OAK INVESTMENT MANAGEMENT GROUP

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Valuation and Real Estate

Valuation in real estate, as with any asset class, is as much an art as a science. No two properties are identical yet investment professionals are always asked to justify an appraised valuation with or without an actual offer and / or transaction on the asset in question (which is the empirical value of an asset). A valuation can be done with reference to contracted and assessed potential cashflows; or with reference to comparables; or with knowledge of participants' hypothetical willingness to pay / to sell.

Intrinsic valuation in real estate can be measured against the cash flow associated with a building as well as with the best estimate of a residual value of the property at the end of that time. An appropriate discount rate is applied to these cash flows and a present value is applied. Understanding of the nature of the contract in this case as well as a best estimate of terminal value is critical in this form of valuation.

Comparable valuation in real estate is arrived at with similar or weighted composites that reference what other participants in the market have been seen to pay for analogous assets. This seeks to see what other participants have paid and see what the market values the asset at. Understanding the dynamic nature of the market (that yields can be widening or tightening) is critical to arriving at a realistic valuation of the asset using this method.

Willingness to pay / sell is the fulcrum band or market price range at which a buyer would buy and a seller would sell. The reason that this is a band or range is that in every case of the working market there is a margin between what the buyer would pay and seller would sell at. This requires deep knowledge of the market and of assets that are not openly available to be bought or sold.

These three fundamental valuation techniques can be blended formally or informally. It is important to note that even a formal valuation is never a guarantee that the price is right for the purchaser or vendor. All valuations can be blinded by *seemingly* decreasing market opportunity cost in all markets (a boom) or *seemingly* increasing market opportunity cost. Rigid valuations can lead to disasterous disposals as well as exuberant purchases at exactly the wrong time in the cycle.

The two main problems for any valuation technique are that 1) price is determined by the last marginal entrant, and 2) that investing is over long inter-temporal periods. A thorough valuation should measure the opportunity cost of an investor over bench mark such as treasuries or gilts but also leave a margin of error. A market that is thriving and liquid could easily be become illiquid the next. What is a valuation worth in an illiquid market – it is a *hypothesis* for reversion to average.

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