

Prepared by Dr. Weam Nasan Agha

REA625
Real Estate Valuation

Lecture 2



Real Estate Management

Lecture 2

REA625

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Recap-Lecture 1

Introduction to Real Estate Valuation

The Definition of the Real Estate Valuation

Valuation Standards

The Definition of the Valuer

The Importance of Real Estate Valuation

The Concept of an Asset in Valuation

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Right

Economic Benefit

Implications for the Valuer's Work

Recap-Lecture 1

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Market Value

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(Market Value, Fair Value, and Equitable Value)

➤ The Definition of the Market Value:

According to the International Valuation Standards (IVS 102), **Market Value** is defined as:

Market value is the **estimated amount** for which an asset and/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**.

✓ The most widely used definition globally in professional valuation practice.

✓ Used as a primary reference in real estate and financial transactions.

✓ Must be applied in accordance with the detailed conceptual framework set out below.

Market Value

➤ Market Context of Market Value:

The concept of **market value** presumes a **price negotiated** in an **open and competitive market** where the **participants are acting freely**.

Market Scope

The relevant market may be International or local, and may consist of:

- ✓ A large number of buyers and sellers, or
- ✓ A limited number of market participants.

Assumed Market

The market in which the asset is presumed exposed for sale is the one in which **the asset notionally being exchanged is normally exchanged**.

Market Value reflects **the price** that would be achieved **if the asset** were sold **in its usual market and under normal market conditions, rather than in atypical circumstances or non-customary markets**.

➤ Types of Real Estate Markets:

Market Type	Characteristics	Examples	Impact on Valuation
International Market	Buyers from multiple countries, high liquidity	Commercial properties in major global capitals	Higher prices, stronger competition
Regional Market	Geographically limited, moderate liquidity	Regional shopping centers	Moderate price levels
Local Market	Local buyers, limited liquidity	Residential properties in small cities	Prices reflect local demand
Specialized Market	Few market participants	Specialized industrial facilities	Longer marketing period

Market Value

➤ Highest and Best Use:

The **Market Value** of an asset reflects its **Highest and Best Use (HBU)**.

Highest and Best Use is the use of an asset that:

✓ Maximizes the asset's potential value

✓ Is Physically Possible

✓ Is Legally Permissible

✓ Is Financially Feasible

Market Value

➤ Highest and Best Use:

Possible Alternatives

Continuation of the asset's existing use

An alternative use

Determination

HBU is determined based on **the use that a market participant would assume when formulating the price they would be willing to offer at the valuation date.**

Market Value

➤ Highest and Best Use:

Example 1

For Old Residential Property in a Commercial Location, What is HBU??

Criterion	Evaluation Questions	Example: Old Residential Property in a Commercial Location
Physically Possible	Can the use be implemented from a technical and engineering perspective?	✓ Demolition and construction of a commercial building is feasible
Legally Permissible	Is the use permitted under zoning and regulations?	✓ Area is zoned commercial
Financially Feasible	Does the use generate a return that justifies the investment?	✓ Commercial use yields higher returns
Maximally Productive	Which use results in the highest value?	✓ Commercial use maximizes value
Conclusion	Highest and Best Use	Commercial redevelopment rather than continuation of residential use

Market Value

➤ Highest and Best Use:

Example 2

For Land plot of 1,000 m² in a central location, What is HBU??

Use Option	Physically Possible	Legally Permissible	Financially Feasible	Estimated Value (USD)	Remarks
Residential Use (Existing Use)	✓	✓ (planning regulations also permit commercial use)	✓	500,000	Existing use, but not value-maximising
Commercial / Office Use	✓	✓	✓	800,000	Generates the highest return and value
Industrial Use	✓	✗	—	—	Not permitted under zoning; excluded

- **Highest and Best Use (HBU):** Commercial use
- **Market Value:** USD 800,000
- **Valuation Basis:** Market Value based on the commercial HBU assumption

Market Value

➤ Summary of Market Value Conditions and Assumptions

No	Condition	Substance	Test / Key Question
1	Estimated Amount	Not an actual price, but a professional estimate	Is it the best reasonable price achievable in the market?
2	Should Be Exchanged	Assumes a hypothetical transaction rather than an actual one	Does it satisfy all elements of the definition?
3	At the Valuation Date	Time-specific	Is the value linked to a specific valuation date?
4	Willing Buyer	Motivated but not compelled	Is the buyer acting in line with current market conditions?
5	Willing Seller	Motivated but not forced to sell	Is the seller hypothetical or actual?
6	Arm's Length Basis	Independent parties	Is there any special or related-party relationship?
7	Proper Marketing	Adequate exposure to the market	Is the marketing period sufficient to attract potential buyers?
8	Knowledgeably and Prudently	Reasonable information and prudent decision-making	Is the decision based on current market evidence?
9	Without Compulsion	Voluntary, not forced	Are the parties free to make their decisions?

