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Residual Value in Real Estate

The value of tenanted real estate can be separated into the value of the net contractual cash flows emanating from a lease as well as the value of the property on a vacant possession basis at the end of the same lease. Contractually obliged cash flows are the most clear to see (and to measure), The costs associated with these cash flows are moderately foreseeable but fairly predictable. The residual value of a building is the hardest to ascertain.

Residual value is hard to ascertain because it needs to accommodate the absolute value of a building in the future, the competitive entry of new supply as well as the requirements of current and yet-to-be-conceived businesses. All of these factors are statistically discrete but the collective results are binomial. In other words, although the contributory factors can be incremental either the residual value is worth something or it is worth nothing. This can make or break for the profitability of an investment in a building.

Residual value is sensitive to investors in the market with large liquidity and, by implication, access to high leverage. However, this does not mean that the fundamentals of residual value do not exist. If an asset is well located, is well maintained throughout a lease and is competitive at the end of a lease it will be desired by the market.

As opposed to the money markets, in real estate there are some exceptional circumstances when the residual value can be of a minus value. The costs of holding real estate in terms of fixed state / local / property taxes, continued ownership protection / enforcement, environmental contamination and other liabilities can be significantly painful in economic terms to the owner of the residual real estate. There can also be exceptional circumstances where the residual value contains almost all of the value of an investment to the extent that there is no cash flow (it is important to note that governments are more favourable to capital gain return than the other). Either way, these exceptional circumstances need to be examined carefully to avoid an investor's value trap.

If the standard residual value of a building is considered by itself, it is driven by what it could be rented for in the future and what a developer might ascribe to its value both of these are pure estimates with a very high standard deviation. The former needs to be adduced from trends in the current market and the latter from pure hypothesis of percentage band of the retail value of a re-developed product a builder might be willing to pay. Neither method can be considered particularly infallible because no one can tell the future.

Residual value is an important metric on which to base the valuation of a property. It is a guide but something that cannot be relied on to the exclusion of other factors. The price is a real time view of what the market sees, a coupon should be discounted at the appropriate rate and a residual value should be seen as the level of trust an investor has in the asset itself at the end of the period.

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