INVESTMENT PRO

Commercial property valuation and the concept of rental yield

The process of valuation of any asset class is perhaps one of the most debatable concepts in finance. While valuation is certainly an individual's or company's subjective assessment of different factors, it must reflect a 'true and fair' value of an asset and not a figure presented in the sole interest of the client.

This is relevant to the property sector in Mauritius where there are clear signs of divergence of values between different valuation methods. We attribute that to (1) a misunderstanding of the valuation process and the risks attached to the model and (2) a problem of asymmetry of information in the market.

Current practices have resulted in overvalued properties in many sub sectors like apartments, bungalows and commercial centres and have fuelled the appetite of speculators. Today, many investors find themselves trapped in illiquid sectors where either the value of their investment has eroded in real terms or where returns have remained low when taking into account the opportunity cost of holding such investments.

Banks have also been victims of the current practices. Significant amounts of loans have been allocated with property being given as collateral. In many cases where clients have defaulted, banks have not been able to recoup the total principal loaned either because the buildings were overvalued or because the lack of liquidity in the market forced the banks to sell at big discounts. In sum, current practices have certainly not optimised the country's allocation of scarce resources.

In a country that lacks a proper supervisory body for valuers, we wish to provide some helpful tips in order for investors to make a wise investment decision when considering a valued property/building.

The most commonly used methods for valuing property assets are:

The investment method

- This method is based on a discounted cash flow method and takes into account the future cash flows that the property can bring to the investor.

- This is typically more prudent and least subjective of all and gives a fairer view of the realisable value of the property.

The comparative method

- Where the valuer uses comparative values from latest sales figures in the market and derives capital values for sites and rental yield.

The contractor's method

● Basically a cost-based approach, which is generally used in rating all compulsory purchases

The residual methods.

● Mainly used in development projects where the developer sells most of the property

The above methods are compliant with the guidelines prescribed by Royal Institute of Chartered Surveyors (RICS), guidelines that are currently being used in Mauritius by property valuers. The guidelines also set the basis on which valuers should base their assumptions, and this reduces significantly the amount of subjectivity in the valuation process. In a liquid and active market and when the economy is booming, the different valuation methods should more or less give the same values. However, in markets where some investors have excess liquidity, where there is widespread asymmetry of information and no proper supervision of the valuation process, these methods would give different values and may result in "mispricing".

In this article, we promote the investment method based on a discounted model as the safest method to measure the value of your property asset or asset you intend to buy. This method goes back to the most fundamental concept in finance in that the value of an asset is the present value of future cash flows. In the case of a building, an investor will receive regular rental income and at the end of the investment period, will receive sales proceeds on disposal of the building.

The first step is to estimate the amount of rental income that the property will earn over the investment period. The rental yield will provide a measure of the income as a proportion of the value of the asset. It gives a quick indication of the return on the asset. It is a simple mathematical calculation which helps compare the returns on properties with other asset classes. An example to calculate rental yield is as follows:

(A)Yearly rental : Rs 1 000 000

(B)Value of building : Rs 10 000 000

(C)Rental yield =

(A/B) x 100 = 10%

The rental income will typically increase during the years when the property will be rented. In general, the annual increase is linked to a predetermined rate as set in the lease agreement or linked to an inflation index such as the consumer price index. At the end of the investment period, the investor will also be left with a residual value, which is the value at which the investor expects to sell the property.

The next step then involves the discounting of the value of the cash receipts as at today i.e. equivalent in today's money. This involves discounting the cash receipts using the required rate of return of the investor. This rate compensates the investor for the level of risk that he or she takes in holding the asset, the opportunity cost of holding the asset i.e. for the time value of money and for the effect of inflation. Broadly speaking, the after tax yield on a risk free long term Government of Mauritius bond compensates for the last two effects and the required rate of return can be calculated by using such a yield plus an adjustment or premium for risk. In any case, an investor should require a rental yield that is higher than the long term bond yield.

Typically we would be looking at a required rate of return of: 9.74% (after tax 7 year bond yield) + 2.92% (30% premium on a risk free bond) = 12.66%

The investment value of the property will be given by the total of all the discounted cash flows.

Going a step further, it would be good to try to breakdown this required rate of return and link it to the rental yield. On average, market figures show that property values have grown by 4.5 - 5% per annum. This is equivalent to a capital gain of 4.5 - 5% per annum. This leaves us with an expected yield of around 7.5 - 8% for the income component of the property. Hence, for an average property asset, an investor should be looking at a minimum rental yield of 7%!

If one were to analyse many commercial properties in Mauritius, one would find many cases where rental yields are substantially lower than the long term bond yield and much lower than the 7% figure mentioned above. This implies that either the rentals paid are too low or that the properties are overvalued. Given current economic activity and the level of rental rates on some newly developed properties, it is more likely that in many cases properties are overvalued. This means that current investors are not getting what they should get from their investment.

To summarise, our message is

To the authorities:

● Local authorities should finalise all the issues concerning the cadastral survey.

● Based on current data, rates must be assigned to the different locations and regular adjustments must be made based on the evolution of market price.

●l A steering committee must be set up to look after the standards of asset valuations so as to make sure that there are certain guidelines that are respected while the valuations are made.

● The CSO must publish on a regular basis, information about the market prices of properties that have been traded.

● The CSO or valuation office must consider the setting up of a Property Index for the commercial sector.

To the investor:

● You should determine the required rate of return you need on your property asset.

● If you wish to buy a property as an investment, make sure that you will be able to realise the return calculated above.

● The investment valuation method will give you a reference for the maximum price you can pay for the property.

● Do not buy into properties where rental yields are lower than what a long term bond will give you, buy the bond instead!

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