Introduction

The purpose of this report is to present a valuation of the property known as 4 Nelson Terrace Stockton On Tees TS18 1NJ which is to be purchased for investment purposes. It will consider different approaches to valuation, to determine which is the most appropriate for this property, taking account of the capital and rental values potentially receivable, and will also advise as to the appropriateness of the asking price. The environmental context will also be examined to assess the possible influences on the property's price and investment potential, both positive and negative. A brief conclusion of the property assessment is followed by a recommendation as to whether the property should be purchased or not, and the terms on which it should be purchased, if this is relevant. Detailed valuations can be found in the appendices to the report.

The Property: 4 Nelson Terrace TS18 1NJ

4 Nelson Terrace TS18 1NJ (hereafter the property) is located along the A139 at the junction with Dovecot Street (see map next page) and is part of a parade of shops and commercial properties. It is assumed to be in reasonable condition, structurally sound and only in need of cosmetic changes such as redecoration. It is available as a freehold purchase with incumbent tenants: the Citizens' Advice Bureau purchased a five-year lease which commenced in August 2008, thus has less than a year to run. The annual rental paid was £10,000. The asking price for the property is £85,000. For comparison purposes, Mouseprice (2012) estimate the property to be worth £96,300, with the value range being £79,000 to £114,000, while Zoopla (2012) estimate the value at £78,917, with a range between £75,395 – £82,439. They also

indicate that Nelson Terrace comprises 12 properties with an average value of £82,936.
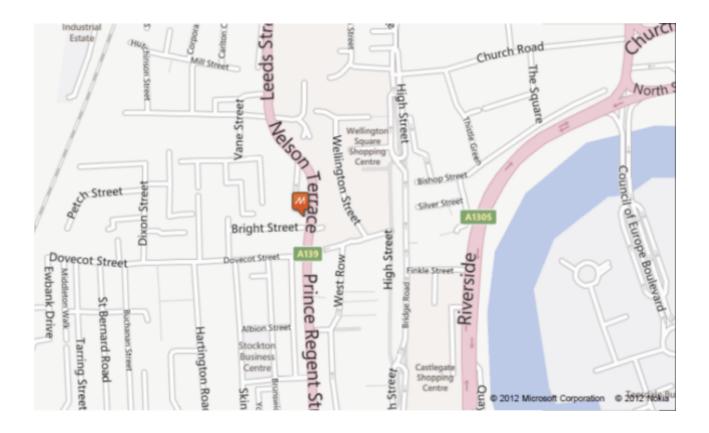

Figure One: Map of Property Location

(www.mouseprice.com)

Current rental income per month is £830 (£10,000 ÷ 12). Mouseprice (2012) estimate rental income at £361 per calendar month (pcm), with a range of £200 - £400, while Zoopla (2012) suggest that rental income would fall within a range of £495 - £562 pcm, with an expected £529 pcm. This information is summarised below in table one.

Source	Mouseprice	Zoopia
Purchase Price Estimate	£ 96,300	£ 78,917
Purchase Price Range	£ 79,000 – £ 114,000	£ 75,395 – £ 82,439
Actual Purchase Price	£ 85,000	
Comparison/Comments	Purchase price appears cheap, being £11,300 less than the primary estimate and at the lower end of the range. Why is the price so low by comparison? What might this apparent under-valuation hide?	Purchase price appears expensive compared to these estimates, being approximately £6k more than the primary estimate and approximately £2.5k higher than the top end of the range. Are there any problems that have not been advised? What might be causing this apparent over-valuation?
Rental Income Estimate	£ 361 pcm	£ 529 pcm
Rental Income Range	£ 200 – £ 400 pcm	£ 495 – £ 562 pcm
Actual Rental Income	£830 pcm	
Comparison/Comments	Both comparators are extremely low, being either just below or just above half of the current rental income. This substantial drop is likely to reflect the significant changes that have occurred between the time the lease was granted (August 2008) and now. It is also possible that the drop reflects the changing environment in this part of Stockton-On-Tees: there is a retail park very close to the property, which could be drawing custom away from the more "high street" nature of the property.	

Table One: Purchase Price and Rental Income Comparison: Same Property

(Mouseprice 2012 and Zoopla 2012)

The current property owner purchased it in August 2006 for £90,000 (Mouseprice, 2012). The previous owner paid £65,000 in November 2004. The 2006 property value represents a 38% increase, reflecting the property boom at that time. The current asking price represents a £5,000 drop, a fall of 6%. It needs to be

determined whether this drop accurately reflects the property's value. Based on the figures in table one, a reduction in the purchase price could be negotiated, potentially reducing the cost by up to £10,000.

