How to value build to rent

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Jason Hardman highlights the key points of the new RICS guidance note

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According to CBRE figures, over the past 3 years an average of ?2bn in capital has been committed to the build-to-rent (BTR) sector by:

- housing associations;
- quoted property companies; and
- UK institutions and fund managers.

There is heavy involvement from North America and significant continuing investment from northern European, East Asian and Middle Eastern sovereign wealth.

Undoubtedly, the motivation for those investing in the sector is net income return from a residential perspective, based on an asset class considered to have low depreciation and provide a secure income stream that could be a good inflation hedge over the long term. To support this market, RICS published an information paper, *Valuing residential property purpose-built for renting* in 2014. The first edition of the RICS guidance note Valuing residential property purpose-built for renting , published in July 2018, came into effect in October 2018 and builds on this paper?s principles.

What the guidance note covers

It is specific to the valuation of completed buildings, and applies to BTR property with the following typical characteristics:

- accommodation usually comprises at least 50 self-contained dwellings, or a concentration of a similar number;
- the dwellings will be separately let, but held in unified ownership and oversight will be under a single entity;
- the building or buildings may be specifically designed or adapted for rent and include some form of shared amenity; and
- the individual dwellings are usually let on assured shorthold tenancies (ASTs).

The principal approach to valuation is by reference to net income capitalisation, with benchmarking against an ungeared internal rate of return ? typically over 10 years ? and, where relevant, against the value of the individual dwellings sold on a unit-by-unit basis ? their break-up value. It would be helpful for the valuer to follow the process shown in Figure 1.

