RICS guidance note

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Valuing residential property purpose built for renting

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RICS professional standards and guidance

RICS guidance notes

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1 Scope

1.1 Since the economic downturn that started in 2007, there has been renewed interest and significant investment in the UK residential rented sector by market participants looking to acquire substantial holdings of residential property for long term letting. This guidance supersedes the RICS information paper *Valuing residential property purpose built for renting*, 1st edition, 2014. This guidance note addresses the valuation of such assets, commonly described as build-to-rent, though it is emphasised that this guidance is directed to the valuation of completed assets – whether restricted to renting or not – rather than those under development.

1.2 Build-to-rent property is likely to possess the following broad characteristics:

- accommodation will typically comprise of at least 50 self-contained dwellings or a concentration of a similar number of dwellings
- the dwellings will be separately let, but held in unified ownership
- management and oversight will be under a single entity, potentially with an onsite presence
- the building(s) may be specifically designed or adapted for rent, and may include some form of shared amenity and
- the individual dwellings are typically let on assured shorthold tenancies.

1.3 The market for build-to-rent property is considered to differ from the buy-to-let market. This is because the former is typically focused upon the ownership of entire blocks of flats/apartments or concentration of dwellings including houses in single locations rather than the smaller scale, more dispersed or granular nature of the holdings of participants in the latter.

1.4 This document is designed to be succinct and does not seek to cover all potential variations. It gives guidance on the general approach to valuation that should be adopted for the build-to-rent part of the residential investment sector and recognises that – reflecting market practice – the principal basis should be an income-driven one. While it is imperative that the valuer has regard for the requirements of the specific valuation instruction, it is intended that this guidance should apply to the assessment of market value for most purposes, for example for acquisition, disposal, financial statements, performance or loan security.

1.5 This guidance is aimed primarily at practitioners in England, Scotland and Wales, but it may also be relevant to valuers practising in the rest of the UK and in other markets.

2 Introduction

2.1 Over recent years there have been several initiatives designed to:

- increase the supply of housing in the UK
- encourage institutional investment in the residential sector and
- promote the growth and quality of the private rented sector.

2.2 Since the 1960s, residential development in the UK has predominantly been focused on owner occupation. Elsewhere in the world, this is not the case. However, a market is evolving in the UK that is focused on longer-term letting with a specific emphasis on:

- long term ownership
- customer service
- maintenance and management costs and
- occupier demand.

2.3 The proportion of people in the UK renting their home in the private sector has been steadily increasing in recent years.

2.4 The majority of this increased demand in the rented sector has been met by private investors acquiring a small number of homes. This has been supported by tax incentives and an ample supply of specialist mortgage credit. While buy-to-let investors are likely to remain active, tax treatment is increasingly less attractive.

2.5 Given the scale of build-to-rent developments, likely purchasers might be:

- financial institutions and funds both from the UK and abroad
- medium and larger corporate investors or
- registered providers of affordable housing.

For smaller schemes, the market may also include speculative investors who wish to target a medium to long-term break up sales opportunity of units into the individual investor/owner-occupier market.

2.6 Purchasers of assets to be held for rent are likely to apply detailed analysis to investments assets and will undertake assessments of value principally based on projected net operating income (NOI) returns rather than assessing the value of an asset based upon a hypothetical sale of the constituent parts to individual buyers.

2.7 It is important for valuers to possess the appropriate expertise and skill to understand the operation of the market and the impact, as well as the motivation, of those participants expressly seeking to acquire and hold an asset for long-term rent. The range of factors to be considered can be very wide – regulation, planning and taxation regimes continue to evolve and need to be properly weighed and reflected. Similarly, valuers should be aware of the different forms of build-to-rent structures being agreed in the market, e.g. forward fund, forward purchase stabilised asset acquisition, etc. Valuers should make sure they understand the deal structure when analysing comparable transactions.

3 Form of tenancy

3.1 The majority of assets that are held for rent will be occupied by tenants on assured shorthold tenancies (ASTs) or contractual tenancies (company lets and those outside AST rental value limits). Under an AST the rent and term are agreed between the parties. Repairing obligations tend to rest almost entirely with the landlord; however, the tenant might be liable for the internal parts and furniture.