Figure Two: Front View of Property

(www.zoopla.co.uk)

The Nature of Investment

Before moving on to valuing the property, it is necessary to provide a brief introduction to the nature of investment and, specifically, property as an investment. An investment can be one of two things:

➢   The purchase of capital goods, such as plant and machinery in a factory in order to produce goods for future consumption. This is capital investment.

➢   The purchase of assets such as securities, works of art, bank and building society deposits, etc. with a primary view to their financial return either as income or capital gain. This is financial investment, which is usually used for saving.

(Oxford Dictionary of Finance and Banking, 2005, p.221)

It could be argued property purchase falls within both definitions, as a business might buy a property when setting up or expanding, while an individual might purchase a buy-to-let property to generating income and capital gains in the longer term. The growth of private property investment is a recent development, occurring due to low interest rates in the last few decades (Scarrett, 2008, p.3). Prior to this, insurance companies created property portfolios to generate income for policy pay-outs (Scarrett, 2008, p.3).

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The property market is prone to crashes: there was a major market crash in the 1970s, requiring intervention by the Bank of England to restore stability to the sector (Scarrett, 2008, p.4). Since then, changes in legislation surrounding rent levels and security of tenure have created a market for buy-to-let properties, as property tends to be regarded as a sound investment and represents adequate security for buy-to-let loans (Scarrett, 2008, p.4).

There has been a significant crash in the property market recently, as a result of the financial markets' crash of 2007-2008. This demonstrated not all property is adequate debt collateral: it was granting mortgages to the US sub-prime market that caused the crash. Financial services organisations bundled such loans as Collatoral Debt Obligations (CDOs) which were originally seen as assets, however, when customers began to default on their loans, the CDOs were revealed to be liabilities (Pratley, 2008). Since then, property investment has reduced significantly, with many buy-to-let purchasers returning keys as rental income fell. It is therefore essential that a full, detailed valuation is completed when purchasing a property, whether it represents capital or financial investment.

For the purposes of this report, it is assumed that the property purchase is a financial investment being undertaken to generate income and capital gains.

Valuation

Valuing a property is necessary to ensure a fair price is paid. With this property, significant variations in both the possible purchase price and rental income have been seen (see table one), meaning the property valuation must be completed carefully to reflect both the current situation and future potential.

The property valuation must assess:

➢ The fairness of the asking price

➢ The likely future income

There are several ways to value a property like this. Scarrett (2008), for example, identifies five methods, namely, comparative, investment, residual, profits and contractors' methods. Richmond (1994) adds a further method to this list in the form of the reinstatement method. Some methods are more relevant than others. Each method is now briefly described, together whether it is appropriate in this case.

The Comparative Method

The comparative method involves comparing properties as similar as possible (Scarrett, 2008, p.67). Scarrett is very clear "a simple market-based comparison alone is insufficient" (2008, p.67), meaning the comparison effected above needs greater detail adding (although some of the weaknesses of the comparison are highlighted in the commentary for each comparison). For the comparative method, several factors are considered. Factors relevant to this valuation are: "the present and prospective incomes; the return that the market determines to be appropriate to

the particular investment; ... and the tenure of the property" (Scarrett, 2008, p.67).

One way of strengthening the previous comparison would be to compare the selling price and current rental income with another property in the same area and with as close a resemblance to this property as possible. However, there are limited comparable properties available. Two commercial properties have been located a short distance from the property considered by this report. These are as follows:

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Source	RightMove		Existing
Property Address	Dovecot Street 1	Dovecot Street 2	4 Nelson Terrace
Purchase Price Estimate	n/a	n/a	n/a
Purchase Price Range	n/a	n/a	n/a
Actual Purchase Price	£ 85,000		
Comparison/Comments	n/a	n/a	n/a
Rental Income Advertised	£ 12,000 p.a. / £ 1,000 pcm	£ 6,500 p.a. / £540 pcm	£ 10,000 p.a. / £ 830 pcm
Size	81.8 m^2 / 881 ft^2	n/a	n/a
Actual Rental Income	£830 pcm		
Comparison/Comments	Based on these comparators, rental income in the area at present covers a wide range, in this case, the annual rental of one being almost double the rental of the other, with the target property being towards the higher end of the range. This suggests that a new lease could be granted on the same terms as at present, although with the pressures being placed on businesses at present, a small decrease might be more viable.		