➤ The Definition of the Market Rent:

According to the International Valuation Standards (IVS 102), **Market Rent** is defined as:

Market rent is the **estimated amount** for which an interest in real property **should be leased on the valuation date** between a **willing lessor** and a **willing lessee** on **appropriate lease terms in an arm's-length transaction**, **after proper marketing** and where the parties had each acted **knowledgeably, prudently** and without compulsion.

Market Rent

➤ Conceptual Relationship with Market Value:

Market Rent is founded on the same conceptual framework as **Market Value**, with the following key distinctions:

Element	Market Value	Market Rent
Subject of valuation	Capital value of the real estate asset for sale/purchase	Periodic rental value of the real estate asset
Parties involved	Willing seller and willing buyer	Willing lessor and willing lessee
Outcome	Sale price	Periodic rent (monthly/annual)
Reference terms	Normal sale terms	Appropriate market lease terms

Market Rent

➤ Main Areas of Application:

When Is Market Rent Used as a Basis of Value

❖ **Market Rent** is used as a **basis of value** when **the purpose of the valuation is to estimate the fair rental income that a property can achieve in the open market as at the valuation date.**

✓ When valuing a let property, to compare the contract rent with the prevailing market rent

✓ When valuing leasehold and leased interests (the rights of the tenant or the landlord)

✓ When valuing investment properties, to estimate the expected rental income

✓ During rent reviews or the renegotiation of lease terms

✓ When valuing a vacant property, to determine the rent that can be achieved under current market conditions

Market Rent

➤ Importance of Distinguishing Between Two Types of Rent

Type	Definition	Use	Example
Contract Rent	The actual rent payable under an existing lease	Assessment of actual income	Lease signed at SAR 10,000/month for 5 years
Market Rent	The estimated rent based on current market conditions	Assessment of potential market income	Comparable properties renting at SAR 12,000/month

Profit Rent

When contract rent is **below** market rent
(**benefit to the tenant**).

Over-rent

When contract rent **exceeds** market rent
(**burden on the tenant**)

At Market

When contract rent **equals** market rent
(**Neutral**)

Market Rent

➤ Relationship Between Contract Rent and Market Rent in Valuation/Illustrative Scenarios/

Scenario	Contract Rent	Market Rent	Impact on Value	Benefiting Party
Under-rented	8,000	10,000	Additional value to the leasehold interest	Tenant
Over-rented	12,000	10,000	Reduced value of the leasehold interest	Landlord (temporarily)
At Market	10,000	10,000	Neutral	Balanced

Market Rent

➤ Key Elements in Determining Market Rent:

1. Appropriate Lease Terms

2. Exclusions and Special Considerations

When determining Market Rent, the assumed lease terms must be clearly specified, including:

Element	Examples of Assumed Terms	Impact on Rent
Lease duration	1 year, 3 years, 5 years, 10 years	Longer leases may result in lower rent
Responsibilities	Maintenance, insurance, taxes	Determines net or gross rent
Permitted use	Residential, commercial, office, industrial	Influences rental level
Renewal options	Automatic renewal or none	Affects security and value
Rent review mechanism	Fixed, inflation-linked, market review	Determines income stability
Break clauses	Early termination penalties, notice periods	Affects flexibility and risk

Market Rent

➤ Key Elements in Determining Market Rent:

1. Appropriate Lease Terms

2. Exclusions and Special Considerations

The following factors **must be excluded** from the **assessment of Market Rent**:

- ✓ Inflated or deflated rents arising from special or non-market conditions
- ✓ Unusual incentives or concessions (e.g. extended rent-free periods)
- ✓ Transactions between related or connected parties

Market Rent

➤ Methodology for Assessing Market Rent:

Methodology for Assessing Market Rent

Case One:

Where an Existing Lease Is in Place

The **existing lease terms** are considered the **appropriate lease terms**, unless they are:

- ✓ Unlawful, or
- ✓ In breach of prevailing legislation

Case Two:

Where No Lease Exists

- ✓ A notional (hypothetical) lease is assumed
- ✓ The lease terms reflect those typically prevailing in the market for similar properties at the valuation date
- ✓ The parties are assumed to be typical market participants

Market Rent

➤ Methodology for Assessing Market Rent:

Case One:

Where an Existing Lease Is in Place

Applied Example:

A property leased for a total term of 10 years with 7 years unexpired.

