Guest Column: George Salden

German property market: If you want profit, you need to value right - Part I

Whether it starts with a highly complex collection of data or a "gut feeling" – every property investment begins with a valuation of the investment property. Yes, the "gut feeling" can sometimes be right. But I am sure that only a robust breakdown of the opportunities and risks presented by an investment allows a sustainable ranking of investments. I have been applying the methods proposed by the legislator myself for some time and also those preferred by the English-speaking property industry. To cut a long story short: none of them convinced me, because they all only reflected some aspects of the reality of the market.

Why is that the case? There are two reasons for this. On the one hand, they recognise that cash flow does not come out of nowhere, it relies on tenants. A secure cash-flow is not automatically bundled with the purchase of a property. Revenue does not flow into the owner's bank account uninterrupted and at a constant level. Rental revenue is a dynamic variable which is determined by a number of factors which can change on a cyclical basis. Only when these fluctuations are recognised and then anticipated can an investment return the best possible revenue on an ongoing basis. On the other hand, the established valuation methods are limited when it comes to analysing rental cycles. Or, to put it another way: They do not reflect or predict market values in real time. In the best-case scenario, the established methods can reflect the macro-cycle with a slight delay. This is hardly a suitable basis for a long-term investment decision.

Whether a method is any good for valuing a property or as a basis for increasing revenue can be measured based on whether it provides robust answers to three important questions:

1. What is the current value of the property?
2. What will the property be worth at the end of the period of investment?
3. How can I increase the start value to the end value?

The established property valuation methods only determine the value of a property at a specific point in time, but neglect the market dynamics. Because calculations on the market price, loan value and insurance value are not relevant in terms of increasing revenue, they do not do the job, even though they can contain interesting information. In the German property market, there are three "classic" methods which are most commonly used to value a property: the comparative value method, the rebuild value method and the revenue value method.

The comparative value, for example, is still highly regarded when it comes to determining the market value of a property. To do this, it analyses previous sales of properties of a similar size and in a similar location. As the comparative value is based on actual purchase prices paid in the market, the method is considered to be very close to the market and reflect current market conditions.

Many property experts would certainly agree that the comparative price method is one of the best methods of determining market values in Germany. However, there is less unity in academic research when it comes to the range of the comparative value method. While some experts believe it is suitable for developed plots and primarily for freehold apartments, others would restrict its applicability to undeveloped plots. Who is correct? Research is more sceptical about the comparative value method for the valuation of revenue properties in Germany which are often purchased in line with a property investment. But here, too, there are isolated specialists who believe the comparative value method is the ideal method for the valuation of rented residential property.

When I am asked about my experiences with the comparative value method, I answer that while there is light, there are also shadows. There is no doubt that the benefits of this method include that it derives the market prices from actual market conditions. I also share the view of many experts that it is particularly well suited to undeveloped plots. But: comparative values are a lagging indicator which do not reflect short-term, current, and future market developments. The fewer comparable properties are available, the more constructed and distant from the market the resulting market prices become. This is not infrequently the case as in reality there are only rarely sufficient comparative properties available.

Next, we come to an old favourite in the German property market: the rebuild value method. A method - and I say this often - which is entirely unsuitable for all types of property investment in Germany. It is essentially different from the comparative value method. Unlike this, the rebuild value method does not determine the market value of a property based on actual prices achieved in the market, instead, it focuses on the costs which would be incurred to rebuild the property. In simple and concise terms, the rebuild value method determines the value of a property based on the question: How much would it cost to rebuild the property in its current condition?

The rebuild value method is primarily used in Germany for valuations of the intrinsic value of residential property with a high level of owner occupation and by the insurance industry. It is no surprise, as for private owners using their own properties, the intrinsic value is mainly an issue because the preservation costs are an important argument when making the decision to buy a property. On the other hand, the insurance industry is primarily concerned with the restoration costs. Normal production costs (NHK 2000) form an important basis and contain tables of the relevant construction costs. Naturally, this does not consider the revenue-driven perspective. The rebuild value method does not include a separate calculation method to determine the value of the land, so the comparative value method has to be applied at this point.

At first glance, the rebuild value method is a simple, clear method of deriving the market value of a property. However, when it is actually used, some doubts arise as to the practicality of the method. On the one hand, the NHK 2000 data still has some striking gaps. New, modern building types, such as low-energy houses in Germany, are not included, and even traditional buildings such as a combination of residential and business spaces are not in the database.

As the data in NHK 2000 is often unable to reflect the complexity and individuality of different properties, experts are forced to amend the data. The same applies to regional factors. Good experts are able to compensate for the intrinsic inadequacy of the rebuild value method. But if they can't, they can't...

So, is the whole rebuild value method useless? No! If it is explicitly a case of determining the restoration costs, then it can, in the best-case scenario, work well. But if it is a question of earning and increasing revenue, I can only recommend steering clear of the rebuild value method!

The revenue value method promises to be the right option for valuing properties in Germany where the focus is on revenue - or at least it is considered so by the specialist literature. In the residential property sector, the properties which are bought as revenue properties based on their performance are primarily apartment buildings.

While the comparative value method and the rebuild value method derive the value of a property based on past prices, the revenue value method promises to determine a "future success value", i.e. a value which takes the development of the property into consideration. The revenue value method sees the property as an economic asset and the economic value is therefore calculated - not the technical value. So far so good! But: in practice, the best possible, normal and sustainable profitability is always assumed for the property. This is where the revenue value method reaches its limits, because it can not adequately reflect the interaction between the property and the market. In the different models of the simplified and general revenue value method, only the long-term rents which can be achieved in the area are factored in. Differences to actual rent are calculated as additions or deductions. But the revenue value method does not consider potential rent increases, perhaps because the rent achieved by the property is below the normal rental level. It also does not include the potential in properties which are overrented and underrented. The differences between the rental level and the actual and statutory rents are simply calculated and the revenue level for the property reduced accordingly. My greatest criticism of this method is that the massive potential for value increases resulting from an adjustment of the rent to the market level is not considered at any stage during the revenue value method.

As you have read, my many years of experience with the traditional property valuation methods have left only a few positives - for good reasons, I think. In the next edition, we will look at important valuation methods from the English-speaking world. Maybe they have more to offer?

George Salden is the author of the book "Die Dynamische Methode" [The Dynamic Method] based on his 19 years of experience as an expert and manager in property and transaction management which highlights the way towards a whole new method of determining the profitability of properties. He was previously a director at alt +kelber Immobilienmanagement, a subsidiary of conwert Immobilien Invest SE, where he was responsible for major international transactions. He then took over as International Head of M&A at AK Holding GmbH & Co. KG. He is now Head of Transaction/Executive Board Member at Dr. Lübke & Kelber / Arbireo.