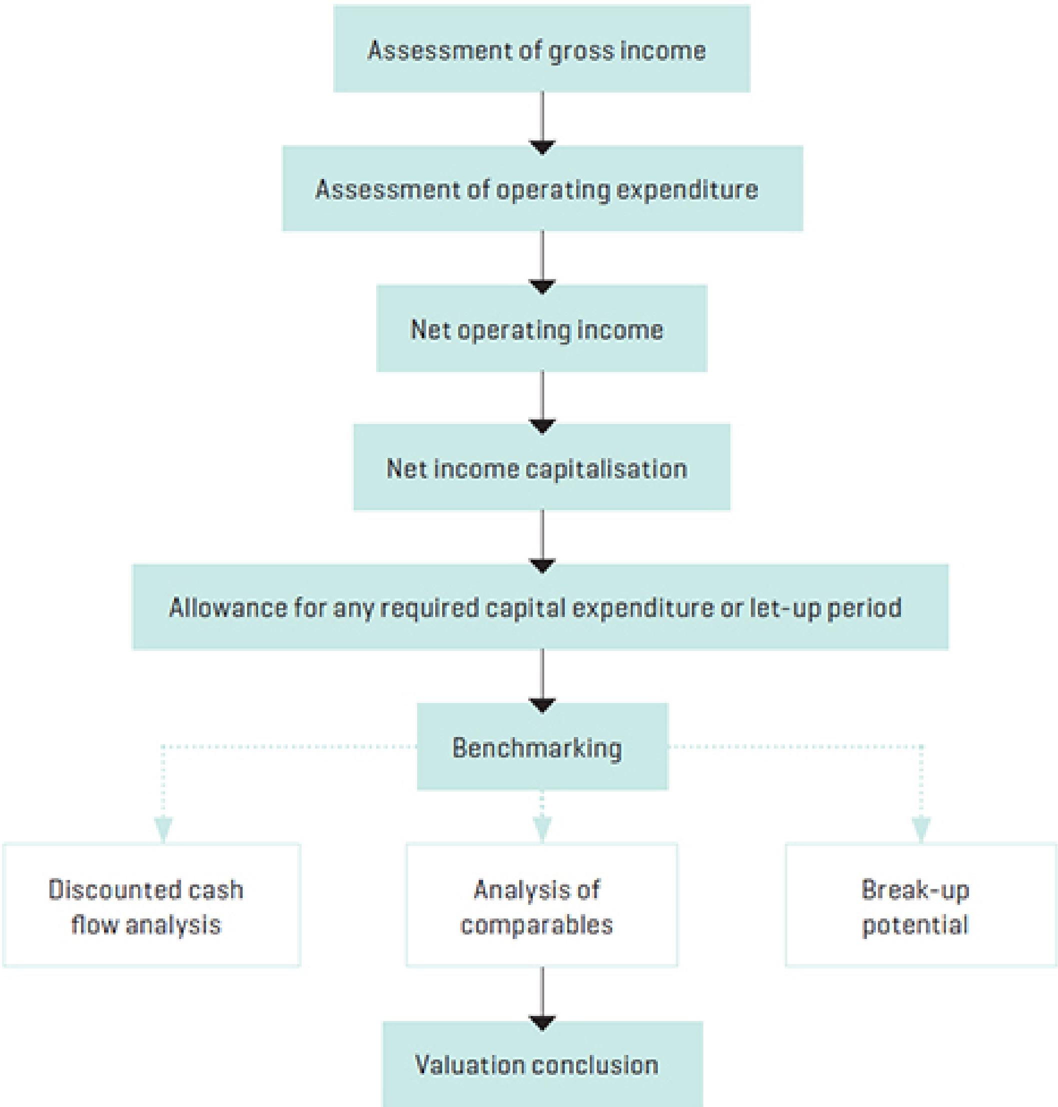

Figure 1: Process for benchmarking BTR property valuation

Gross income

Currently, many BTR properties will be new and are nearly always different from equivalent accommodation in the buy-to-let market, offering services such as:

- concierges;
- parcel delivery and grocery collection; and
- amenities including residents? gyms and communal roof terraces.

The layout might be designed specifically for renting or to have greater appeal for shared households.

BTR allows landlords to control the management of the entire building. The valuer should consider the usual fundamentals: location, specification, dwelling size and detailed analysis of current rents, as well as reflecting additional features. Potential ancillary income may include parking spaces, storage, services and utilities, and landlords should ensure that any such income is fully analysed and its value attributed if it would be reflected in bids by prospective buyers.

As residential property is typically let on an AST, most outgoings fall to the landlord rather than the tenant

Valuers must think laterally if there are no direct comparables in the immediate locality, and the vendor must know how BTR properties in other locations are performing relative to local markets. Experience has shown that BTR schemes can achieve better rents than local averages, but the valuer should always be comparing like with like.

Other considerations include length of tenancy, supply pipeline and restrictions on rents in the case of affordable privately rented dwellings. Landlords are increasingly offering terms of 3 years or more with break options in favour of the tenant, and annual rent review provisions that are typically indexed.

Operating expenditure

As residential property is typically let on an AST, most outgoings fall to the landlord and not the tenant. The valuer must assess the appropriate amount of irrecoverable expenditure required to secure and maintain their gross income.

How these costs are categorised and what different owners include varies, but many are attempting to standardise these. The guidance note adopts the categories used by MSCI in calculating its residential index, as illustrated in Figure 2.