- **The Market Rent** is assessed based on the **existing lease terms**, not on the assumption of a new lease with different terms.

Case Two:

Where No Lease Exists

Applied Example:

A vacant property requiring an assessment of Market Rent.

A **notional lease** is assumed reflecting **market norms** (e.g. a 3-year net lease with annual rent review).

Market Rent

➤ Professional Requirements in a Market Rent Valuation Report

A Market Rent valuation report should include:

✓ Clear statement of the assessed Market Rent

✓ Valuation date

✓ Assumed lease terms, including:

✓ Valuation methodology adopted

✓ Market evidence and comparables relied upon

✓ Any special assumptions made

- Lease duration
- Rent structure (Net/Gross)
- Responsibilities
- Review mechanism

Market Rent

➤ Summary Presentation Format /Market Rent Assessment/

✓ **Assessed Market Rent:** SAR 120,000 per annum

✓ **Valuation Date:** 1 January 2024

✓ **Assumed lease terms, including:**

- **Lease term:** 5 years
- **Lease type:** Net Lease
- **Rent review:** Annual at 5%
- **Permitted use:** Commercial / Office

Overview of Valuation Bases

➤ Why Are Bases of Value Other Than Market Value Required?:

In professional valuation practice, the default basis of value is **Market Value**, as it reflects the amount for which an asset can be exchanged in the open market between independent parties under competitive conditions.

However, professional practice often requires the use of alternative bases of value that are appropriate to:

- ✓ **The purpose of the valuation** (financing, financial reporting, taxation, special settlements);
- ✓ **The nature of the parties involved** (identified parties, investors, financial institutions);
- ✓ **The legal and regulatory framework** (national legislation, international standards).

Overview of Valuation Bases

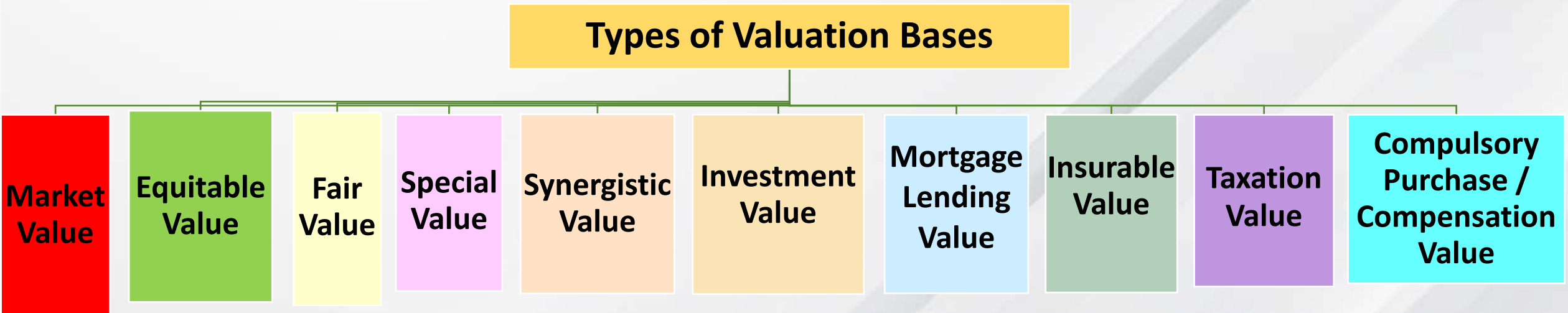
➤ Why Are Bases of Value Other Than Market Value Required?:

In such cases, **the valuer** may apply a **basis of value other than Market Value**, provided that **the following requirements are met**:

- ✓ The **purpose of the valuation** must be clearly identified **before** selecting any **basis of value other than Market Value**.
- ✓ The **valuer** must apply a **recognised basis of value** that is **appropriate and consistent with the stated purpose**.
- ✓ The **valuer** must adhere to **the principles of transparency, coherence, and consistency** in defining, applying, and reporting **the chosen basis of value**.
- ✓ Where the **valuation outcome** does not represent **Market Value**, the **valuer** must explicitly state this in the **valuation report**.

Overview of Valuation Bases

➤ Types of Valuation Bases :



Fair Value

➤ The Concept of Fair Value:

Fair value is regarded as one of the **most conceptually ambiguous bases of value** in real estate valuation, both academically and professionally, due to its use in **different contexts with differing underlying assumptions**. It is therefore essential to draw a clear distinction between two principal meanings:

Fair Value in transactions between identified parties
(Equitable / Non-Market Fair Value)

Fair Value for financial reporting purposes under
International Financial Reporting Standards (IFRS 13)

Fair Value

➤ Fair Value in transactions between identified parties (Equitable Value)

Fair value is the price that is considered equitable for the transfer of an asset or a liability between two specific, identified parties, who are knowledgeable, willing, and able to transact. The price reflects the respective interests, benefits, and obligations of those parties.