3.2 The valuer needs to take all the terms of individual ASTs or occupational agreements into account when valuing the asset. Particular regard should be given to the obligations of each party, length of the tenancies and any rent review provisions or break clauses, particularly in view of the prevalence of terms of more than 12 months.

4 Valuation considerations

4.1 When valuing build-to-rent assets, it is especially important that the valuer clarifies at the outset:

- the precise nature and extent of the asset(s) being valued
- the purpose of the valuation
- the basis of value to be adopted
- the information (about lettings, etc.) to be relied on
- the nature and extent of the valuer's work, including investigations and
- any assumptions or special assumptions to be made.

RICS Valuation – Global Standards 2017 (the Red Book) Part 4 provides guidance on valuation requirements, process, inspection and assumptions.

4.2 The asset may or may not coincide with what is physically seen on the ground. Great care is needed to ensure that there is no ambiguity as to the precise nature and extent of the interest being valued, including limitations or constraints on its use.

4.3 The purpose of the valuation may influence the basis of value to be adopted. Common instances where a valuation is likely to be sought include (but are not limited to):

- acquisition
- disposal
- financial reporting
- asset performance or
- loan security.

4.4 Owners of build-to-rent are often keen to establish Investment Value, e.g. when reviewing portfolio performance, rather than market value or fair value, for IFRS/UK GAAP for financial statements.

4.5 Refer to the *RICS Valuation – Global Standards 2017* Part 4 for further detail on requirements and guidance on bases of valuation and reporting.

4.6 Clarity about the market in which the asset would trade is essential. Valuers should initially consider the likely categories of purchasers and buyer profile relevant to the asset, and the competition that might come from participants with different motivations.

4.7 The primary driver for a buyer of a build-to-rent asset is the value of the existing and potential net income stream. Key valuation considerations in this context are:

- security of the existing income
- the potential for rental growth and assessment of the market rent
- likelihood of tenant change, speed of let up, depth of occupier market and void rates
- assessment of the likely expenditure necessary to sustain the current income and market rent
- an assessment of any additional factors that could materially affect the value of the asset, such as legal or planning considerations (such as a covenant that may limit individual dwellings to rent for a period)
- an assessment of the appropriate investment return and
- as a 'sense check' the underlying potential to sell off the individual dwellings, one by one for sale – often referred to as the 'break-up potential' – assuming this is permitted in planning/legal terms.

5 Valuation approach

5.1 Key principles

5.1.1 The primary driver for a buyer of an asset to be held for rent is for secure long-term income. Valuations should reflect this where such an approach is consistent with the motivation and practice of market participants generally.

A valuer's principal approach is likely to be an income capitalisation one, not dissimilar to the practice widely adopted by the commercial real estate sector.

A key difference between commercial and residential occupational tenancies is that, in residential, the liability for the majority of the maintenance and upkeep (and associated costs) rest with the owner rather than the occupier. Hence a detailed assessment of relevant costs associated with the income that can be obtained from a property is a key consideration in the valuation of properties held for rent.

Figure 1 illustrates the valuation approach, and the following sections of this document provide more detailed guidance and comment on its practical application.