Table Two: Purchase Price and Rental Income Comparison: Different Properties

(RightMove, 2012)

This comparison reveals that rent charged for commercial properties can vary significantly, with the highest comparator being almost twice the lowest. However, it must be remembered this is not a like-for-like comparison, so results should be used with caution.

The Investment Method

The traditional valuation process involves a close inspection of the property concerned, together with the assembly of the property's relevant data, such as tenure and planning permissions and approvals (Scarrett, 2008, p.83). Once this information has been gathered, the valuation is calculated using either current rents and values, or discounted cash flows (DCF). The property covered by this report presents some issues relating to the calculation of such valuations:

➢ The current tenant will be gone next year, unless a renewal is agreed

➢ If there is no renewal, the rental charge becomes theoretical, unless a new tenant is found who can take possession in September 2013, which makes investment appraisal difficult, especially if a loan is used to purchase the property

➢ Identifying the best discount rate for the DCF analysis is difficult, unless a loan has been used to effect the purchase, in which case, the interest rate charged can form the basis of the calculation. Another option would be to find an investment vehicle that pays the best rate available and use this to see if the property investment is the best use of the funds (although there is still the issue as to future tenancy)

➢ The expected length of ownership is also required to provide the timescale.

Real Estate & Property Management Assignment Sample

Current rents and values have been calculated previously and these figures will be used for the valuation calculation. Other calculations will need to be based on hypothetical scenarios, to provide a range of possible outcomes (although whether providing several scenario outcomes will prove helpful in reality is unclear).

There are two DCF investment appraisal methods: internal rate of return (IRR) and net present value (NPV). The advantage of using DCF is that it takes account of the time value of money (Lumby and Jones, 2011, p.68). It makes the decision simple: if the investment generates more money than is spent, then the investment should be undertaken (Lumby and Jones, 2011, p.67). NPV is easier to use than IRR because an investment can sometimes produce more than one than one IRR, creating confusion as to which IRR is the relevant one (McLaney, 2011, p.91). In addition, some investments do not generate any IRR (McLaney, 2011, p.92). Both methods involve calculations as well as uncertainty over many of the inputs (see problems outlined above).

For the purposes of this valuation, NPV will be used and four scenarios created. Detailed information and calculations can be found in Appendix One.

The results of the different scenarios are:

Scenario	NPV (£)	Comment
1	(39,998)	Over half of original investment recovered
2	(20,471)	Around three quarters of original investment recovered
3	(34,998)	Over half of original investment recovered
4	(15,381)	Four fifths of original investment recovered

Table Three: Results of Scenario Calculations

The main decisions for the buyer revolve around whether to negotiate a lower purchase price, which enables a faster investment recovery, and what duration any future leases should have. With the current uncertain economy, it might be appropriate to negotiate a longer lease to ensure the property is occupied for as long as possible. However, if a long lease is negotiated and the tenant becomes insolvent, the purchaser will be left facing receiving no income and having no tenant in the property. Shorter leases might be better to allow what are anticipated to be better economic conditions to be taken into account after a further five years. Some newer businesses might also be happier taking on a shorter lease, although they might not be able to afford the kind of rent being sought.

The Residual Method

This approach takes account of any residual value that the asset will have after the duration of the project/lease (Scarrett, 2008, p.117). This is not applicable to the property being purchased because it is being purchased freehold. This method will therefore not be used to produce a valuation.

The Profits Principle or Method

This approach takes account of the profits that can be made by the tenant and how this allows the landlord to charge a market rate rent (Scarrett, 2008, p.139). However, the current tenant is the Citizens' Advice Bureau, who are a charity and do not make profits from their activities. This method might be appropriate if the tenant changes to a trading tenant, but at present, this method is not applicable here and shall not be used to produce a valuation.

The Contractor's Test

This test involves the professional knowledge and experience of the agent selling or letting the property to assess the price of the property being sold or let (Scarrett, 2008, p.159). This experience should be reflected in the information provided by the agent, giving the purchaser the best information possible about the property. This test has been applied throughout this report to both the comparative method and the investment method.

The Reinstatement Method

This method involves adding the property's rebuilding costs to the cost of the land on which it stands to arrive at the property value (Richmond, 1994, p.153). As the property will be insured against events that require the property to be rebuilt, it is not appropriate to undertake such a valuation here.

Conclusion

This report has provided details of the property known as 4 Nelson Terrace TS18 1NJ as the basis for valuing the property for purchase purposes. Comparisons have been effected with information relating to the property itself and with comparable properties to help determine whether the price being asked is fair. A brief overview of investment was provided to provide the context for the rise in buy-to-let activity before the financial crash of 2007-2008, when lenders became far more cautious about lending for buy-to-let purposes following many cases where tenants could not be found to pay the required rent to repay the loan secured on the property. From this it was established that the basis for the property purchase was as a financial investment.

