



APPLIED VALUATION

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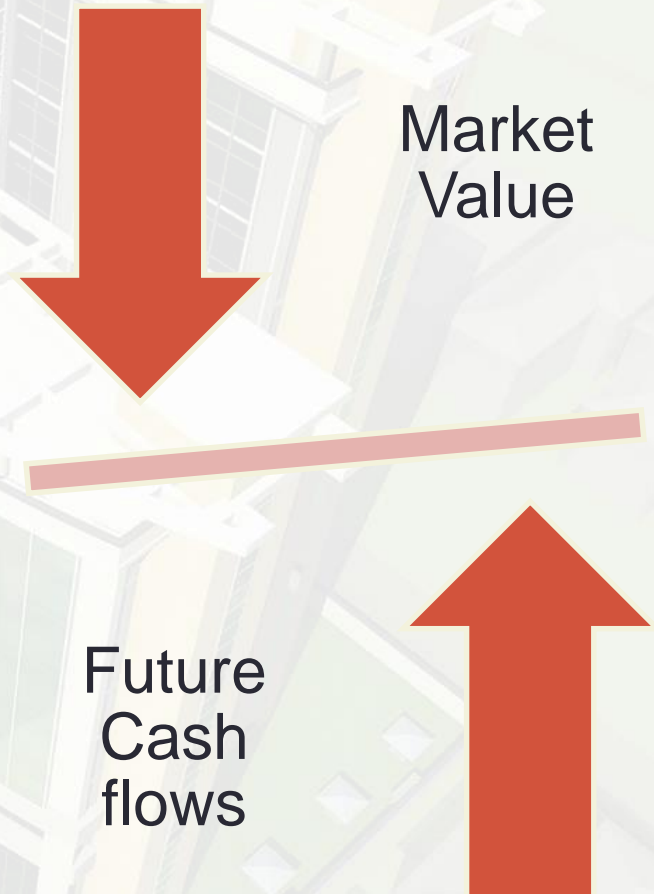
INCOME APPROACH

EAEQ 3209: LESSON FOUR



Income Approach

- Provides an indication of value by converting future cash flows to a single current capital value- IVS-2013).





Procedure

- Arriving at a value by multiplying the incomes from the property by suitable multipliers.

Establish the total income flows

Establish the reviews

Establish voids which are lettable and give rent

Establish the rate of return

Apply the rate of return to the incomes



Incomes

- Market rents are obtained from recent lettings of comparable properties, listings. Comparable- in terms of location, accommodation, etc.
- Details of rent reserved (contract rent) are obtained from lease agreements.
 - E.g. a commercial lease for a term of 6 years from 1st September, 2014.
 - Protected tenancies
- Rent reviews are provided for in the lease (contract). The review could be fixed e.g 10% pa, or review to market rent.



Outgoings

- Outgoings include electricity, water, rates, ground rent, etc.
- These are usually computed from actual expenses and subject to audited. Taking 15% or 20% is not adequate unless it is actual or derived from the market.
- Outgoings are deducted from the Gross Rent to obtain the Net Rent



Rate of Return

- Rate of return is the percentage of the capital investment that an investor obtains as income per annum usually expressed as a percentage.
- Rate of Return = Yield = $(\text{Net Market Rent} / \text{Sale Price}) \%$
- Years Purchase - YP - is the inverse of rate of return. It is the number of years it takes to recoup the invested capital
- $YP = (\text{Sale Price} / \text{Net Market Rent})$
- YP and Rate of return are market driven. It will not suffice to use a rate of return obtained from other markets (money, capital markets), though this may be important to compare real estate investment with those vehicles e.g. stocks, and bank deposits.



Rate of Return

Return on Investment

Sale Price Kshs.25,000,000
Market Rent Kshs.120,000 pm

Return on Investment/Yield

ROI = (Market Rent/Sale Price) %

- $\frac{(120,000 \times 12)}{25,000,000}$
- 5.76%

Years Purchase

Sale Price Kshs.25,000,000
Market Rent Kshs.120,000 pm

Years Purchase (YP)

YP = (Sale Price/Market Rent pa)

- $\frac{25,000,000}{(120,000 \times 12)}$
- 17.36



Valuation: Freehold Interest

Property NOT lease out

1. Establish the net market rent of the property per annum.
2. Establish the rate of return (or YP).
3. Multiply the rent with YP (or inverse of rate of return).
4. Result: Market Value



Valuation: Freehold Interest

Property NOT leased out

Simple Calculation
(YP to net income):

