

Part 6: Principles and Practice of Property Valuation

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SUPPLY AND DEMAND

1. One dominant feature of the property market in Hong Kong is that the total supply of land is by and large fixed, although land reclamation can provide marginal increases.
2. Another feature of the property market in Hong Kong is the Government's dual role. The HKSAR Government is both the market regulator and the biggest landowner in the land market. Its policies affect the supply of land considerably. The three guiding principles of the Government's housing policy, as set out in the 2010-11 Policy Address, delivered by the Chief Executive, are:-
 - the focus of the Government's subsidised housing policy is to help the low-income group who cannot afford private rental accommodation by providing public rental housing (PRH);
 - apart from PRH, the major role of the Government is to supply land. The Government should refrain from participating in subsidised housing schemes as far as possible, and minimise intervention in the property market.; and
 - the Government will ensure sufficient land supply and provide quality infrastructure to maintain a fair and stable environment for the healthy and sustainable development of the property market.
3. A third feature of the supply side of the property market is the relative inelasticity of supply. Whenever there is substantial demand, developers will start to build new buildings to meet the demand. As it generally takes a few years to construct new buildings, demand cannot be satisfied immediately. If economic conditions continue to be favourable, demand will increase further. As demand increases, prices will rise and other developers will join the market. However, at some stage, supply will catch up with or even surpass demand and prices will then start to fall. A boom-bust cycle is thus common in the property market.
4. The following are some of the factors that affect demand for properties:
 - Political stability is an important consideration.
 - As Hong Kong is an international city, it is affected by the international situation. Oil prices, movements in US interest rates, the state of the World economy, wars, terrorist attacks, etc, all affect the Hong Kong economy and therefore the Hong Kong property market.
 - The state of the economy and economic indices, particularly gross domestic product and the unemployment rate, will substantially affect demand for housing.
 - If an economy goes through restructuring, its property market may experience some turbulence.
 - Interest rates are an important factor as most purchasers depend on mortgage financing for their purchases. Similarly, banks' policies towards mortgages also affect demand. A tighter lending criteria and less preferential mortgage rate make property purchases less attractive.

- A high inflation rate can increase demand as properties are generally seen as good hedges against inflation. Conversely, deflation can reduce demand for properties.
- The proportion of people of marriageable age in a population will affect demand as married couples require more privacy in their accommodation than single people.
- Seasonal variations may also have a mild influence on the property market. During the festive seasons of Christmas and Chinese New Year, and also during summer holidays, there may be fewer purchasers entering the market because many people go away or are otherwise in a “holiday mood”.

POSSIBLE VALUES OF LANDED PROPERTIES

5. In the context of property valuation, the word “value” refers to “market value”. According to the International Valuation Standards Council, market value is the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. This definition assumes that the parties to the transaction are prudent, act without compulsion, and have adequate knowledge of the potential and worth of the property. The vendor will only sell at the price he requires and the purchaser will only buy at what he considers to be a satisfactory price. They are both willing parties because they both consider the deal to their advantage. In general, property professionals are more concerned with the assumption of a willing seller. This is because it is more likely for a seller to be under undue pressure to sell than a purchaser to be under similar pressure to buy.
6. In a valuation for insurance purposes, the market value of the property is irrelevant. The valuer’s job is to calculate what it will cost to replace the bricks and mortars of a building should it be destroyed. He focuses solely on the cost of replacement of the building and disregards the value of the land. This cost of replacement is the “insurance value” of the property.

METHODS OF VALUATION

7. Direct comparison is the most widely used method in Hong Kong as well as other mature markets. The property under consideration is directly compared with similar properties which have been sold recently, and a valuation is arrived at on the basis of such comparison. The reason behind this method is that the best evidence of value is the price paid for similar properties. This method works well in a place like Hong Kong which has an active and well-publicised property market, but if and only if the market works reasonably rationally. Direct comparison is also quick and straightforward, and is the best method for valuing standardised units in housing estates. Even if a valuer uses other methods he will invariably have recourse to the method of comparison as well.
8. Appraisal or valuation, by literal Chinese translation, is normally referred to as “price guessing”. But the word “valuation” implies the objective is to assess “value”, not to find “price”. Such a translation does not help very much in defining the exact rationale of appraisal. Appraisal is a process of collecting market data, analysing the variables and making a judgment. The investment approach is a valuation method that requires property professionals to be well versed in this process.

