Determining the Correct Price of Real Estate

By Michael Hart

I was recently listening to economist Mike Munger talk about how people agreed on prices when they were exchanging goods or services and he made an interesting point. He said, “For people to agree on a price, they have to disagree on the value.” That’s somewhat contrary to what we often think, but it raises a good point. For two people to agree on a transaction, each one needs to think they are getting a good deal, or at least the best deal they can under the current circumstances. And as the economy is changing amid the shocks brought on by Covid-19 and many real estate assets sit empty, at some point soon, things will sell. And for that to happen, people are going to have to start agreeing on prices. So how are prices determined in real estate?

Real Estate Valuation

There is a specialty in the property industry called valuation, sometimes called appraisal, where property professionals are called in to assess a property and give it a value. When you apply for a property loan for example, the bank will first request an official appraisal to determine the price. Over many years, valuers have developed several methods of reaching a value. In a normal appraisal, valuers will assess a property from at least three different perspectives and then hopefully find that these different values match up roughly at a similar number, which they can then assign as the current value of the property. We’ll discuss each method below, but common methods are the comparable sales approach, the cost approach and the income approach.

Comparable Sales

Using the comparable sales method to determine a property value is what most people are familiar with. This means if you want to buy a two-bedroom apartment or 50-storey office building, first check to see what the prices were from a list of recent transactions of a similar property type. If you are shopping for the apartment, this is pretty easy, because there are loads of two-bedroom apartments for sale. Adjustments need to be made to make sure the apartment is in the same district, in a similar style complex, perhaps has the same school district, is on a similar floor, has the same amenities, etc but with plenty of stock available at any time, this can be done pretty quickly. For an office building, it’s a bit more complicated. There are databases of commercial office buildings, but there are not nearly as many and probably not many that have sold recently, nor are they necessarily of a similar age or quality standard. Valuers will usually find three examples that are similar to the target property and then note down their differences to allow for price adjustments to be made later in the final analysis.

Cost Approach

The cost approach is very simple in concept, but sometimes a little trickier to complete. With the cost approach you do the thought experiment, if you had to build the project again today, what would that cost you? This approach is sometimes also referred to as the replacement cost method. You start by looking at land costs, then at construction costs, then at things like contractor and developer profits, agent fees, etc and you arrive at your estimated total cost. This is why there is big news when land lots are sold at record high prices. These record prices are telling us that the value of our apartments or office buildings have probably also gone up, because the input costs to build something similar have also gone up. There are often challenges to this approach because there may not be much new land being sold in a crowded district, you have to make estimates for the current input prices of things such as steel, concrete, labor, etc. Since I've been in China, the cost of labor has increased substantially as have most input prices since the country has been on a multiple decade long building boom. Again, it sounds easy, but this approach makes you look far outside of simple real estate to find the price of an asset. Few buyers of residential real estate will undertake this exercise, but for buyers of commercial real estate it is essential.

Income Approach

The income approach can be used to value anything from a business to a stock to a real estate asset. It is sometimes also called the Discounted Cash Flow or DCF method and there are plenty of detailed descriptions available online. DCF is in fact the preferred method of valuation for most professional investors outside of China. Potential buyers want to know, if I buy this asset, how much money will it produce for me? For this method, you estimate the income generated by the property each year and then you apply a discount rate, because a dollar earned today is worth more than a dollar earned a few years from now you are discounting the value of those future payments. According to this method, empty real estate isn't worth anything and that is one reason that it isn't very popular in China today. Many investors have bought a property, left it empty and then after a few years sold it at a profit because the overall market prices have increased. I don't think this is likely to continue for much longer and I find the income approach gives potential buyers a much more sober view of what the value of their asset might really be. The method often doesn't work well in developing markets were prices and the market are changing rapidly, but you should still calculate the number as a baseline. I do think over the next few years this will be an increasingly important approach to values. In some foreign countries, when buying an investment property, if you take out a loan, banks will require you to agree to minimum rental levels, to ensure the income generated by the property can help cover the mortgage payments.

What if there is a disagreement?

Remember I said in their official reports, valuers are supposed to use three different methods and hopefully they all generate a similar result. What if they don't? As I noted, when a market is rapidly developing and prices are moving fast sometimes there is a mismatch. Sometimes there is a problem with the comparable chosen. For example, don't let an agent tell you an apartment with the view of a green park on one side of the building is worth the same as one facing the parking garage. If there are loads of empty apartments and they are generating no income for owners, prices should go down because the income they could potentially generate is also declining. And sometimes a discrepancy between the three calculation methods indicates an opportunity. One famous real estate investor says when property prices have fallen below replacement cost, he thinks it is time to buy. Make sense to me, but you have to dig a bit to find replacement cost.

Conclusion

I think before you buy a real estate asset you should at least try and calculate the price through these three different methods. If nothing else it will give you some insight into how the market works and how different factors can impact prices. I think for commercial real estate investors in China, the income approach will become increasingly important. It is vitally important when property investors borrow money to buy assets that they have some sense of what income those assets will generate and the income approach is the only method that really addresses this issue. When buying apartments in China today, there is often no way to match what the rental income from a property will generate with its current price. This may be because there is a premium attached to owning an apartment in a specific school district, or as I generally believe, property prices here are generally inflated because there aren't good alternative investments and so there is too much money chasing too few property assets. If nothing else make sure you check that the comparable transactions your agent is quoting you, are in fact similar, that will help you decide the value of the property, before you agree on a price.

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