✓ Does **not** assume an **open and competitive market**.

✓ Does **not** represent the **opinion of the market as a whole**.

✓ Represents the **fairness of the price between two specific parties**.

✓ May take into account:

- Special benefits
- Particular burdens or obligations
- Elements of synergistic value that are not available to market participants generally

Fair Value

➤ Fair Value in transactions between identified parties (Equitable Value)

Typical Applications

✓ Settlements between landlord and tenant relating to:

- Acquisition of a leased asset
- Surrender or cancellation of a lease

✓ Transactions between related parties

✓ Determination of Fair Rent between a specific landlord and tenant
(with full disclosure of lease assumptions such as term, rent review pattern, repairing obligations,
and other material conditions)

Fair Value

➤ Fair Value in transactions between identified parties (Equitable Value)

Reporting Requirements

✓ Clear identification of the basis of value adopted.

✓ Explicit disclosure of:

- The identity of the parties
- Any special benefits or burdens influencing the price

✓ Disclosure of Market Value is recommended, where relevant, for comparison.

Fair Value

➤ Fair Value for financial reporting purposes under IFRS 13

"The **price** that would be **received to sell an asset or paid to transfer a liability** in an **orderly transaction** between **market participants** at the **measurement date**."

Key Characteristics

❖ **Fair Value is an exit price**, not an entry price.

The **price** that would be obtained from **selling an asset in the market at the measurement date**, rather than the price that was paid to acquire it in the past or that might be paid to acquire it in the future.

Example

- *A company purchased a building in 2015 for 10 million.*
- *At the current measurement date: Market evidence indicates that the building could be sold for 14 million.*
- *Under IFRS 13: Fair Value = 14 million*
- *✗ Not 10 million (the entry price).*

Fair Value

➤ Fair Value for financial reporting purposes under IFRS 13

Difference Between Exit Price and Entry Price

Element	Entry Price	Exit Price
Timing of measurement	At the date of acquisition	At the date of sale (measurement date)
What it reflects	The cost of acquiring the asset	The value of disposing of the asset
Basis of determination	Circumstances of the buyer at acquisition	Market conditions at the measurement date
Owner-specific?	Yes	No

Fair Value

➤ Fair Value for financial reporting purposes under IFRS 13

Why Does
Accounting
Adopt the Exit
Price?

Accounting adopts the **exit price** because **financial reporting** aims to:

- ✓ Present the current economic value of an asset;
- ✓ Reflect the amount that could be realized if the asset were disposed of at the measurement date;
- ✓ Rather than recover historical costs incurred in the past.

Fair Value

➤ Fair Value for financial reporting purposes under IFRS 13

Key Characteristics

❖ Fair Value is measured from the perspective of market participants, not a specific owner.

“At what price could this asset be sold today between typical market participants?”

Who Are
“Market
Participants”?

- ✓ Independent of each other;
- ✓ Reasonably knowledgeable about the market;
- ✓ Able and willing to transact;
- ✓ Acting in their own economic best interests.

Fair Value

➤ Fair Value for financial reporting purposes under IFRS 13

Key Characteristics

- ❖ Fair Value Ignores any special value attributable to the current owner.

✗ Examples of Factors Not Taken into Account:

- ✓ Owner-specific financing arrangements;
- ✓ Exceptionally high operational efficiency of the current owner;
- ✓ The owner's intention to hold the property for 20 years;
- ✓ High historical acquisition or development costs.

Examples of Factors Taken into Account:

- ✓ The income that a typical market participant could generate;
- ✓ The highest and best use available to all market participants;
- ✓ Market conditions at the measurement date.

Fair Value

➤ Fair Value for financial reporting purposes under IFRS 13

Key Characteristics

❖ Fair Value assumes:

- ✓ **Highest and Best Use (HBU)** that is legally permissible, physically possible, and financially feasible
- ✓ An orderly transaction
- ✓ A specific measurement date

Fair Value

➤ Fair Value for financial reporting purposes under IFRS 13

Practical Significance

✓ **Mandatory basis of value for:** Financial statements and Asset valuations for listed entities

✓ **Adopted in:**

- Over 130 jurisdictions worldwide
- International **Financial Reporting Standards (IFRS 13)**
- United States **Generally Accepted Accounting Principles (US GAAP) - Accounting Standards Codification (ASC 820)**

Fair Value

➤ Fair Value for financial reporting purposes under IFRS 13

Reporting Requirements

- ✓ Strict compliance with the definition and assumptions of IFRS 13.
- ✓ Disclosure where Fair Value differs materially from Market Value.
- ✓ The valuation is not prepared for a specific party, but for general financial reporting purposes.

