

New Property Valuation Technique ?

Case Study

The commercial real estate market is becoming increasingly complicated and sophisticated. Developers and investors try to use innovative legal, tax and investment solutions to optimize their investment performance. Therefore, based on completed investment transactions on the commercial real estate market and legal regulations concerning the ownership of land and improvements in Poland, it is possible to have an open market transaction in which land owned by Company A is sold separately from improvements on that land, which include a commercial building developed for a lease by Company B, independent from Company A. As a result, despite a number of restrictions, it is possible under such circumstances to establish Market Value of the land.

What is the Market Value of the right to such land?

In this case the owner of the land under valuation is not in a forced position and on the free market may reasonably dispose of the right to the land. Buyers of the land, in this particular legal and financial condition, i.e. improved with a leased up commercial building, are solely investors/investment funds, who buy income generating properties from developers. Their interest in such purchase results from their will to own rights to a whole property, including both the land and the improvements. Based on several hundred market transactions involving investment properties, developers sell them at a price that includes the so called developer's profit. It is a sort of developer's compensation for a risk, entrepreneurship, incurred costs and organizational efforts. The profit is expressed as a percentage of total project costs, including price/cost of purchasing the land and is treated like a gross profit before tax. A percentage is the same on land acquiring costs, costs of construction and financing. In other words, referring to the Market Value definition contained in the *Real Estate Act*, the most likely price for which such land would exchange on the market is the price that includes the developer's profit on land acquisition costs.

Valuation methodology

Since the commercial real estate market in Poland is only at the development stage, the number of land transactions that involve developer's profit is limited. Also, very often the access to detailed information on such transactions is restricted. Therefore, it is practically infeasible to find comparable land transactions with the profit component and to apply the comparison method of valuation to the subject land. Another reason that makes it more difficult to assess a market developer's profit from such transaction is lack of its transparency. Therefore, referring to and based on §16 of the *Ordinance of the Council of Ministers of 21 September 2004 on property valuation and development of the Valuation Report*, particular clauses 3 and 4 of the § 16, as well as taking into consideration a considerable number of already closed investment transactions of income generating properties and information thereof, it is acceptable to establish the Market Value (W_{kg}) of the above-mentioned land in the following procedure:

- 1/ establish the Market Value of the land in the market approach with the assumption the land is undeveloped and can be developed with the existing commercial facility and leased at the date of valuation (C_{zg}).

The commercial development sites market brings a sufficient number of transactions and information, so the value of the title to undeveloped land can be established with a high accuracy. No other approach than the comparison method of valuation is justified in order to assess the Market Value of such land.

- 2/ determine the market developer's profit as a percentage based on relevant investment transactions involving whole developed according to the principles and bases of the residual method of property valuation. This method is widely used to determine the developer's profit. In investment transactions, the profit expressed in percentage is equal for the whole

property and for each component of a developed property, among other components, land acquisition costs (Z_d).

The sum of C_{zg} and Z_d gives the market value of the land described above.

Residual method

It may seem that the valuation procedure described above is equivalent with the procedure used to establish the land value under the residual method. However, valuation of land or the developer's profit using the residual method leads to determination of a non-market value and boils down to the following formula:

$$W_{kn} - C_{kp} - Z_d = C_{zg}$$

or

$$W_{kn} - C_{kp} - C_{zg} = Z_d$$

Where:

(W_{kn}) Capital Value of the Property

- it is the value of the developer's project after its completion, calculated as capitalized forecasted annual rental income the project is going to generate. It is equal to W_{kg} (capital value of the land) plus W_{kz} (capital value of improvements/ buildings);

(C_{kp}) Total Project Costs

- includes total costs of construction and other works needed to prepare the site and its infrastructure for the project, professional fees, brokers' commissions, costs of financing;

(Z_d) Developer's Profit

- calculated as a percentage of total project costs, usually set by developers on an individual basis;

(C_{zg}) Land Purchase Price

- it is the maximum price (value) the developer can pay for the land.

The above formula can be transformed as follows:

$$W_{kg} = C_{zg} - W_{kz} + C_{kp} + Z_d$$

Bearing in mind the condition of the subject of valuation, C_{kp} and W_{kz} are equal zero, so formula can be shown as:

$$W_{kg} = C_{zg} - 0 + 0 + Z_d$$

$$W_{kg} = C_{zg} + Z_d$$

and thus, from the viewpoint of the principles of the residual method, confirms the appropriateness of the suggest approach to a market valuation of the subject land and the adjustment for selling the land as a part of an investment project.

Summary

Please note that the procedure proposed in the Valuation Methodology section is based on market analysis and comparable analysis of market transactions. Therefore C_{zg} and Z_d are

established in a procedure leading to an assessment of their market values, while in the residual method to assessment of their non-market values. The residual method is applied to establish non-market/ individual (worth)/ investment values associated with a particular, clearly defined planned concepts of land development. Hence the proposed Valuation Methodology, although in mathematical terms identical to the residual method, can not be perceived as such.