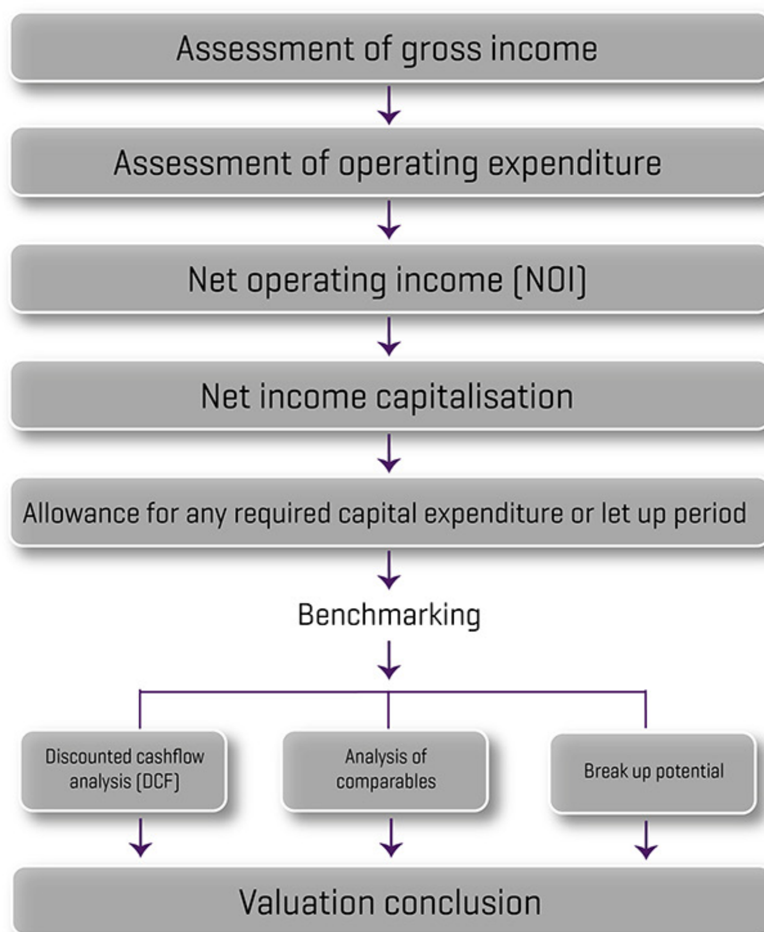

Figure 1: Valuation approach

5.2 Assessment of gross income

5.2.1 Valuers should arrive at their own views on the market rent for the asset. The market rent should represent the total potential gross annual rental income. When comparing the current gross income against the market rent the valuer should have regard to the circumstances relating to the existing lettings, such as incentives to achieve let up and the seasonality of the lettings market. The valuer should use his or her judgment to make any necessary adjustments from comparable rental evidence to the subject asset, considering factors such as:

- location
- unit size/aspect
- age
- quality
- design
- amenity and
- length of tenancy, etc.

5.2.2 Valuers should reflect any reduction in potential gross rental levels for units that may be restricted to being let at affordable private rent – formerly known as discounted market rent, intermediate rent or any other affordable housing tenures – as part of planning obligations.

5.2.3 Valuers should ensure that all the different features of each unit in the block are reflected and their actual or potential income accounted for. Other than rental income, sources of potential ancillary income may include parking spaces, storage, services and utilities (e.g. cleaning, broadband), furniture hire, etc. The valuer should ensure that any ancillary net income is fully analysed in the context of the market and value attributed if it would be reflected in bids made if the property were to be marketed.

5.2.4 Consideration should be given to potential income lost through bad debts or delays in payments, non-recoverable arrears, voids and tenancy turnover. Valuers should also consider any local legislative provisions, for example relating to actual or potential for rent controls. Similarly, valuers should assess the impact of existing and future supply of similar accommodation.

5.3 Assessment of operating expenditure

5.3.1 Investors looking to hold properties for rent typically assess assets on the basis of net income returns. The valuer should where appropriate reflect this – always having careful regard to the basis of value being adopted and where they do they should assess the likely expenditure required to maintain the current and assumed market rent levels. The valuer should undertake a detailed analysis of the expenditure for the asset together with a benchmarking exercise against the cost of running comparable build-to-rent assets.

5.3.2 In order to assess net operating income (NOI), the relevant costs can be categorised according to the flow chart set out in figure 2.

Figure 2 is based on the operating expenditure categories collected by MSCI (formerly IPD) for their residential index.

5.3.3 Valuers should carefully consider the VAT treatment on expenditure, as to whether it is recoverable or not.

5.3.4 Where detailed accounts are available for individual assets, both comparable and the subject, the operational costs should be scrutinised and an appropriate deduction made from the gross income in order to determine the net operating income. Where operational costs are not available, i.e. assessing the market value on the special assumption of being completed at the valuation date (see *RICS Valuation – Global Standards 2017* (Red Book) VPS 4 Section 9), a deduction should be made based on market driven operational costs. This can be identified from the analysis of comparable properties and based upon the valuer's knowledge of the market. Similarly, when the valuer is provided with information from the client, consideration should be given to whether the lettings and management functions are undertaken in house or by an external agent, as the impact on operational costs may be significant. Where operational costs are considered abnormally low or high adjustments should be considered, again based on comparable properties, together with the valuer's judgment.

5.3.5 Valuers should seek as much information as possible about actual operating costs from the owner or manager where practicable, and use their skill and judgment to source appropriate market information to support their assumptions in relation to the expenditure items.