MV = Market Rent pa x YP

Market Rental Value	120,000
	<u>x12</u>
Annual Income	1,440,000
Less o/g @15%	<u>216,000</u>
Net income	1,224,000
YP@6% in perp.	<u>16.667</u>
Capital Value	20,400,400
<i>Call</i>	20,500,000

Or Simple Calculation
(YP to gross income):

MV = Market Rent pa x YP

Market Rental Values	120,000
	<u>x12</u>
Annual Income	1,440,000
YP@7% in perp.	<u>14.286</u>
Capital Value	20,571,840
<i>Call</i>	20,500,000



Valuation: Freehold Interest

Property lease out

1-Term:

Establish all the fixed period incomes

Rent reserved (contract)

Reviews

Protected

Apply appropriate rate of return for the term

Usually a lower rate of return since rent is secured

2-Reversion:

Market rent

Apply market rate of return in perpetuity deferred by term

Usually higher than term since the rent after contract is rather riskier

Note: Do not loose focus:- the rate of return is market driven



Valuation: Freehold Interest

Compute the values of the following:

1. A freehold property measuring 5,000 sq.ft. is leased for 5 years, first 2 years at Kshs.50 and next 3 years at Kshs.55 per sq.ft. Current market rent is Kshs.60 per sq.ft. (All rents are exclusive).
2. Compute the market value of a freehold property
3. Value the freehold interest assuming the lease **does not** exist
4. Assuming that the property is not freehold but leasehold for 30 years, compute the value of the head lease.
5. Compute the value of the 5 year leasehold interest



Valuation: Freehold Interest

Property LEASED OUT

Term (first 2 years)

Rent Reserved	5,000sq.ft@50/-pm	3,000,000 pa	
YP in 2yrs @6%		<u>1.8334</u>	5,500,200

Review (next 3 years)

Rent Reserved review	5,000sq.ft@55/-pm	3,300,000 pa	
YP in 3yrs @6.5%	2.6485		
PV 2yrs @ 6.5%	<u>0.8816</u>	<u>2.3349</u>	7,705,170

Reversion to perp.

Market Rental Value	5,000sq.ft@60	3,600,000	
YP in reversion to perp. after 5yrs @7%		<u>10.1855</u>	<u>36,667,800</u>
Capital Value			49,873,170

Call

50,000,000



Valuation: Freehold Interest

Property ASSUMING NO LEASE

Market Rental Value 5,000sq.ft@60

3,600,000

YP in perp. @7%

14.2857

Capital Value

51,428,520

Call

51,500,000



Valuation: Leasehold Interest

HEAD LEASE

1-Term:

Establish all the fixed period incomes

Rent reserved (contract)

Reviews

Protected

Apply appropriate rate of return for the sub-lease term

Usually a lower rate of return since rent is secured

2-Reversion:

Market rent

Apply market rate of return in head lease deferred by sub-lease term

Usually higher than term since the rent after contract is rather riskier

Note: Do not loose focus:- the rate of return is market driven



Valuation: Leasehold Interest

HEAD LEASE: (30 Years)

Term (first 2 years)

Rent Reserved	5,000sq.ft@50/-pm	3,000,000 pa	
YP in 2yrs @6%		<u>1.8334</u>	5,500,200

Review (next 3 years)

Rent Reserved review	5,000sq.ft@55/-pm	3,300,000 pa	
YP in 3yrs @6.5%	2.6485		
PV 2yrs @ 6.5%	<u>0.8816</u>	<u>2.3349</u>	7,705,170

Reversion to head lease (25 years)

Market Rental Value	5,000sq.ft@60	3,600,000	
YP in 25 yrs @7%	11.6536		
PV 5yrs @ 7%	<u>0.7130</u>	<u>8.3090</u>	<u>29,912,400</u>
Capital Value			43,117,770

Call

43,000,000



Valuation: Leasehold Interest

Lease: (5 Years)

A) Term (first 2 years)

Full Rental Value (Market Rent) 5,000sq.ft@60/-pm	3,600,000	
Less Rent Reserved in lease 5,000sq.ft@50/-pm	<u>3,000,000</u>	
Profit Rent	600,000	
YP in 2 yrs @6%	<u>1.8334</u>	
Capital Value		1,100,040

B) Review (next 3 years)

Full Rental Value (Market Rent) 5,000sq.ft@60/-pm	3,600,000	
Rent Reserved review 5,000sq.ft@55/-pm	<u>3,300,000</u>	
Profit Rent	300,000	
YP in 3yrs @6.5%	2.6485	
PV 2yrs @ 6.5%	<u>0.8816</u>	
Value	<u>2.3349</u>	700,470
Total A+B		1,800,510
Call		1,800,000



Limitation

- Used where in income generating properties and where rental data is available.

