Valuations

Formal property valuation techniques are regularly used to arrive at an estimate of the price at which a building might be sold. This capital value is known as Market Value which term has a precise definition in international valuation standards. It is effectively a substitute for the price and should be thought of as the contract price i.e. the amount the buyer would pay the seller.

Valuation calculations can also be used to provide an assessment of the property's value, usually called Worth. In market terms, an investor will buy a property if its Worth is considered to exceed its Market Value and will sell if the property's Market Value exceeds that of its Worth.

The view of the buildings Worth to an investor almost always differs from its Market Value because of variables like different income requirements, expectations, attitudes to risk, tax status etc. It is these differences that create a market in which investments are bought and sold.

The RICS (Royal Institution of Chartered Surveyors) lays down rules on how the valuation process should be conducted in terms of definitions, instructions, reporting etc. These are contained in the RICS Valuation Standards, commonly known as The Red Book.

In arriving at an estimate of Market Value, the valuer must copy the methodology used by the investors operating in the relevant market to negotiate a market price. This means that valuation methodology is determined as much by convention as by rigorous mathematical logic. These methods may be explicit or implicit.

The value of an asset is based on the present value of future expected cash flows. An investment valuation method could therefore seek to identify the expected cash flows and discount them at a target rate of return. An investment valuation method that identifies expected cash flows and discounts them at a in this way is known as an 'explicit valuation method'.

However, if the objective is to estimate Market Value and there is comparable market evidence of investment prices, a simpler comparison method can be adopted. Based on market evidence of lettings and investment sales of similar properties, the valuer says: "This property could be let today for £x pa and market evidence suggests that investors buy investments of this type for Y times the annual market rent."

For properties let at less than their market rent, valuers take the investment multiplier (Y) and use its reciprocal – the initial investment yield or 'capitalisation rate' – as a discount rate to compute the present value of the contractual income up to the next review, and the reversion to market rental value thereafter.

A method that uses a capitalisation rate and current market rent in this way is known as an 'implicit valuation method'.

The RICS (Royal Institution of Chartered Surveyors) has a Valuation Professional Group which promotes best practice, regulation and consumer protection to business and the public in both real estate valuation and business valuation. www.rics.org/valuation