LOC AT I O N, LOCATION — and who’s paying the rent?

Assessing a suitable capitalisation rate for office investment property requires the consideration of a number of factors. How do valuers rank their importance? David Parker explains.

Capital values of commercial investment properties in Australia have plummeted over the past year (see Table 1), sharpening the focus of attention on the property market, its operation and its participants—especially valuers and the valuation process.

This decline in values accompanies the economic recession which has caused an increase in the number of personal and corporate financial collapses (compounding in Australia by 19.47 per cent and 15.86 per cent in the years to June 1990 and June 1991 respectively, according to the Australian Securities Commission). This in turn, with other factors, has resulted in an increased incidence of financial default under leases in investment property.

The security and reliability of the income stream of an investment property has, accordingly, become highly topical, although relatively little original research appears to have been done into importance of this factor in the valuation process.

This article considers the importance of security of income as a determinant of the capitalisation rate for Sydney CBD office property (the findings are also of relevance to other sectors of the investment property market). While security of income is important for all types of investment property, the current oversupply in the office market dictates that it is more crucial there than in the retail and industrial property sectors.

While it is not proposed to consider the investment method of property valuation in detail, it is relevant to note, in the context of the method, the sensitivity of the computation of capital value to relatively small changes in the capitalisation rate adopted.

A conventional property valuation for a CBD office building using the investment method would be:

Net income pa $30m
Capitalisation rate @ 6% x 16.67
Capital Value $500m

Assuming that the net income has been faultlessly derived, small changes in the capitalisation rate can cause significant changes in the resulting capital value figure, as is shown in Table 2.

This aspect is particularly important for major CBD office investments because of the size of the numbers involved. As in other cities, several major office towers in Sydney could have an annual net income of more than $30 million, so a change in the capitalisation rate from 5.5 per cent to 6 per cent could make a difference of at least $45 million in capital value. With so much at stake, the assessment of an appropriate capitalisation rate becomes critical.

Determinants of the capitalisation rate

From a literature review, the author’s personal experience and a practitioner questionnaire, the

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following were identified as determinants of the capitalisation rate for CBD office investments:

- Special characteristics of property as an asset class
- Economic situation
- Alternative investments
- State of the property market
- Risk
- Legal environment
- Planning
- Location
- Building
- Tenants
- Growth
- Sentiment

Although many authors identified the same factors as being among determinants of the capitalisation rate (in particular, Millington, Rost and Collins, Richmond, Britton et al, Baum and Mackmin, Enever), with some authors identifying matters not considered by others, none provided a comprehensive list. However, the various factors listed in this article as determinants of the capitalisation rate are likely to have arisen in the work of several authors and the contribution of each is acknowledged.

It is important to note that the determinants are varied and numerous, rather than similar and limited (Shepherd and Dubois).

This list was subsequently used as the basis for a questionnaire to ascertain the relative importance of the various determinants.

**Special characteristics of property as an asset class**: These have been described as:

- high returns, low risk and low correlation with other asset classes;
- heterogeneity, indivisibility, inelasticity of supply, perpetual nature, imperfect knowledge, decentralised market, government intervention, scarcity, long-term nature, illiquidity;
- high costs of transfer, management, legal issues;
- property-specific risks such as earthquake, flood, third-party liabilities, obsolescence, etc.

Are all these characteristics taken as read or do valuers make adjustments for current market factors—such as the effect of confidentiality clauses compounding the characteristic of imperfect knowledge?

**Economic situation**: Conventionally, it may be expected that if the economy is booming then property will be strong (and that slump would be accompanied by slump), although the evidence in the Sydney CBD challenges this.

Cairns notes that yields for Sydney CBD property moved only in a band of 5.75 per cent to 8 per cent between 1970 and 1984 despite dramatic movements in other economic indicators. So how do valuers reflect the economic situation in assessing a capitalisation rate?

**Alternative investments**: The existence of competitors for investment funds is one determinant of the capitalisation rate (Enever). Do valuers have a specific regard for this factor, make a broad assumption or consider property in isolation?

**State of the property market**: The state of the property market may refer to the overall market for all classes of property; or the market for a particular sector, such as the office sector, or sub-sector such as CBD office.

The general stability of a market, relative levels of supply and demand and prevailing social, political and economic influences may all affect the determination of a capitalisation rate within a property sub-sector.