5.3.6 In addition to the assessment of operating expenditure, the valuer should also consider other costs that might be incurred. This includes any capital replacement costs relating to major repairs and replacements of items, such as:

- roofs
- lifts
- internal fittings
- appliances
- furniture
- kitchens
- bathrooms
- heating plant and
- redecoration, etc.

These costs may be significant but can occur infrequently and need to be reflected in a capital deduction where investors would obviously wish to make an adjustment. They might be difficult to estimate and a valuer may need to seek separate advice from construction professionals.

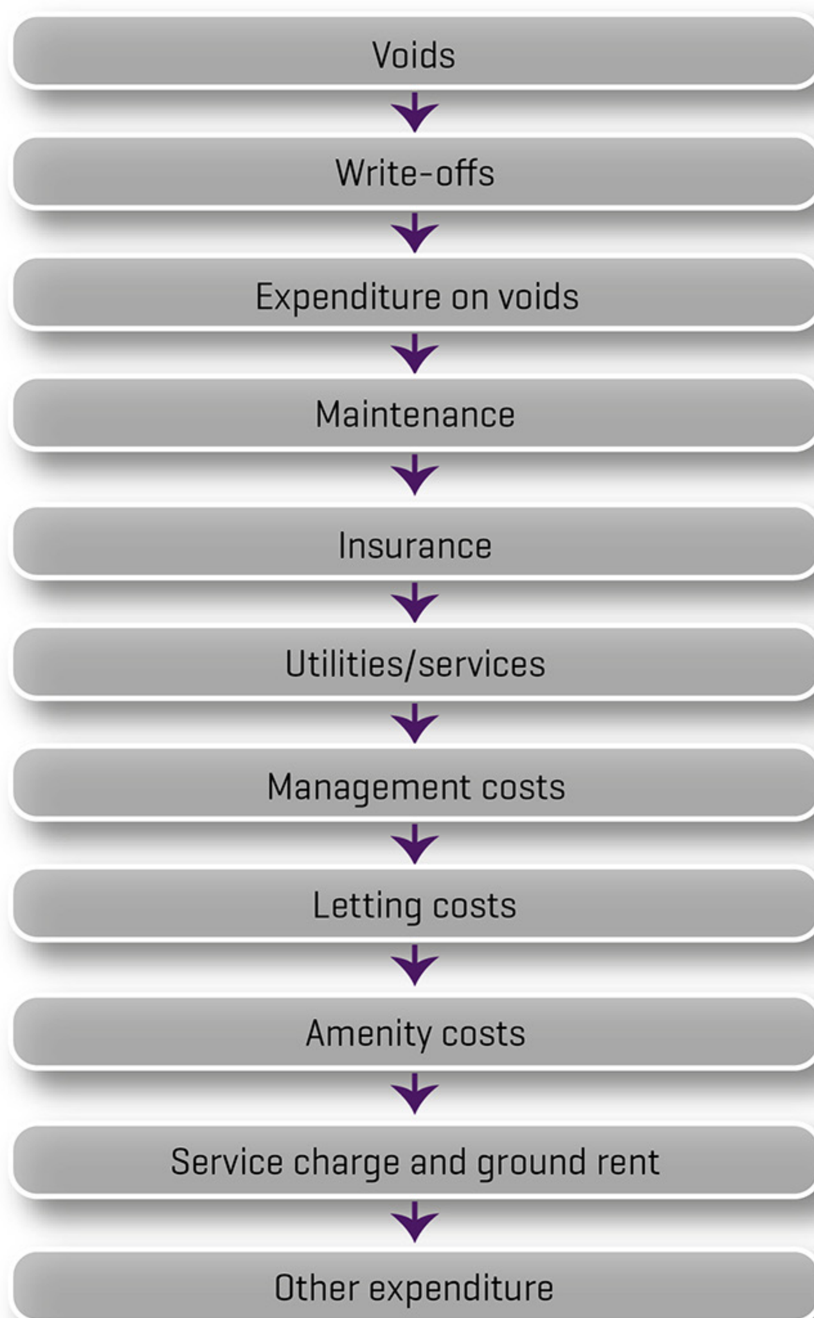

Figure 2: Assessment of operating expenditure

5.4 Net income capitalisation

5.4.1 The valuation of assets of this nature will typically be derived from the capitalisation of the net income, with a deduction made for purchaser's costs. For properties that are vacant at the date of valuation an allowance for a letting up period and associated costs (such as furniture where relevant) should be made. Similarly, where due diligence highlights that works are required to achieve the assessed market rent, an allowance for capital expenditure will also be appropriate.

