiquid developers are now presented with serious issues in regard to their ability as borrowers to honour banking covenants and to service and repay their loans. Banks are facing serious issues as the counterparties to the borrowers. Some of the issues of technical covenant default are just that and are not yet hitting cash-flow. However, in other situations default is real - where loan facilities have expired and the borrower does not have the wherewithal to repay, where borrowers cannot make scheduled repayments or where loans are non-performing, in all situations, technical or otherwise, banks need to consider, assess and quantify their exposure.

Banks also face fast approaching issues relating to their prudential and statutory financial reporting – auditors and valuers can expect to share the stress, distress, heartache and soul searching that valuation corrections shall inflict on bankers.

Frank O'Neill FSCS FRICS FCA is a director of W.K. Nowlan & Associates.