**Risk**: A consensus appears to exist that property is a riskier form of investment than a government bond and should be priced accordingly, with allowance for factors such as security, liquidity, ease of purchase and sale, management requirements, growth prospects etc.

The margin for risk for Sydney CBD office property has been variously assessed at 1-1.5 per cent (Cairns) to 2 per cent ("Student"). Brown notes that in the UK a risk premium of about 2 per cent is probably acceptable for property as a whole, although it cannot be applied to individual properties or sectors.

**Legal environment**: Title, covenants, encroachments and leases are traditional legal factors, although other considerations such as health and safety, asbestos, environmental issues and site contamination are now generally agreed to be fundamental to the determination of the capitalisation rate.

In the UK, the problem of proving title under the deed system is a consideration. However, in Australia, the indefeasibility of title conferred by the Torrens system overcomes this problem although issues of strata title, company title and community title require consideration in capitalisation-rate analysis.

**Planning**: Of all the determinants of the capitalisation rate, planning may be the most property-specific. For certain types of property, such as development sites or shopping centres, the planning situation and any likely changes are crucial both to what can be developed on the site and to the likelihood of competition. Except for changes to CBD zonings and permitted intensities of development, planning tends to be a relatively dormant determinant for CBD.
office buildings.

**Location**: The old adage of "location, location and location" is likely to lead valuers to consider this factor one of the most important determinants. However, the relatively small size of the CBDs of Australia’s capital cities may make the factor less important than it might be in larger overseas cities.

**Building**: Adequacy of finishes, foyer, services, etc. arc important in attracting tenants in a period of oversupply. The modern trend to open-plan floors and full-height office windows adversely affects the appeal of older buildings—although how relevant is such a factor to a valuer in selecting a capitalisation rate?

**Tenant**: The credit-rating or credit-worthiness of the tenant is important in assessing the security and reliability of the income stream; so are the provisions of the lease. An analysis of lease clauses will point to any possibility of the rent going down, as well as the prospects of it increasing (perhaps by fixed annual increments or periodic reviews to market). The procedure in the event of tenant default could be a factor.

Valuers are likely, then, to consider the overall quality of the tenant (and therefore the security and reliability of the income stream) to be an important determinant of the capitalisation rate.

**Growth**: The growth potential of investment property may be in increasing rents or capital appreciation, or both. Growth may also be considered relative to other asset classes, between different sectors of the property market and between different properties within each sector.

**Sentiment**: General investment-market sentiment, the attitude of investors towards property as an asset class, and investor feelings about particular types of property may all be considerations in the determination of an appropriate capitalisation rate for an investment property. For consistency, valuers should also consider the sentiment prevailing at the time of a comparable transaction.

**Practitioner questionnaire**

The chief valuers of seven of the major international real-estate agencies in Sydney were interviewed in October and November 1991 to establish a ranking for the identified determinants of the capitalisation rate. The seven employed a total of 65 other registered valuers and valued about 4,740 properties in the year to September 1991 including all of the major office towers in Sydney’s CBD (some having been valued twice or more by different agencies).

The seven respondents had an average of 27 years as practising valuers and included three fellows of the RICS, six fellows of the Australian Institute of Valuers and Land Economists, and presidents and past-presidents of the institute; given the number of valuers under their control, this group effectively represents a larger sample of practising valuers.

**Relative importance of determinants**

Each valuer was asked to rank each of the above determinants in the context of a Sydney CBD office investment property in the current market. Respondents were encouraged to add other factors that they considered relevant. A three-level ranking—Very important, Important, and Less important—with a 3-2-1 weighting was used. This ranking was designed to accommodate a response that all determinants listed were important, while some may be marginally more important than others.

The following ranking resulted, starting with the most important:

1. Location
2. Tenant/Growth (equal)
4. Building
5. Risk/State of the property market/Economic situation (equal)
8. Legal
9. Characteristics of property as an asset class/Sentiment (equal)
11. Alternative investments
12. Planning

Location was the only determinant classified by all respondents as very important, the result demonstrating the continuing relevance of the old adage. There was no indication that the small size of the CBDs of the major Australian capital cities, compared with the rest of the world, made this determinant less important.