5.4.2 While the role of the valuer is to interpret the way in which potential purchasers of the property would assess their bids in pricing the asset, which may include the use of a discounted cash flow model (as set out in *Discounted cash flow for commercial property investments*, 1st edition, 2010), the most comparable frame of reference to calculate value is typically to apply an appropriate capitalisation rate to the net income. Where a building is being developed and a capitalisation rate is applied to the anticipated 'stabilised' net rent, a valuer should make an allowance for let up to determine the market value on the special assumption of completion. For build-to-rent, 'stabilised' is taken to mean the likely longer-term steady state of occupation following the initial let up period. When this will be achieved will vary from asset to asset.

5.4.3 A further deduction should be made within the valuation for purchaser's costs, reflecting an investor's true net position, comprising acquisition fees – agent's and legal fees plus VAT – and stamp duty. Care should be exercised when doing so to ensure deductions are representative of the market rather than the specific stamp duty position of the individual investor. Note: At the time of publication, care needs to be taken to identify whether commercial SDLT or residential SDLT subject to Multiple Dwelling Relief (MDR) would apply. Comparable transactions should be analysed on this basis and the same methodology applied to the valuation, to provide a uniform approach.

5.4.4 Adjustments should be made to the yields reflected by comparable transactions to determine the appropriate capitalisation rate to be applied to the valuation. Factors affecting this include:

- location
- lot size
- tenure
- existence of a covenant restricting the dwellings to renting for a defined period
- lease structure
- security of tenure
- income security and rental
- capital growth prospects (e.g. whether the property is rack rented, reversionary or overrented)
- investor sentiment and
- competition (both existing and pipeline).

5.4.5 The capitalisation rate will be informed by careful analysis of comparable transactions and applied to the net yield (net of purchaser's costs). Where appropriate, this will be adjusted to be on the special assumption of a stabilised state, if the comparable transaction occurred during the development or let up phase.

6 Benchmarking

6.1 Principal benchmarks

6.1.1 Having arrived at an assessment of value through the application of an appropriate net income, capitalisation rate and deduction for purchaser's costs, valuers should undertake benchmarking prior to concluding their opinion. This will be especially relevant in relation to market value. Benchmarking is likely to comprise of:

- comparison with the aggregate of the vacant possession value plus notional ground rent value (if applicable) and car parking (aggregate break-up value) and
- a cash flow analysis to estimate the likely returns to an investor of ownership of the asset. Valuers should refer to *Discounted cash flow for commercial property investments*, 1st edition, 2010.

6.2 Aggregate break-up value

6.2.1 Valuers should also, as appropriate, benchmark the proposed valuation against the theoretical aggregate of individual unit market values on the special assumption of vacant possession plus notional ground rent value (if applicable) and car parking.

6.2.2 While there is no defined relationship between the two, valuers should consider that investors will reference both figures in their analysis to ensure any difference between them is readily explainable.

6.2.3 As part of their considerations concerning the relationship between market value and the aggregate market value on the special assumption of vacant possession, valuers should also consider whether it is appropriate to undertake a cashflow assessment of disposing of individual vacant units into the marketplace. Key indicators such as:

- absorption rates to protect from flooding the market
- the ability for a development to be practically 'broken up'
- the buyer's desired profit/return, costs of sales
- potential house price changes during the disposal period and
- the costs of holding vacant units.

These should all be reviewed to give a like for like comparison with the market value figure of a let investment. This factor may be particularly relevant for large-scale schemes.

6.3 Cash flow analysis

6.3.1 By undertaking a detailed cash flow analysis, valuers are able to assess the likely level of return from investment of the asset at the determined opinion of market value by utilising assumptions for all key investment variables such as initial letting up period and costs, rental growth, house price inflation and potential changes in expenditure over time.

