©IDOSR Publication
International Digital Organization for Scientific Research ISSN: 2550-7974
IDOSR JOURNAL OF ARTS AND MANAGEMENT 5(1): 46-50, 2020.

The Appropriate Yield for the Valuation of Real Property Investments in Enugu Metropolis

Mba, William Osondu

Department of Estate Management, Caritas University, Amorji Nike, Emene, Enugu, Nigeria.
Email; williamosondu@yahoo.com
Tel: +2348033472877

ABSTRACT

Yield as its name implies is the return on an investment. This however is the amalgam of risk and the pure interest. Anyone involved in property investment would know that yield is critical to property valuation. Invariably, professionals and authors alike sternly insist that returns and yield are not necessarily the same and hair split into more than 50 variations. But what is the difference between an equivalent yields, an initial yield, all risks yield**,** a redemption yield, and so on. For Estate Valuers and students of Estate Management and Valuation, these splits can be confusing. The truth remains that, notwithstanding the principle behind the derivation and the terminology adopted, they are not more than discount or interest rate. Hence, the aim of this paper is to assist especially valuers and students to understand the principles governing yields on investment, and the rational for a choice of yield and it's derivation for the valuation of property investments in Enugu Metropolis. Data were collected on four recently sold comparables and analysed for the derivation and determination of the appropriate yield adopted for the valuation of the subject property. This recommends that, valuers and students should always identify and differentiate these derivation processes for effective application to property valuations.
Keywords**:** Valuation, Appropriate, Yields, Comparables and Conventional

INTRODUCTION

We certainly buy most investments because we expect them to generate cash flows for us in future. This means that the value of an investment is not what someone perceives it to be but it is a function of the expected cash flows. But for what an investor should expect from an investment. The first is the likelihood that an entity will default on a commitment to make a payment, such as interest or principal due, this is called default risk. Secondly, the variation of actual returns around expected returns, thus, the actual returns on a risky investment can be very different from expected returns, the greater the variation the greater the risk. In a simple form, the yield will be a function of the riskiness of the estimated cash flows, with higher rates for riskier investments and lower rates for safer ones. Expected return has a positive relationship with the perceived risk of the investment. When investing, investors develop an expected return for investment. This can be achieved by attempting to quantify the risk that an investment might entail or by examining the long-run historical returns of the particular investment. In developing the expected return, the following formula is in use:

$E(R)= P_1R_1 + P_2R_2 + P_3R_3 +.....+ P_nR_n$

Where,

R= Possible return

P_n= Probability of return R_n occurring (p1, p2....pn Must sum to 1.)

Essentially, investment is the foregoing of immediate or today's consumption for an

enhanced later or future benefit. This benefit however need not be financial but in the case of financial benefit, it could come in the form of income or capital appreciation.

REVIEW OF THE RELATED LITERATURE

Real estate investors make an immediate and certain sacrifice of current purchasing power in expectation of future economic benefit. [1] posits that the primary purpose of an investment is the future income or profit which he summed thus: "The critical issue in appreciating the quantum or quality of returns or profit realized from an investment lies in the real value rather than nominal value of the return. Also, [2] argues that "these risks are important features of property performance measurement but the variability in returns of rent and capital appreciations are most crucial in their determination. In effect, the return from an investment, must as a matter of course be projected on a plane of time in order to give credibility to the quantum of the return." As such, investment proposals are evaluated by comparing the magnitude of the sacrifice with the quantity and timing of expected benefits and by considering the level of certainty with which expectations are held. "Investment return is therefore a function of income, capital return, and psychic income."[3]. Adjusting for time and uncertainty permits comparison among competing alternatives .In discounted cash flow valuation; an estimate of the value of an investment is;

$$\text{Value of investment} = \frac{E(CF_1)}{(1+r)} + \frac{E(CF_2)}{(1+r)^2} + \frac{E(CF_3)}{(1+r)^3} \ldots + \frac{E(CF_n)}{(1+r)^n}$$

Where:

R = rate of return re t s timate( )ws

n = Life of the Investment.

$E(CF_n)$ = the cash flow expected in period n.