The remainder of the report considered the valuation of the property based on six methods, namely, the comparative method, the investment method, the residual approach, the profits principle or method, the contractor's test and the reinstatement method. After reviewing each method, it became clear that the comparative and investment methods were appropriate for this valuation. Comparisons with nearby properties were effected, and four scenarios used to generate the net present value of the property.

Recommendation

This report recommends the prospective purchaser negotiate a £5,000 discount on the purchase price, based on depressed property values in the area and the average value of commercial properties in Nelson Terrace itself (£82,936 – see page) while making efforts to negotiate a five-year extension to the current lease held by Citizen's Advice Bureau, ideally at the same price as the current lease, or potentially reducing the annual lease by £1,000 at most. Negotiating a further five year lease should allow the freeholder to take advantage of the projected improved economy in 2018, facilitating a faster repayment of the initial capital investment and allowing a profit to be made as early as possible.

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Appendix One: NPV Calculations

Net Present Value

This approach is based on the assumption that if an investment generates more money than it costs, it is worth doing (Lumby and Jones, 2011, p.67). It takes into account the time cost of money, and can be used to assess multiple projects and dependent projects.. NPV can be calculated using discount tables or a mathematical formula based on the compound interest formula:

$$\text{NPV} = \sum_{t=0}^{n} \frac{A_t}{(1 + r)^t}$$

where

A = The project's cash flow

t = Time

r = Annual rate of discount

n = The end of the project's life

(Lumby and Jones, 2011, p.71)

The best business savings rate currently available is 2.75% (MoneySupermarket, 2012), while the best buy-to-let loan has a variable rate of 4.5% (MoneyFacts, 2012). Allowing for costs and potential delays in finding a new tenant next year, a discount rate of 6% will be used for these calculations.

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Scenario One: Price paid for property is £85,000. Current tenant negotiates a further five-year lease at an annual cost of £9,000, representing the half-way point between the two comparator rental properties. Calculated for the six years of the leases.

Year	Cash Flow	x	Discounting Factor	=			=	Present Value Cash Flow[2]
0	- 85,000	x	$(1 + 0.06)^{0}$	=	- 85,000	x 1	=	- 85,000
1	+ 9,800[1]	x	$(1 + 0.06)^{-1}$	=	+ 9,800	x 0.9434	=	+ 9,245
2	+ 9,000	x	$(1 + 0.06)^{-2}$	=	+ 9,000	x 0.8900	=	+ 8,010
3	+ 9,000	x	$(1 + 0.06)^{-3}$	=	+ 9,000	x 0.8386	=	+ 7,547
4	+ 9,000	x	$(1 + 0.06)^{-4}$	=	+ 9,000	x 0.7921	=	+ 7,129
5	+ 9,000	x	$(1 + 0.06)^{-5}$	=	+ 9,000	x 0.7473	=	+ 6,726
6	+ 9,000	x	$(1 + 0.06)^{-6}$	=	+ 9,000	x 0.7050	=	+ 6,345
						NPV	=	(39,998)

Note 1:   calculated as 10 months at £830 + 2 months at £750 =   £ 9,800

Note 2:   calculated to nearest pound

Real Estate & Property Management Assignment Sample

<u>Scenario Two:</u> Price paid for property is £85,000. Current tenant negotiates a further ten-year lease at an annual cost of £8,000, representing the half-way point between the two comparator rental properties, discounted for the extended length of the lease (provision of income for longer period). Discount rate still 6%, calculation for whole of eleven years covered by leases.

Year	Cash Flow	x	Discounting Factor	=				=	Present Value Cash Flow[2]
0	- 85,000	x	$(1 + 0.06)^{0}$	=	- 85,000	x	1	=	- 85,000
1	+ 9,620[1]	x	$(1 + 0.06)^{-1}$	=	+ 9,620	x	0.9434	=	+ 9,076
2	+ 8,000	x	$(1 + 0.06)^{-2}$	=	+ 8,000	x	0.8900	=	+ 7,120
3	+ 8,000	x	$(1 + 0.06)^{-3}$	=	+ 8,000	x	0.8386	=	+ 6,709
4	+ 8,000	x	$(1 + 0.06)^{-4}$	=	+ 8,000	x	0.7921	=	+ 6,337
5	+ 8,000	x	$(1 + 0.06)^{-5}$	=	+ 8,000	x	0.7473	=	+ 5,978
6	+ 8,000	x	$(1 + 0.06)^{-6}$	=	+ 8,000	x	0.7050	=	+ 5,640
7	+ 8,000	x	$(1 + 0.06)^{-7}$	=	+ 8,000	x	0.6651	=	+ 5,321
8	+ 8,000	x	$(1 + 0.06)^{-8}$	=	+ 8,000	x	0.6274	=	+ 5,019
9	+ 8,000	x	$(1 + 0.06)^{-9}$	=	+ 8,000	x	0.5919	=	+ 4,735
10	+ 8,000	x	$(1 + 0.06)^{-10}$	=	+ 8,000	x	0.5584	=	+ 4,470
11	+ 8,000	x	$(1 + 0.06)^{-11}$	=	+ 8,000	x	0.5268	=	+ 4,214
						NPV		=	(£ 20,471)