6.3.2 Effectively, the resultant internal rate of return/ discount rate will be representative of investors estimated annual returns. The level of long-term interest rates, and the overall cost of funds, would be reflected in the investment return assessment and will enable comparison with other potential property or other investment opportunities. In addition to considering the cost of funds, the valuer should also make an allowance for the risk attributed to the cash flow assumptions. The margin for risk needs to be considered on a case-by-case basis, having regard to the location, supply and demand now and in the foreseeable future, plus the nature of the building. Detailed guidance is provided to valuers in *Discounted cash flow for commercial property Investments*, 1st edition, 2010.

6.3.3 The cash flow approach also enables valuers to investigate the potential for different exits for investors, enabling an analysis of both onward sale as a single transaction to another investor or a break-up sale into the owner-occupier/buy-to-let market as applicable. The practicality of either option will depend on the individual characteristics of the asset in question and market conditions.

6.3.4 Valuers should also consider the application of growth assumptions to income, the effect of inflation on expenditure variables and capital values where reflected in market activity. In adopting explicit growth assumptions within their financial projections, valuers should be mindful of the impact on the discount rate/internal rate of return to be adopted.

6.3.5 Any financial modelling will require the valuer to test a variety of assumptions and exits to measure potential levels of return and analyse the sensitivity of key assumptions. It is important to note that it is unlikely there is one 'market assumption' for the key investment case variables.

7 Other valuation considerations

7.1 Valuers should be mindful regarding the likely age and condition of the property at the end of the cash flow period and reflect these where appropriate. This may apply to both capital and rental values. Similarly, relative obsolescence should also be taken into account.

7.2 Valuers should be aware of the different forms of build-to-rent financing structures being agreed in the market (e.g. forward fund, forward purchase stabilised asset acquisition, etc.) and make sure they understand the deal structure when analysing comparable transactions.

7.3 For valuations that include elements of commercial property or other uses – such as affordable housing – appropriate valuation methodologies should be applied to the relevant property uses and included in the overall market value for the asset. Care should be taken to ensure that potential investors' appetite for mixed use investment is taken into consideration. It should not automatically follow that, for example, the market value is simply the sum of the residential and commercial elements of the valuations, although this may be the case.

7.4 Build-to-rent assets that include a proportion of affordable rent dwellings are also emerging. The valuer should pay close attention to the treatment of the valuation of such dwellings (and any impact on the remainder of the asset) and should reflect the terms of any legal agreement relating to their occupation, including any clawback, viability review or potential reversion to private use as appropriate.

7.5 In some instances a build-to-rent asset may be the subject of a restriction to renting only, either in perpetuity or for a defined period. This may be by way of the imposition of a covenant through the planning permission for the property. The valuer should take such restrictions into account, particularly when undertaking the benchmarking element of the valuation. The covenant is likely to differ from asset to asset and might be subject to clawback provisions to allow a sale of the individual dwellings. The valuer must therefore ensure that it has reference to such relevant provisions and takes these into account appropriately in the valuation.

8 Valuation considerations in Scotland

8.1 Valuers should have regard to any specific Scottish government initiatives that may be in existence at the valuation date, i.e. the Rental Income Guarantee Scheme (RIGS).

8.2 There are a number of differences between Scotland and the rest of the UK worth noting when considering taxation of the asset. The valuer must refer to the relevant Scottish legislation.

8.3 The Scottish government has also made available a multiple dwellings relief where six or more residential properties are purchased in a single transaction. This is comparable with the multiple dwellings relief available under SDLT (Stamp Duty Land Tax). However, such transactions in Scotland are also exempt from the three per cent LBTT (Land and Buildings Transaction Tax) Additional Dwellings Supplement.

8.4 The private residential tenancy came into force on 1 December 2017 and aims to strike a balance between the needs of landlords and tenants. This provides a modern, streamlined tenancy system reflecting the recent growth in private renting as a mainstream housing tenure. Through consultation with industry and wider stakeholders, the Scottish government has developed a Model Tenancy Agreement. Rather than having an initial term, the tenancy is open-ended, which landlords are able to terminate using one of 18 defined 'grounds for eviction', and tenants by providing a 'notice to leave'. All initial rents will be market-led and can be increased annually. Enforcement of the new tenancy system will come via a specialist housing tribunal.

8.5 In addition, valuers should always consider requirements specific to individual jurisdictions within the UK.

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