Property Capitalization Rates_2022

INTRODUCTION

This technical note, as delving into the mechanics on the build up of property capitalization rates will give a meaning to the buzz phrase that property is a hedge against inflation. It further notes that the discounted cash flow methods should be used sparingly in property investments, only in the short term. For the long term, valuation methodology is well catered for with the initial yield (caps rate) and earnings' multiplier factor to estimate the market value of investment (office & retail outlets) & trading properties (hotels, petrol stations, schools) respectively. As these factors are dependent on rates of return, the practitioning valuer is to be well versed & fully comprehends their build up, as applying varying rates of return from the present actual will yield varying market values.

COMPUTATION MECHANICS

To arrive a property capitalization rate reference is made with Gordon's growth equation which notes that:

I = r + x + y - r - d

Where i is the initial yield of return

r is the risk free rate

x is a premium added on due to the lumpiness of property investments as compared to other forms of investments. This entails added purchase expenses, whilst disposal of property is more cumbersome than other forms of investment. This is normally taken at 2% for investment properties. For trading properties this premium can tend towards 4%. INSERT CONCLUSION NOTE HERE.

y is the tenant risk normally taken at 1%.

r is the annual increases in the rental amounts received.

d is a factor to cater for depreciation, which could vary from 1% for office premises, to other depreciation rates for other types of property..

To gauge how the riisk free rate has varied over the years, table 1 contains various rate of returns as published by the Central Bank of Malta, for the safe Government Bonds over the years, with varying years to expiry. As property is normally considered as a long term investment, the 15-year Government Bond, as averaged over a 4 to 5 year period, is considered a good proxy. On the other hand a long term risk free rate for property is taken as to not go below 2.25%.

TABLE 1 _CBM interest rates over varying time periods.

CBM	2004	2007	2009	2011	2013	2014	2015	2016	2017	2018	2019	2020	2021
2 YR	3.25	4.50	2.40	2.407	1.004	0.624	0.168	0.027	-0.081	0.015	-0.137	-0.092	-0.35
5 YR	4.25	4.70	3.65	3.481	2.128	1.498	0.708	0.278	0.228	0.470	0.051	0.053	-0.18
10 YR	4.70	5.10	4.55	4.489	3.363	2.612	1.488	0.886	1.282	1.386	0.678	0.510	0.42
15 YR	4.95	4.90	4.95	4.90	4.352	3.557	2.109	1.572	1.793	1.856	0.979	0.808	0.82

Table 2 now notes the initial yield rate as adopted over the years to an office block in Floriana. It is to be noted that whilst the money market over this period, although going from a period of high interest rates to minimal rates, the initial yield of property has only varied by 2.25% over this period. This as noted from the property capitalization rate having varied from 7% in 1988 down to 4.75% in 2020. This low variance in interest rates over time is one inkling, why property is considered a hedge against inflation. This when the discount rate varied over the same period from 14% in 1988 down 6.25% for 2020.

Table No. 2 Floriana Office Block - REVALUATIONS

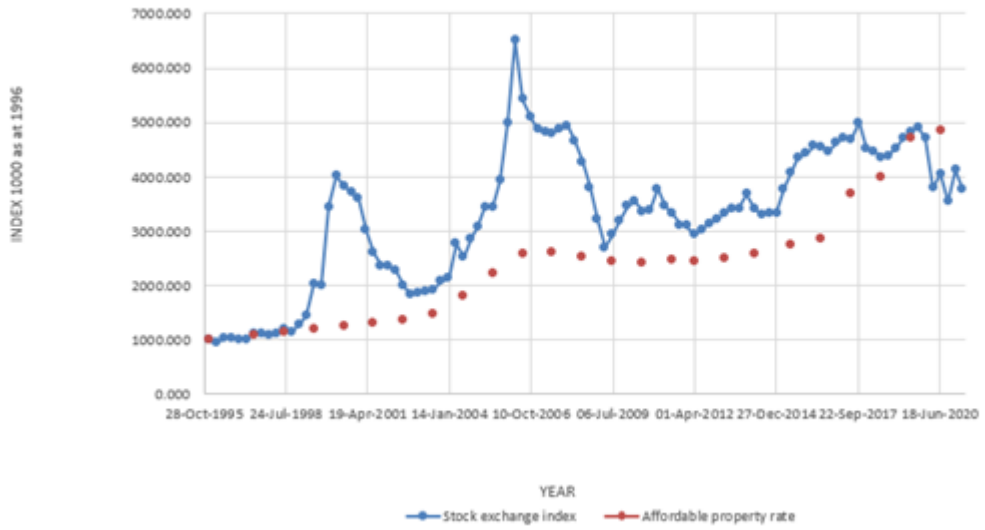
Year	Discountt Rate	Initial Yield	Risk Free Rate
1988	14.00%	7.00%	
1992	11.00%	7.00%	7.25%
1998	10.75%		7.75%
2004	8.00%	5.25%	5.00%
2007	8.00%	5.25%	5.00%
2010	8.00%	5.00%	4.75%
2014	7.75%	4.50%	4.50%
2018	6.25%	4.75%	2.25%

The valuation of investment & trading properties, although tied to an investment methodology, is also based on comparative methods, similar to residential properties. The comparables in these instances refer to the rental rates for investment properties, with sufficient data available, together with the applicable yield. In the case of trading properties it is the earnings multiplier, which due to scarcity of sales for these type of properties may not be too easy to obtain. The importance of arriving at an adequate initial yield or earnings' multiplier cannot be underplayed. The above outlines the mechanics how this may be guided on investment principles, when prior to 1995 valuation methodology was based on the experience of the valuer. The cut off year of 1995 coincides with the deregulation as occurring within the banking global system.

CONCLUSIONS

The limited variance of property discount rates over the years as noted in table No. 2, highlights that property investment is considered much less volatile than the other forms of investment available. Chart No. 1 clearly indicates the great volatility1 of Malta's Stock Exchange since its inception, as compared to Malta's residential property market over the same period.

CHART No.1: PROPERTY vs STOCK EXCHANGE INDEX 1996 – 2021



Valuation methodology as outlined above, is based on the low volatility of the property market. This implies the application of the initial yield or the earnings' multiplier whichever is applicable, which as noted in table No. 2 has not altered all that much over the past 33 year period.

DCF on the other hand provides for a false sense of security. As noted above it is probably very difficult to predict what the market conditions will be in say 3 years' time. The immediate 15-year past period from 2007 onwards, notes the global markets to have been subjected to a financial meltdown as from 2008, whilst in 2019 the Covid pandemic again wrought havoc. Once relief had been obtained from the Covid property market disruption, the onset of the Russian-Ukraine war commenced in 2022 creating havoc to the low global inflation era, as occurring for more than a past decade, with inflation post-Covid + ongoing European war being rampant.

The valuation method used may adjust for input uncertainty. For example, in a discounted cash flow model the cash flow inputs are based on current expectations of future performance and are therefore uncertain, with predictions being uncertain over a 3-year period, let alone a 10-year period. However, market participants' views of the potential risk or reward implied by the expected cash flows differing from those that actually occur in the future can often be reflected in the discount rate applied, leading onto the initial yield adopted in valuation methodology, known as caps rate in US terminology.

So in truth the DCF analysis in property valuation should only be adopted for short-termism situations, such as when an overall refurbishment job is necessary in the immediate future, or a tenant shortfall is to occur, thus creating a vacant period.