Note 1:   calculated as 10 months at £830 + 2 months at £660 =   £ 9,620

Note 2:   calculated to nearest pound

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<u>Scenario Three:</u> Price paid for property is £80,000. Current tenant negotiates a further five-year lease at an annual cost of £9,000, representing the half-way point between the two comparator rental properties. Calculated for the six years of the leases.

Year	Cash Flow	x	Discounting Factor	=			=	Present Value Cash Flow[2]
0	- 80,000	x	$(1 + 0.06)^{0}$	=	- 80,000	x 1	=	- 80,000
1	+ 9,800[1]	x	$(1 + 0.06)^{-1}$	=	+ 9,800	x 0.9434	=	+ 9,245
2	+ 9,000	x	$(1 + 0.06)^{-2}$	=	+ 9,000	x 0.8900	=	+ 8,010
3	+ 9,000	x	$(1 + 0.06)^{-3}$	=	+ 9,000	x 0.8386	=	+ 7,547
4	+ 9,000	x	$(1 + 0.06)^{-4}$	=	+ 9,000	x 0.7921	=	+ 7,129
5	+ 9,000	x	$(1 + 0.06)^{-5}$	=	+ 9,000	x 0.7473	=	+ 6,726
6	+ 9,000	x	$(1 + 0.06)^{-6}$	=	+ 9,000	x 0.7050	=	+ 6,345
						NPV	=	(£ 34,998)

Note 1:   calculated as 10 months at £830 + 2 months at £750 =   £ 9,800

Note 2:   calculated to nearest pound

Real Estate & Property Management Assignment Sample

<u>Scenario Four:</u> Price paid for property is £80,000. Current tenant negotiates a further ten-year lease at an annual cost of £8,000, representing the half-way point between the two comparator rental properties, discounted for the extended length of the lease (provision of income for longer period). Discount rate still 6%, calculation for whole of eleven years covered by leases.

Year	Cash Flow	x	Discounting Factor	=				=	Present Value Cash Flow[2]
0	- 80,000	x	$(1 + 0.06)^{0}$	=	- 80,000	x	1	=	- 80,000
1	+ 9,620[1]	x	$(1 + 0.06)^{-1}$	=	+ 9,620	x	0.9434	=	+ 9,076
2	+ 8,000	x	$(1 + 0.06)^{-2}$	=	+ 8,000	x	0.8900	=	+ 7,120
3	+ 8,000	x	$(1 + 0.06)^{-3}$	=	+ 8,000	x	0.8386	=	+ 6,709
4	+ 8,000	x	$(1 + 0.06)^{-4}$	=	+ 8,000	x	0.7921	=	+ 6,337
5	+ 8,000	x	$(1 + 0.06)^{-5}$	=	+ 8,000	x	0.7473	=	+ 5,978
6	+ 8,000	x	$(1 + 0.06)^{-6}$	=	+ 8,000	x	0.7050	=	+ 5,640
7	+ 8,000	x	$(1 + 0.06)^{-7}$	=	+ 8,000	x	0.6651	=	+ 5,321
8	+ 8,000	x	$(1 + 0.06)^{-8}$	=	+ 8,000	x	0.6274	=	+ 5,019
9	+ 8,000	x	$(1 + 0.06)^{-9}$	=	+ 8,000	x	0.5919	=	+ 4,735
10	+ 8,000	x	$(1 + 0.06)^{-10}$	=	+ 8,000	x	0.5584	=	+ 4,470
11	+ 8,000	x	$(1 + 0.06)^{-11}$	=	+ 8,000	x	0.5268	=	+ 4,214
						NPV		=	(£ 15,381)

Note 1:   calculated as 10 months at £830 + 2 months at £660 =   £ 9,620

Note 2:   calculated to nearest pound