

Guest Column: George Salden

The German Property Market: Correct Valuation is Essential for a Good Return - Part Two

In my previous column I focused on established valuation techniques. There I came to the conclusion that the three “classic” techniques – the sales comparison technique, the asset value technique and gross rental technique – had only limited suitability when applied to real estate investments. Why? Because all three only give insufficient answers to the most important questions:

1. What is the property currently worth?
2. What will the property be worth at the end of the investment period?
3. How can I raise the initial value to the final value?

One method that was not taken into account by legislators in the ImmoWertV (Immobilienwertermittlungsverordnung = German Ordinance on the Valuation of Property/Real Estate) is the residual contribution valuation technique. This technique is applied to property that will be subject to real estate development. The residual contribution valuation technique ascertains the value of real estate based upon the difference between the value of notional development in the context of a project and the investment costs. In order to reach the contribution that would constitute this value, the value of the real estate at the end of the project is determined. The value of this notional property can then be ascertained with the help of the comparative price technique or the gross rental technique. However, investment costs must be deducted from the anticipated sales price. In this regard, the various costs accrue in various stages of project development: in the planning stage it is primarily acquisition costs as well as experts’ fees that accumulate. The construction costs and the ancillary construction costs accrue during the implementation stage, at the time of actual building, while it is in the disposal stage that both vacancy and recycling and disposal costs first arise. This is important, because unaccrued interest must be deducted from each individual cost.

A major problem of the residual contribution valuation technique is that one does not have the ability to predict future developments. On a professional level, it is virtually impossible to predict the planning and implementation costs of a major real

estate project as can be seen time and again from such public projects as the Berlin-Brandenburg Airport or the Elbe Philharmonic in Hamburg. However, the methodology underlying the residual contribution valuation technique is of great importance for arriving at a detailed projection, because the residual contribution is ascertained from two values: the construction costs and the expected sale value. These two amounts are not only much higher than the residual contribution itself, but furthermore are almost identical. If accumulated costs increase or there is a reduction in the expected sales price, then the residual contribution can be erased or even pass into the negative.



It is for this reason that in academic circles the residual contribution valuation technique is in part made subject to the criticism that one can arrive at a residual contribution in the amount desired. It is indeed true that the highly subjective nature of investment costs allows them to be

easily manipulated. Moreover, in order to ascertain the residual contribution, a second technique is always necessary, one that allows one to arrive at the expected sales price. However, because both the gross rental technique and the sales comparison technique are subject to methodological limitations, these limitations are then imported into the residual contribution valuation technique through the predicted sales price.

Another technique is the discounted cash flow method – in short the DCF method – which has its origins in the evaluation of companies. Strictly speaking, it is incorrect to speak of the DCF method, because an evaluation using discount rates belongs to the same type of procedures as the gross rental technique. In the language of experts in the real estate sector, which is being adhered to here, the concept DCF method is used for a special variant of the gross rental technique.

There is a discussion going on among experts as to whether or not to incorporate the DCF method into the ImmoWertV. There are two reasons for this: first, the DCF method is very close to the gross rental technique in terms of methodology and the latter has already been incorporated into the ImmoWertV. Second, the DCF method has proven itself successful in management consulting. However, at this point the DCF method has not yet been incorporated into the ImmoWertV, because it has not been sufficiently standardised. While use of the DCF method has not been prohibited by German courts, it

is nonetheless possible that its use could skew the value of real estate and thereby render an expert opinion vulnerable. This is because the DCF method has not proven itself in ascertaining a commercial price, i.e. a market value, but rather treats real estate as an investment asset and ascertains its investment value.

The methodological core of the DCF method is, as the name already suggests, cash flows, i.e. the periodic future inflows that are generated by an investment during a certain period of time. In the context of real estate evaluation such cash flows are treated as payment surpluses generated from rental income above non-recoverable costs. These cash flows are subject to a review period of between five and fifteen years and are discounted accordingly based on the measurement date. An amount is then added to this cash value that represents the residual value of the property after the review period. Up to this point the mathematical approach of the DCF method still resembles that of the multi-period gross rental evaluation technique. In contrast to the gross rental technique the DCF method also expressly takes into account factors such as inflation, maintenance expenses or financing costs.

Another crucial difference in the application can be observed in discounting. For while the gross rental technique seeks to obtain an objective discount in conformity with the market on the basis of property interest rates, the DCF method uses a subjective target rate, i.e. a discount rate at which the investor wishes to see his capital bear interest. This target interest rate, in contrast to the property interest rate, is subjective, thereby reflecting the investor's expected return as well as the risks of the investment. It is composed of a risk-free interest rate, to which a predicted risk is added. The amount of the base interest rate and the risk premium lie in the discretion of the investor who determines these independently of individual capital availability. In the context of an investment analysis this is not only unproblematic but also desirable. However, this interest rate is not suited for the determination of market value.

The limitations of the DCF method are due on the one hand to its methodological design and on the other hand to the problem of the predictability of economic development. The latter has a two-fold significance in the DCF method because it enters into the calculations at two different points. On the one hand, a review period of up to 15 years is established for the exact prediction of cash flows. However, even here inaccuracies enter into the calculations. This is because it is hardly possible to provide a detailed description of rental income over such a period of time. Moreover, general economic developments - and above all, the development of the regional location - can no longer be accu-

rately predicted for such a time frame. Changes in the infrastructure can influence the level of rent or the economic power of the tenants can drastically change - to name only a couple of examples. The DFC method does not have any systematic instruments with which to monitor the marketplace and to create a forecast of its development. Although the suitability of the DCF method may appear reasonable for investment analysis, the lack of any systematic underpinnings makes it impossible for this method to provide accurate results for determination of market value.

At the end of this analysis of different methods for the valuation of real estate, the difference between the valuation procedures based on statutory norms, i.e. the classic three methods under the ImmoWertV and the new valuation methods based on international norms, becomes clear. Both the discounted cash flow method as well as the residual contribution valuation technique have a conception that focuses on the investor. It is the expected returns of the individual investor that have a highly subjective influence on the value of the property. However, it is these basic premises that limit the procedure because they thereby impose limitations on viewing the reality of the real estate market.

Furthermore, the process is not unjustly accused of having a static understanding of the market. The complex dynamics of the real estate market cannot be grasped by a market adjustment factor because the movement of the market as so far described cannot be broken down into individual cities, districts, and streets of houses.

Is property evaluation therefore a problem that really has no satisfactory solution? No, because the real estate itself can - as an asset and part of a market - specify a range of investment opportunities that can be identified - if one looks at the details, as we shall see in the next column.

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.