The Relevant Splits

For the hair-splitting, the initial yield is based on annual passing rent. Company reports often use investment yield or yield on present income to summarise returns on a portfolio, and current or running yield as a snapshot of past year's performance. Valuers go further, incorporating risks and potential for growth in what we call an all risks yield. This is a comparison rather than a return rate but recognizes the real value of an investment. It lies not in what it earns today but over a period of time. If a property is close to a rent review or lease renewal, it will be valued by the reversionary yield based on the estimated, hopefully higher, rents to which rents are expected to rise. This will be set according to the ERV (estimated rental value), this reflects the worth at the rack rent for that property let on the open market. Market reports quote sector benchmarks but these are often the prime yield, which is narrowly defined for a fully rented property of the best physical quality, the best location and with the best tenant covenant. Most investments would be better compared with average yields, but even then individual property will vary according to lease lengths, covenant strength and time left before review. A rounded view of investment worth is encapsulated in the equivalent yield, which averages the initial and reversionary yield to produce a real income stream over time. This is also known as the IRR (internal rate of return). The gross redemption yield is seen more commonly in shares and bonds but can be a good disciplinary tool for property. Instead of vague predictions based on hope and judgement, investors can set a target for total returns on rent and capital growth over a specific period. It also provides a benchmark for comparison with alternative investments such as gilts (government stock).The most secure

investment is conventionally taken to be investment in undated or long-term government stock or bond referred to as gilt-edged security. This is secured on the total wealth of the Nation and so unlikely to be broken [3] [4]. The yield on gilts, therefore, is generally regarded as the riskless or default-free rate of interest which provides the datum for measuring the yields on other investments in the economy. Each investment should be valued at its total yield; the yield which reflects all the risks, including inflation, this is equated yield, the discount rate or internal rate of return which when applied to the income expected over the life of the investment produces a present value that is equal to the capital outlay. Shares can be rated by an earnings yield or dividend yield, calculated by profits net of corporation tax or dividends as a percentage of the current stock market price [5].

Applications to property valuation

The value of a property by an investment method of valuation is the sum of the present values of all the anticipated future net incomes from the property, discounted at the appropriate yield. Thus the market value of a property by investment method is given by;

CV = NI x YP

Where;

CV= Capital value or Market Value

NI= Net Income

YP= Years purchase

In single rate valuation, the remunerative and accumulative rates of interest are identical. For instance, if an investor expects a return of twenty five percent in perpetuity on an investment of N1per annum, the capital value to return ratio will be 100: 25 which gives a co-efficient of 4. This co-efficient is referred to as years' Purchase in perpetuity. Thus, it is evaluated with the model;

$$YP = \frac{1}{i} \quad \text{or} \quad YP = \frac{1}{\text{Appropriate yield}}$$

This sa i ication goes f term;

$$YP = \frac{1}{i}\left[1-\frac{1}{(1+i)^{n}}\right]$$ where n approaches infinity (∞) the model(1+i) grows large

$$YP = 1\left[1-\frac{1}{(1+i)^{\infty}}\right]$$ that the reciprocal tends to zero; we are therefore, left with; $= \frac{}{i}$

To embark on valuation the under listed factors must be taken into consideration, these factors must be weighted accordingly to adjust appropriately for the observed differences. These could be better archived by the creation of an adjustment table. The relevant factors are as hereunder stated;

- The nature of interest; Quantity and Quality.
- The purpose of Valuation.
- The basis of Valuation.
- Location.
- Age
- Legal factor
- State of repairs/maintenance
- The use to which the property is put
- The scope of the Valuation Exercise
- The method of Valuation to be adopted.

The detailed explanation of these factors should be examined in valuation text books by the relevant valuer, students or reader to fully appreciate and understand the process. These factors must be considered seriously especially in the analysis of comparables which will

eventually throw out the 'appropriate' yield. For instance, a five bedroom detached duplex at Independence Layout, Enugu and such property at Achara layout, Enugu could share the same accommodation features but are in different locations. Also, these properties may have similar title, in Quality and Quantity, say, Certificate of Occupancy and unexpired period but might Age differently and their maintenance cost can equally vary. For these reasons, care must be taken in the analysis of comparables [6] [7]. To aid in the adjustment of the data collected from comparables, an adjustment table could be prepared.

Table 1 Adjustment/ Analysis of Comparables.