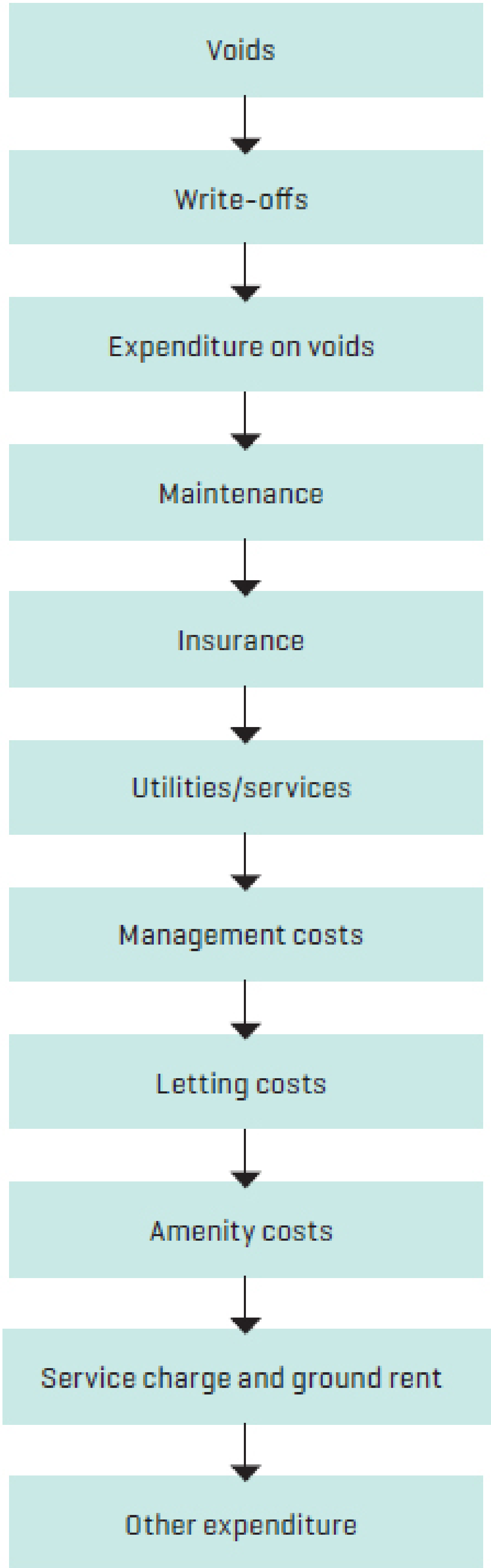

Figure 2: Assessment of operating expenditure

It is anticipated that, as the sector matures, valuers will have access to historic operating costs from the subject property that can be analysed and benchmarked against data from similar buildings. For now, the valuer must analyse the information provided and make an educated assessment of the appropriate costs against market evidence. This means considering the assumed costs that buyers have underwritten for forward purchaser and forward funding transactions.

Net income capitalisation

Many investors in this market are more familiar with commercial real estate and assess overall returns on the same basis. The guidance note?s approach to valuation mirrors the methodology established among valuers when dealing with shops, offices and warehouses. They are guided to analyse comparables having regard to purchasers? costs and examining initial, equivalent and reversionary yields. Residential investment property has frequently been assessed in terms of gross yield ? ignoring operational and acquisition costs ? so this approach may constitute a change. Investors are assessing returns on a triple net yield basis and valuers must do the same.

The capitalisation site will be informed by careful analysis of comparable transactions and applied to the yield net of purchasers? costs, to include stamp duty land tax, agents? and lawyers? fees. Typical considerations might include:

- location;
- lot size;
- tenure;
- any restrictive covenant restricting the dwelling

to renting;
- lease structure;
- income security and rental growth prospects; and
- existing and future competition.

The valuer should also reflect the property's physical circumstances and identify whether any capital expenditure or residual works are required over and above normal running costs, making an appropriate allowance for these. For vacant or part-let buildings, the valuer should also allow for the time and costs of letting the building fully.

Benchmarking

This element is vital, and the guidance note sets out 2 ways of benchmarking.

1. **Aggregate break-up value** typically includes the value with vacant possession of each of these dwellings and car spaces plus any ground rent. This is most relevant where there is a fully functioning sales market for the individual dwellings. I believe that for many town centres where the development of flats has been limited or non-existent in the past 10 years, comparison of a new BTR block against the sales of older flats, although informative, would be challenging. This is emphasised by the fact that the valuer should also have regard, when considering a break-up option, to:
    - the rate of absorption;
    - a buyer?s desired

- profit;
- cost of sales; and
- holding costs and potential price changes during a sale period.

There is no rule of thumb for any difference between the value assessed on a net income basis and the aggregate vacant possession.

2. **Cash flow analysis**: the note refers to other RICS guidance for valuers on discounted cash flows. It recommends applying such techniques, using market growth rates to income and cost to assess the internal rate of return on an ungeared basis, then comparing this to desired returns from investors. It is important to emphasise the role of discounted cash flow analysis benchmarking. Although desired internal rates of return will vary between investors, a pattern and range are emerging. This provides a critical way of checking the output of a net income capitalisation approach to ensure the valuation advice is robust and accurate.

It is acknowledged that this sector is growing, which will present valuers with challenges. The guidance note aims to create a consistent approach for the market, enabling participants to decide whether to buy, sell, lend or hold on a basis that can be supported by standard valuation metrics.

Jason Hardman is Executive Director, Valuation and Advisory Services at CBRE , and Technical Author of Valuing residential property purpose-built for renting .

Further information

- Related competencies include Property finance and funding and Valuation
- This feature was taken from the RICS Property journal (October/November 2018)
- Related categories include Adding a block management portfolio , Newbuild property , Residential valuation