
EDUCATION BRIEFING

Property valuation in the UK: market value and net of costs

Property
valuation in
the UK

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Abstract

Purpose – The purpose of this paper is to comment upon the relatively straightforward but often contentious practice of allowing for costs on the capital value derived by the investment model of property valuation.

Design/methodology/approach – This education briefing is an explanation of the discounting process to allow for costs used in practice.

Findings – Although, the deduction of cost is a simple use of algebra, often valuers (and, in particular, students) fail to make the allowance correctly.

Practical implications – The process of allowing for cost is a simple heuristic based on market averages for various individual costs such as agents' fees and legal fees (including VAT) and property taxation (stamp duty).

Originality/value – This is a review of existing models.

Keywords Property valuation, Market value, Capital value

Paper type Editorial

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Introduction

All valuation approaches[1] are attempting to estimate market value (MV), the price of the property in the market on the date of the valuation. MV is defined as:

The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion. (IVS 30, 2017)

It is a price definition. The International Standards go on to say that:

Most bases of value represent the estimated exchange price of an asset without regard to the seller's costs of sale or the buyer's costs of purchase and without adjustment for any taxes payable by either party as a direct result of the transaction. (IVS 210.1, 2017)

This paper looks at the adjustment to the calculated capital value (by the investment method) to determine MV (before costs).

Costs of purchase

In the UK, when an investor purchases an investment property, they incur various costs. These are:

- (1) agents' fees;
- (2) legal fees;
- (3) VAT on the above; and
- (4) Stamp Duty Land Tax (SDLT) (property transfer tax)[2].



For the fees, average percentage costs are applied and then VAT is applied (at 20 per cent) to these figures and added to the SDLT percentage (based on the purchase price). For most transactions, these are lumped together as a total cost of 6.78 per cent on the purchase price (MV) for most commercial property. This will be slightly lower for less expensive property as SDLT is a progressive tax based on purchase price (see below).

The figure of 6.78 per cent for larger properties may be calculated in Table I. Although 6.78 per cent seems very precise, two of the main components (agent and legal fees) are aggregated averages from the market and they may vary for different investors according to their particular arrangements with the professionals involved. Likewise, the nature of the SDLT calculation means that the precise tax percentage paid varies according to the purchase price. The total figure for costs is an approximation.

Thus the use of 6.78 per cent is a heuristic.

Stamp Duty Land Tax (SDLT)

In the UK, an investor must pay SDLT for all properties and/or land purchases over a certain price. The current (November 2018) SDLT threshold is £125,000 for residential properties and £150,000 for non-residential land and properties.

Non-residential property primarily relates to the commercial property but also includes agricultural land, forests and any other land or property which is not used as a residence[3]. SDLT is a progressive tax based on the property value (purchase price) (see Table II).

This progressive tax means that the actual percentage paid will vary according to the price of the property. For example, a property at a price of £500,000 will pay 2 per cent on £150,000 (£3,000) and 5 per cent on £350,000 (£17,500) which is total of £20,500 tax which is 4.10 per cent on the purchase price. Whilst another property at a price of £1,000,000 will pay 2 per cent on £150,000 (£3,000) and 5 per cent on £850,000 (£42,500) which is total of £45,500 tax which is 4.55 per cent on the purchase price.

Thus, if the valuer is estimating a stamp duty cost by a simple averaging, it has to be based on an average price. Different valuers may estimate slightly different figures but the convention in the London market at the moment (2018) is 6.78 per cent (see Table I).

The deduction of costs

It is interesting that many valuers, with whom I have debated the deduction of costs, argue that as the IVS says that MV is the figure calculated “without regard to the buyer’s costs of purchase and without adjustment for any taxes payable”. They argue that the deduction of cost is therefore contrary to this requirement.

Table I.
Calculation of average
% purchase costs

(a) SDLT Calculation (see below) (based on an average price of £2 m)	4.78%
(b) Acquiring agents’ fees	1.00%
(c) Acquiring lawyers’ fees	0.67%
(d) VAT on (b) and (c) @ 20%	0.33%
Total	6.78%

Table II.
SDLT for freehold
sales and transfers

Property value	SDLT rate (%)
Up to £150,000	0
The next £100,000 (the portion from £150,001–250,000)	2
The remaining amount (the portion above £250,000)	5

But that misses the point of the investment method (using an implicit model, see Figure 1). The investment method derives the gross figure that the investor can pay including costs. So in the example below, the investor has a “kitty” of £17 m to spend to buy the property at an initial yield of 5 per cent. This is the “total” expenditure or capital value. But the capital value is the price of the property “plus” costs of purchase. That means that the investor needs to pay 6.78 per cent on the purchase price.

The MV of the property is the capital value (MR×YP) allowing for costs. In this case, it is assumed that the cost of purchase (fees, stamp duty and VAT) is 6.78 per cent. Thus if the investor pays £15,920,584 for the property then the total spend, including fees of £1,079,416, will be £17 m. Remember that the 6.78 per cent is paid on the purchase price so to calculate the purchase price the valuer needs to divide the capital value by 1 plus the per cent costs:

$$CV/(1 + \text{costs}) = MV,$$

$$£17\text{m}/(1.0678) = £15.92\text{m},$$

$$\text{Costs at 6.78 per cent} = £17\text{m} - £15.92.$$

So the deduction of costs from the gross capital value figure is actually 100 per cent consistent with the IVS statement that MV is the figure before the addition of costs. The confusion lies as the valuation method initially determines the gross capital value and NOT the MV. Hence the deduction of costs from the capital value to derive the MV. An analogy from a different market is to look at auction sales. When the hammer comes down, that is the price or MV of the asset. Yes we all know that the gross payment will be increased by the auction fees. Price plus fees is the capital value.

Net initial yield

This is also consistent with the calculation of net initial yields. The net initial yield is simply the ratio of the initial “net” rent over the GROSS capital value (price plus costs); the NIY is an observed yield calculated by looking at comparables.

Thus in this case, the Net market rent = £850,000, Gross capital value is £17 m:

$$\text{Net initial yield} = \frac{\text{Net initial income}}{\text{Gross capital value}} = \frac{850,000}{17,000,000} = 5\%(\text{NIY}).$$

Conclusion

The goal of this briefing is to comment upon the market practice of deducting costs from the capital value. Most textbooks and most university courses fail to discuss this market heuristic and suggest that value is the capital value. It is important that the simple market practice of deducting (average) costs from the capital values calculated is recognised as the appropriate way to derive MV when using the investment method.

Market Rent	£850,000		
YP perp @ 5.00%	20	Capital Value (CV) before costs	£17,000,000
		less costs at 6.78%	£1,079,416
		Market Value (MV)	£15,920,584
		MARKET VALUE, rounded say	£15,925,000

Figure 1.
Implicit income
capitalisation

Notes

1. The International Valuation Standards (IVS, 2017) are published by the International Valuation Standards Council (IVSC). The IVS recognises three main approaches to valuation: the income, cost and market approach.
2. SDLT is paid in England and Northern Ireland; in Scotland the equivalent tax is called “Land and Buildings Transaction Tax” and in Wales it is the “Land Transaction Tax”.
3. Non-domestic also captures six or more residential properties bought in a single transaction as these are most likely to have been bought to let (income producing properties).

Reference

IVS (2017), *International Valuation Standards*, IVSC, London.

Further reading

RICS (2017), *RICS Professional Valuation Standards*, Royal Institution of Chartered Surveyors, London.

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