Fair Value

➤ Fair Value for financial reporting purposes under IFRS 13

Relationship with Market Value

✓ In many cases, the outcomes of **Fair Value (IFRS 13)** and **Market Value** are **very close or indistinguishable**.

✓ Differences may arise in circumstances such as:

- **Development potential or hope value**

- Differences in measurement timing or assumed use

Development potential (Hope Value) represents value arising from market expectations of a future change in use or development of a property, even if such potential is not yet legally approved or certain.

✓ **Under Market Value**, **hope value** is reflected when the market actively prices in these expectations and multiple purchasers are willing to pay a premium.

✓ **Under Fair Value (IFRS 13)**, such potential is recognised only if it is available to market participants generally and forms part of the property's highest and best use **at the measurement date**.

Fair Value

➤ Fair Value for financial reporting purposes under IFRS 13

Relationship with Market Value

✓ Differences may arise in circumstances such as:

- Development potential or hope value

- Differences in measurement timing or assumed use

- ❑ Measurement Timing

Fair Value is measured: At a specific and clearly defined measurement date.

Accordingly, any changes in:

- Market prices
- Interest rates
- Supply and demand conditions

may result in a **difference between Fair Value and a Market Value** assessed at a different date.

Fair Value

➤ Fair Value for financial reporting purposes under IFRS 13

Relationship with Market Value

- Differences in measurement timing or assumed use

☐ Assumed Use

➤ **Under Market Value:** The existing use may be assumed if it represents the **prevailing market use**

➤ **Under Fair Value (IFRS 13):** The assumption of Highest and Best Use (HABU) is required.
Even if: It is not the current use, and the owner does not intend to implement it.

Example

- *An old warehouse located in a prime commercial area:*
- *Current use: storage*
- *Highest and best use: commercial or office development →*
- ***Fair Value** may exceed **Market Value** when the latter is based on the existing use.*

Comparative Analysis of Value Bases

Market Value, Fair Value, and Equitable Value

Comparison Aspect	Fair / Equitable Value	Market Value	Fair Value (IFRS 13)
Scope of parties	Identified and named parties	Hypothetical market participants	Market participants
Number of participants	Limited (two parties or a small number)	A broad pool of competing participants	A hypothetical group representing the market
Nature of parties	Actual parties with specific interests and characteristics	Hypothetical parties reflecting the general market	Hypothetical parties for financial reporting purposes
Nature of knowledge	Full and specific knowledge of the transaction facts	Reasonable knowledge of market conditions	Reasonable knowledge possessed by market participants
Special interests	Taken into account	Excluded	Excluded
Measurement perspective	Perspective of the identified parties	Market-based perspective	Market-based (accounting) perspective

Comparative Analysis of Value Bases

Market Value, Fair Value, and Equitable Value

Comparison Aspect	Fair / Equitable Value	Market Value	Fair Value (IFRS 13)
Nature of value	Equity-based value reflecting fairness between parties	Market opinion of exchange value	Accounting exit price
Basis of assessment	Consideration of party-specific benefits and burdens	Exclusion of non-market advantages or disadvantages	Exclusion of owner-specific value
Assumed use	As agreed between the parties	Highest and best use	Highest and best use (HBU)
Temporal reference	Point in time linked to the agreement	Valuation date	Measurement date
Expected outcome	A fair price between the identified parties	The most probable price in the market	The price achievable in an orderly transaction
Degree of objectivity	Relatively low	Relatively high	Moderate to high (accounting-based)
Primary application	Special settlements; related-party transactions	Most professional valuation assignments	Financial reporting under IFRS

Lecture Summary: Quick Review

Market Value

Market Context of Market Value:

Highest and Best Use:

Summary of Market Value Conditions and Assumptions

Market Rent

The Definition of the Market Rent:

Conceptual Relationship with Market Value:

Main Areas of Application:

Relationship Between Contract Rent and Market Rent

Key Elements in Determining Market Rent:

Methodology for Assessing Market Rent:

Professional Requirements in a Market Rent Valuation Report

Summary Presentation Format /Market Rent Assessment/

Lecture Summary: Quick Review

Why Are Bases of Value Other Than Market Value Required?:

Fair Value

The Concept of Fair Value:

Fair Value in transactions (Equitable Value)

Fair Value for financial reporting purposes under IFRS 13

**Comparative Analysis of Value Bases:
(Market Value, Fair Value, and Equitable Value)**



Thank You