9. In its simplest form, the investment approach means the summation of all future (discounted) rental income. This is a very logical assertion of property value as no one will buy a property at a price that is higher than the total income it can generate. On the other hand, no owner will sell at a price that is smaller than the total income the property can generate, or he may as well keep the property for rental income himself. The process of summation is called capitalisation which takes the present values of these future rental incomes into consideration. In an inflationary economy, it is normally expected that a dollar receivable this time next year is worth less than the same dollar today. The basic logic in investment appraisal is therefore the understanding that money has a time value. Hence, the present value (*PV*) of one dollar receivable after n years at an interest rate (or discount rate) is obtained by means of a mathematical formula. This process is called discounting. In the process of summing up all the future discounted rental values (assuming rental continues to be receivable in the long run), we can apply a simple formula by dividing the current annual market rent of that property by the market yield of that class of property. Hence, the higher the expected income, the higher the expected capital value of the property.
10. The profits approach is used for valuing operating commercial properties, especially hotel properties, and is based on the assumption that the value of some properties will be related to the profits generated from their use. The predominant consideration in this valuation method is the nature of the business activities carried on in the property. The aim of the method is to find the portion of the profits of the business going into the rent. The rent is then used to find the capital value.
11. The replacement costs approach is seldom used and is used sometimes as a last resort to value the type of properties which rarely change hands and for which there are few or no comparables, e.g. hospitals, town halls, schools, libraries, churches and other such buildings. In this method, the value of the property is equal to the value of the site (for that specific purpose) plus the estimated cost of replacement of the building, or the cost of rebuilding a structure for the same functional use.

SITE VALUATION METHODS

12. The comparative method has been discussed above. However, this may not be appropriate for the valuation of land as no two pieces of land are identical. Each may have different characteristics and be subject to different lease conditions. The following factors all affect the development potential and value of a piece of land:
 - Area of land: generally speaking, the smaller the land the lower the efficiency ratio of the building on the land, i.e. the ratio of saleable floor area to the gross floor area (GFA) of the building.
 - Site classification: there are three kinds of sites, namely, class A, class B and class C sites, and they all have different permitted site coverage and plot ratio.
 - Density zoning: there are three density zones, and permitted site coverage and plot ratio are different for each zone.
 - Lease restrictions: as the Government is the ultimate owner of all land, it is empowered to impose restrictions on the use of land. The restrictions in a government lease on permitted user, site coverage and plot ratio may vary from lease to lease.

- Zoning and other restriction such as Maximum Plot Ratio as stipulated in respective Outline Zoning Plan: this would affect the permitted site coverage and plot ratio of the building.
 - Amalgamation of sites: if two adjoining sites can be amalgamated, the development may become more profitable.
13. In theory, demand for land is a derived demand, which means that purchasers' demand for properties to be built on land makes land itself a valuable asset for a developer to bid for. As such, land value is a residual value. In the residual method of valuation, an estimate is made of the value of the completed development, called the gross development value (GDV). From that, deductions are made to cover the costs, including building costs, bank interest, professional fees, marketing and agency expenses, contingencies, administrative charges for purchase of the site, etc., as well as the developer's profit, and the residue is the value of the land, the maximum bid price that can be paid by the developer.
14. The discounted cash flow (DCF) model basically works on the same logical flow as the residual method. The only difference is the emphasis on present values of all payments and incomes. In the traditional residual approach, it is assumed that all inflows and outflows of money are made on a lump sum basis. In reality, no developer would pay their contractor the total construction cost at the beginning of the project. Similarly, no banks would accept a single repayment of the loan at the end of the project. Developers may also not receive GDV in one single sum due to pre-sale and different market conditions. If the construction period is long enough, the assumption of a lump sum payment will create a discrepancy in the final site value due to the difference in present value. For example, the total construction cost of a project is HK\$10 million. Under the traditional residual method, this is set as cost against GDV. If, in reality, the developers pay their contractors in 10 equal instalments over the construction period, the first HK\$1 million, in times of an inflationary economy, will be worth more than the tenth payment in terms of present value. Hence, the total present value of overall construction cost will not be HK\$10 million. It should be less than this amount. DCF targets this problem by outlining a cash-flow approach, allowing developers to distribute the actual inflows and outflows of money throughout the construction period to the actual point of time incurred. By choosing the appropriate discounted rate, payments and income that occur at different points of time during the project can be added and subtracted on the same present value basis.

