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Time is not Money

Property has a problem with time...

Business plans consider the viability and value of property developments in terms of the business operations' capacity to generate revenue streams. The operational value is part of a business plan, which is formulated within the context of, typically, a 10 year time horizon. This is a sensible and realistic amount of time, as businesses depend on ongoing operations, which are susceptible to changes in the market, technology and other forms of variability.

A valuation of a property can be obtained using the profits method, where its value-in-use is derived from ongoing revenue and profits discounted back to the present, and expressed as Net Present Value (NPV). NPV is an *extrinsic* value: it is derived from the activities in and around the building, i.e. the occupying business. Calculating the NPV value is impacted by the discount rate, whereby future revenue reduces to such an extent that the future earning potential is of no material NPV value. For example, consider a property that has a rental income of £1M pa. With a typical discount rate of 7%, in ten years' time this equates to half as much at ~£0.5M and this then further reduces to ~258K after 20 years, about a quarter of the value. This is a huge reduction in value resulting in the passage of time.

However, a property also has *intrinsic* value: it is bricks and mortar, form and a location. The building is static and not dependent on what goes on within its walls. Its intrinsic value is not dependent on maintaining operations within it. As such, a building is enduring. The time horizon of 10 years is insignificant, it is not unusual for buildings to endure for 100 years or more. This is an order of magnitude greater than than business plans, reaching beyond their extrinsic value calculations.

The sustainability of a building is calculated using Whole Life Costs (WLC) and Life Cycle Costs (LCC). These calculations look to the long term, so are more aligned with the intrinsic valuations.

Unusual buildings, i.e. those that cannot be valued by other means, can be valued using the contractor's method, which is the cost to build/replace. This is a valuation based on intrinsic value. This is a useful methodology that best calculates intrinsic value, being a method of valuation already used and recognised.

Some valuation methods, such as those used in Germany, separately calculate the value of the land and the building. This is demonstrates a methodology of considering different aspects of a property contributing to its overall value.

This proposal is to have formal valuations include both extrinsic and extrinsic values.

To enable both extrinsic and intrinsic value to be incorporated in a formal valuation, a similar methodology of separation, as used in Germany, could be adopted. A valuation therefore incorporates and combines two parts: a NPV deriving an extrinsic value, and a contractor's method deriving an intrinsic value.

Including two valuations as above might appear to double the value of a property. However, this need not be so. Either the types of value are components of the overall value, similar to the German methodology, or, there are two valuations seen in parallel.

A comparison might be drawn between this new form of valuation and financial statements. A short(er) term outlook is presented in an income statement, whereas long term value is presented separately in a balance sheet. Both together reflect the true value of a company.

<u>Some discussion examples:</u>
Prefab buildings built in the 1950s met the immediate housing need of the 1950s. The time horizon context was short for these buildings, so they were designed and valued for a short lifespan. The extrinsic value was predominant. Yet, many of these still stand and are occupied more than 60 years later; their intrinsic value has endured (albeit with faults in accordance with the specification).

If commercial buildings were to be designed to fit perfectly within the time horizon and flexibility of their business plans, then all commercial properties would be Portacabins.

With a new valuation type as described above, the non-financial and intrinsic values that an architect provides: a well designed and enduring building can be more clearly represented in a formal valuation.

Developers have buildings as their manufactured product. Their product cycle, to build and sell buildings, is shorter than their business plan horizon. Each building is built within the time horizon of, say, 2 years. There is a familiar consequence of this, where the quality of the buildings is poor. This quality problem is traditionally improved by raising minimum standards. Alternatively, a new valuation method incorporating intrinsic and extrinsic value will better reflect the quality of manufacture and therefore incentivise better buildings.

Published on April 13, 2017 https://www.linkedin.com/pulse/time-money-thomas-rasche