Address	Description	Interest	Purpose	Basis	Location/ density	age	Repairs	Use	method	Initial Yield
Subject ppty. 7 carr, Asata, Enugu	Block of Six Flats	Building lease-deemed C of O	Mort-gage	OMV	High	30yrs	Fair	Res/ Commercial	Invest-ment	.03
4Nos True Comparables Asata, Enugu	Block of Six Flats	Building lease-deemed C of O	Sale	OMV	High	30yrs	fair	Res/ Commercial	Invest-ment	.03
Comparable New Haven	same	Assign ment	Sale	OMV	High	35yrs	fair	Res	Invest-ment	.025
Comparable Indep/layout	same	C.of O	Sale	OMV	Medium	25yrs	Good	Res	Invest-ment	.035
Comparable Uwani	same	Assign ment	Sale	OMV	Medium	6yrs	Good	Res	Invest-ment	.04
Comparable G.R.A	same	Allocation	Sale	OMV	low	32yrs	Fair	Res	Invest-ment	.025

Source: William Mba & Co; (2019)

To arrive at the appropriate yield, the mean yield of the comparables should be ascertained and adopted. These adjustments however cannot be done intuitively owing to the fact that it is essential to interpret the market and the property environment, since the valuer's advice is no guesswork but an interpretation of the prevailing Economic, political/social, legal and technological factors affecting the subject property [8].

Application of Conventional Valuation Model

Enugu is a well-known urban town in Nigeria. It is called 'Coal city' because it started as a coal-mining town. Its political importance as a capital city has greatly facilitated its speedy development and urbanization with the resultant appreciation in property values. The data on comparable properties were collected from the various layouts as well as the details of the Subject property as stated in the adjustment table.

Valuation worksheet, for the subject property, at No.7 Carr Street, Asata, Enugu. A block of 6nos residential/ commercial three bedroom flats. Required: to ascertain the Capital Value of the subject property having known the relevant yield as shown in the above table.

Basis of Valuation:

Our basis of valuation is the Open Market Value namely the best price at which an interest in the property might reasonably be expected to be sold by private treaty at the time of valuation, assuming a willing seller and a willing buyer, allowing a reasonable period for negotiation and property being freely exposed to the market such that all likely buyers are aware of its existence and no account being taken of a special purchaser [9]. Whereas the valuation approach is investment being that the property has periodic income.

Valuation:

Current Rental Value N200,000.00 per Residential flat per annum

			N250,000.00 per Commercial flat per annum
Gross Rent			1,300,000.00
Less Outgoing @	15%	x	.85

Net rent			1,105,000.00
YP in perp. @	3.0%		33.333

Capital Value			₦36,833,333.00
			==========

CONCLUSION

The Capital Value of say, N37,000.000.00 was estimated as the value of the subject property after due analysis of the comparables as shown in table 1 above. The hair-splitting therefore is no more than unique descriptions of the nature of the returns and the derivation processes, being a fully occupied residential/ commercial property with stream of rental income, the initial yield (Appropriate yield) was ascertained due to the availability of true comparables. As such, valuers and students should always identify these derivation processes for effective application to property valuations.

REFERENCES

1. Baum, A. Crosby, N. (1989), *Property Investment Analysis*, Routledge, London.
2. Baum, A. & Mackmin, D. (1996), *the Income Approach to Property Valuation*.4th Edition. Routledge London.
3. Idowu O. B. A, & Babawale G.K. & Anyakora M.I.(2012). An Evaluation of the appropriateness of the investment method of valuation for residential properties in Lagos: *Journal of emerging trends in economics and management sciences* (JETEMS) 3(1): 77-84.
4. Kalu I.U (2007). *Property Valuation and Appraisal*, Bon Computers, Nigeria.
5. Mba W.O (2017). A critical examination of discounted cash flow model as it relates to
6. investment in Nigeria. PhD Thesis, University of Nigeria Nsukka.
7. Ogbuefi; J.U (2004*). Aspects of Feasibility and Viability Studies*, Institute of Development Studies, University of Nigeria, Enugu Camps, Nigeria.
8. Ogunba, O. A. and Ajayi, C. A. (1998). An assessment of the accuracy of valuations in the residential property market of Lagos. *The Estate Surveyor and Valuer*. 2(2): 19-22.
9. Udo, G.O. (2003). *Model Building in Property Valuation*, Institute of Development Studies University of Nigeria. Enugu, Nigeria.