Property Valuation

in an economic context

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Preface

There is no denying it, this was a difficult book to write; satisfying and ultimately very rewarding but difficult nevertheless. The difficulty stems from defining the roots of valuation: conventionally regarded as a professional discipline it is only in recent years that valuation has undergone serious academic scrutiny and an attempt made to place it in an academic setting. The outcome of this scrutiny is a move away from valuation being taught as a branch of surveying and a move towards it being regarded as applied economics in a business finance context. The challenge does not stop there though, academically valuation might be regarded as applied economics but practically it requires the practitioner to call upon other disciplines, particularly law (including the ownership and use rights of property), finance and land economics, geography (including the physical attributes of land and human activities that take place on it) and management. These are enormous subjects in their own right and therefore this book navigates around them by not getting into the detail of case law, statutes and organisational behaviour. Also, I have not ventured far into the world of investment asset appraisal and portfolio analysis. There are already several excellent text books covering these topics and the reader is referred to them in the relevant places.

This book focuses on the valuation of commercial and industrial property (collectively referred to as business property) across three interlinked market sectors; namely the markets for investment, development and occupation. Chapter 1 places the property market and its various sectors in an economic context. Chapters 2 and 3 identify the basic principles of valuation, introducing the process and a broad range of methods. Chapters 4, 5 and 6 are concerned with the application of valuation techniques to the development, occupation and investment sectors of the market for business property. These three market sectors are interrelated and their analysis forms the backbone of the text. But it should be remembered that there is no one-to-one match between market participants and the sector in which they might operate. Ball *et al.* (1998) define three types of market participants, namely, users, developers and investors, and three types of relationship to property, namely, tenants, developers and owners, but users may own or rent, investors may

own, develop, and so on. This book considers valuation from the standpoint of market participants because they are responsible for commissioning valuations. Although the focus is market valuation rather than worth appraisal, Chapter 7 considers how property valuation fits into an appraisal context. The chapter does no more than introduce appraisal concepts and methods and provides a springboard to more comprehensive texts already published on this subject matter. In covering this ground, the book attempts to combine the academic and practical roots of valuation. The various disciplines mean that terminology is a problem and so all the key terms emboldened in the text are defined in the glossary at the back of the book.

The primary dictionary definition of the term *property* is used in this book, namely the ownership of landed or real estate. The term property is, however, used interchangeably to describe the physical entity itself and the ownership of a legal interest in a piece of landed or real estate. The word property is also used to describe property in a singular and plural sense. Many of the calculations in the book were performed using a spreadsheet but appear as rounded figures so there may be some differences.

Reference

Ball, M., Lizieri, C. and MacGregor, B. (1998) *The Economics of Commercial Property Markets*, Routledge, London,UK.

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Chapter 1
The Economics of Property Value

1.1 Introduction

The legal ownership of land and buildings, collectively referred to as **property** throughout this book, confers legal rights on the owner that enable it to be developed, occupied or leased. The physical occupation of property is essential for social and economic activities including shelter, manufacture, commerce, recreation and movement. Typically, physical property ownership is not desired in its own right, although prestigious or landmark buildings can generate what Baum and Crosby (1995) refer to as 'psychic income'. Rather, demand for property is a derived demand; occupiers require property as a factor of production to help deliver the social and economic activities that take place within its fabric and investors require property as an investment asset. This concept of derived demand has a direct bearing on its valuation, as we shall see later.

This book is all about valuing *individual* properties or premises (units of occupation) within properties that are used for business purposes – what will often be referred to throughout this book as commercial property. Yet it is interesting at this early stage to consider the total value of *all* commercial property in the country. The Office for National Statistics publishes annual estimates of the net worth of various categories of assets, including business property. Table 1.1 shows the estimates of net worth of commercial, industrial and other non-domestic property between 1997 and 2005. So at the end of 2005 the total net worth of commercial property was estimated to be approximately £626 billion. By way of comparison, the UK National Accounts estimate that households occupy £3355.8 billion worth of residential property (not including housing association properties), a figure more than five times the size. Nevertheless, a huge amount of money is tied up in commercial property in the UK. The Investment Property Forum (IPF) estimated that around 80% is occupied by the core commercial land uses – retail, office and industrial space (IPF, 2005) – and that approximately half of the stock is owner-occupied, chiefly by private companies but also by

Table 1.1 National balance sheet asset totals for commercial, industrial and other buildings.

Year	Net worth (£ billion at end year)
1997	492.8
1998	477.4
1999	509.3
2000	599.7
2001	562.7
2002	588.4
2003	591.9
2004	626.0
2005	625.9

Source: UK National Accounts: *The Blue Book* (2006).

public and quasi-public bodies. The remaining half is owned by investors. It is argued that the proportion of owner-occupied commercial stock is falling as freehold interests in property are sold, and the properties are leased back by business occupiers as a means of releasing money that is tied up in the value of these properties and as a way of focusing investment in the core business activity (IPF, 2005).

The value of commercial property as estimated by the IPF was calculated by capitalising the assessments of rental value that the government assigns to individual commercial premises every 5 years for tax purposes. It is individual valuations of each commercial property like these that interest us most in this book and that is why we start with a look at microeconomics. The interaction between the supply of and demand for property generates exchange prices, and valuation is concerned with the estimation of those prices. Value is thus an economic concept and valuers are primarily concerned with how the market and sectors of the market measure value. This chapter will begin by explaining the microeconomic concepts that are relevant to property markets and estimates of exchange price therein. It will introduce microeconomic terms and concepts associated with the supply and demand of land and buildings, the concept of rent as a payment for the use of land and buildings, and some land use theory. The second part of the chapter will consider macroeconomic concepts, including the commercial property market and its constituent sectors; namely development, occupation and investment. In the case of investment a brief look at other major asset classes is included. The chapter ends with a look at macroeconomic property market cycles.

1.2 Microeconomic concepts

Economics is conventionally divided into two types of analysis: microeconomics and macroeconomics. **Microeconomics** studies how individuals and