VALUATION REPORTS

15. Valuation reports are drawn up by valuers on the instructions of their clients. Generally speaking, a valuation report contains the following information:
- Purpose of valuation: a valuation report may be compiled, for example, for sale or insurance, or mortgage purposes.
 - Definition of the meaning of the valuation: for example, the valuation may be made for the purpose of sale and, therefore, it will be based on the "market value" of the property.
 - Date of valuation: no valuer should produce a report trying to assert asset value in the future. There must be a date of valuation on which all the assumptions of this valuation are made.
 - Essential information about the property, which may include the following:

- tenure (i.e. term of years in the government lease) of the property, particulars of the government lease, other title particulars and any encumbrances affecting the property, and whether it is vacant or subject to an existing tenancy;
 - location;
 - description of the building of which the property forms part;
 - the GFA, saleable area, user, orientation, and general condition, etc., of the property.
- The report will then arrive at a valuation of the property, based on the foregoing information.
 - Usually attached to a valuation report are (i) a location plan, (ii) a floor plan, and (iii) a land search for the property.

THE PROPERTY MARKET AND SALES METHODS

16. Market trends can be gauged by examining the factors affecting supply and demand of properties. If the factors enumerated are all favourable, then the market is likely to be on an upward trend. Conversely if these factors are all unfavourable, then the market is likely to be on a downward trend.
17. In identifying market trends, the following indicators are usually relied upon by the real estate sector:
- Number of recent transactions: of particular interest is the number of agreements for sale and purchase of building units and land received each month by the Land Registry for registration. The Land Registry regularly publishes such information on its website.
 - Land sales results: the prices paid by developers in government land actions are generally accepted as a leading indicator of the health of the property market.
 - Level of the Hang Seng Index: the stock market usually reacts to economic indicators ahead of other sectors of the economy. A booming stock market generally heralds the coming of good economic times and a rising property market.
 - Bank policies: banks are cautious lenders. When they begin to reduce lending to the property market, it may be a sign the property market is overheated and is due for a correction.
18. The following four methods of sales are common in Hong Kong:
- Primary market: prior to the currency crisis of the late 1990s, developers usually sold their own properties. However, after the currency crisis, it became common practice for developers to appoint estate agents to market and sell their uncompleted units.
 - Secondary market: sales in the secondary market are almost always effected through estate agents. Appointment of an estate agent may be exclusive or non-exclusive. If it is exclusive, the owner may be liable to the agent for commission if the property is sold through another agent during the validity period of the agency agreement. The agency relationship between the agent and the client may be a

single or dual or potentially dual agency. In a dual agency, the agent can act for both the vendor and the purchaser. All such matters are subject to negotiation between the parties.

- Auction: under this process, an auctioneer invites bids (offers) for the property which is for sale. The highest bidder is the purchaser, unless the reserve price (if any) is not met. A contract is created when a bid is accepted by the fall of the auctioneer's hammer. Government land is usually sold by auction. Most banks also sell mortgaged properties by auction.
- Tender: a bid to purchase a property submitted by a person in response to an invitation by the owner of the property. The bid constitutes an offer. A binding contract is created when the owner accepts the bid.