A number of respondents noted that the present depressed property market led to their ranking of tenant strength and growth prospects together as the second most-important determinants of the capitalisation rate. The strength of the tenant determines the security and reliability of the income stream and the prospects for growth are implicitly greater with a strong location and tenant.

It is interesting that valuers consider the building itself to be a more important issue in determining a capitalisation rate than such factors as the general state of the market and risk. Characteristics of a particular property in terms of finishes, services and reputation were considered particularly important if location and tenant quality (and, therefore, growth prospects) were similar to those of other properties being considered.

A frequent comment was that, in the current market, tenants have a wide choice of buildings of comparable quality of location in the Sydney CBD and it is the features and finish of a particular building which may make that building preferable to others. It would be interesting to see if this factor achieved a similar ranking in a bull market.

The grouping of risk, the state of the property market and the economic situation as of next and equal importance is significant. While the description of risk adopted for the questionnaire was limited, comments by most respondents suggested that they were considering risk in a wider context. The economic situation and the state of the property market are linked to some extent, and many aspects of property investment risk are closely dependent on these two factors.

Legal issues ranked higher than expected, although respondents' frequent references to freehold/leasehold indicate that their views may have been coloured by the recent spate of valuations and transactions involving long leasehold interests in the Sydney CBD.

Considering the significance attributed to the state of the property market and the economic situation, the closely related concepts of the characteristics of property as an asset class and sentiment were given a surprisingly low joint ranking. The characteristics of property had been expected to rate equally with alternative investments, given their concep-
tual similarity, but this was not the case.

Similarly, the ranking of sentiment above alternative investments is surprising, as it could be argued that sentiment is a subjective assessment of the likely performance of property relative to other investment media and the economy as a whole. The distinction between sentiment prevailing in the past and that in the present or future was not mentioned by any of the respondents.

The ranking of alternative investments as the penultimate consideration suggests a disconcerting insularity among valuers regarding the role of property in the capital markets. All respondents except one appeared to have very little awareness of the relative returns from other asset classes. This may merely be confirmation of the limited relevance of alternative investments as a determinant of the capitalisation rate—or it may be a manifestation of the respondents' views of the limited relevance of the relationship.

When pressed on how it was possible to determine what was an acceptable IRR for a particular property without regard to total returns from other investment classes, most respondents became uncertain and fell back upon comparable sales to justify their logic.

The ranking of planning as the least important determinant of the capitalisation rate for CBD office investment property was not unexpected. The respondents agreed that the planning position should be confirmed, but appeared to acknowledge through the rankings the limited likelihood of rezoning or other significant planning-related changes affecting an existing Sydney CBD office tower.

The ranking exercise drew some interesting ancillary comments. All respondents sought to confirm that the ranking applied to the Sydney CBD office market at the present time, indicating that the determinants of the capitalisation rate are likely to change over time. The use of DCF techniques was generally agreed to permit greater attention to risk, particularly through sensitivity analysis, although there was little evidence of the use of probability analysis.

While there was a consensus that all determinants were important and required simultaneous evaluation, most valuers appeared to undertake this through subjective deliberation, rather than using a more objective method involving weighting, ranking or probabilities.

It is interesting that none of the respondents added further determinants to the existing list and that the point scores attributed to each of those determinants identified were all relatively close together. Given that the maximum score that could be attributed to each determinant was 21 and the minimum score 7, it is significant that all answers scored between 13 and 21.

Further, more than half of the determinants scored between 18 and 21, illustrating the difficulty presented by the choices and suggesting that the determination of the capitalisation rate is a process of mentally juggling a set of variables of almost identical importance. However, a clear and consistent order of ranking emerged and the results of the questionnaire are, therefore, considered reliable.

Conclusion

The relative importance of security of income as a determinant of the capitalisation rate in the current Sydney market is amply illustrated by these results. Tenant strength (and hence security and regularity of income) is shown to be a major determinant—second only to location and equal to growth—of the capitalisation rate for office investment property. This key finding of the study is a significant confirmation of the general, although subjectively derived, understanding of many market participants and commentators in Australia and overseas.

This finding does, however, need to be viewed in context: it represents the relative importance of the respective determinants at one point in time for one given market. It would be interesting to compare such relativities in different property markets, between different property sectors and over time. Research into these factors, which is already under way, could form the basis for a highly useful predictive model to forecast the capitalisation rate for investment property.

REFERENCES


