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Principles of Property Investment and Pricing

Second Edition

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Glossary of Terms Used

Note: Some of the following terms cannot be accurately defined by a brief summary only; in these cases, a fuller description is given in the text.

All risks yield The yield used to capitalise rent when valuing property by the Years Purchase method, being the rental income yield on rack-rented or fixed-income freeholds and the equivalent yield on reversionary freeholds.

Annuity An annual income received for life, or for some shorter period.

Bear A speculator who acts on an expectation of falling share prices, or anyone who expects investment prices to fall.

Bear market A market in which investment prices are falling.

Beta (β) A measure of a share's market risk; its volatility to the market as a whole.

Blue chips The equity shares of large reliable companies.

Bond Interest-bearing debt stock. Also an investment unit backing a unit-linked life assurance policy.

Bull A speculator who acts on the expectation of rising share prices, or anyone who expects investment prices to rise.

Bull market A market in which investment prices are rising.

CAPM Capital asset pricing model.

CBI Confederation of British Industry; an organisation of company employers.

CCC Competition and credit control agreement.

CGT Capital gains tax – a tax levied when investment gains are realised.

Collateral Assets which are pledged as security for a loan.

Convertible A stock which gives the holder an option to convert into another stock, usually equity shares.

Corporation tax A tax charged on company profits in the UK.

Cost push inflation Inflation caused primarily by rising factor costs.

Coupon The nominal rate of interest paid on a fixed-interest stock.

Covenant The terms of a lease contract which help to determine the quality of a property investment.

Cover The amount of assets or income available to pay the capital or income due to an investor.

DCF Discounted cash flow.

Debenture A corporate fixed-interest bond.

Demand pull inflation Inflation caused primarily by excessive demand for goods and services.

Discount rate The rate of return which reduces the sum of an investment's future income flow to its present value or price.

Dividend The income periodically received by investors in shares.

Dividend yield The annual dividend per share, grossed up for tax and expressed as a decimal (or percentage) of the share's price.

DIY Do-it-yourself (home improvements).

DLT Development land tax – a UK tax on the development value of land; discontinued.

Earnings The net profits of a company available for distribution to ordinary shareholders.

EC European Community.

EEC European Economic Community.

Efficient market A market in which prices fully reflect information affecting the worth of investments.

EMT Efficient market theory.

Equated yield The IRR – or total return per annum – from a property investment.

Equity shares Ordinary shares issued by companies.

Equivalent yield The total annual return (IRR) to be received from a reversionary investment over the period to reversion, assuming no change in the property's rental value or market yield.

Freehold The highest form of land tenure under the Crown in England.

FRI A lease under which the lessee is responsible for all repairs and insurance.

GDP Gross domestic product.

Gearing Financial leverage. The relationship of debt and possibly other fixed liabilities to total capital employed (but see Chapter 2 for distinction between capital and income gearing).

Gilts Gilt-edged securities. Bonds issued by the British government.

Gross fund An institution exempt from tax, e.g., pension funds and charitable trusts.

Ground rent A rent paid under a lease of urban land, i.e. excluding buildings.

Head rent The rent paid by a head tenant to his landlord.

Head tenant The tenant under the head lease granted by the freeholder.

Income yield An investment's annual income, expressed as a decimal (or percentage) of the investment's current market price.

Index-linked gilts Government bonds on which the interest payments and redemption value are linked to the Retail Price Index (RPI).

Investment dollar premium The percentage by which investment currency exceeded the spot price of foreign currency when the exchange control regulations were in force.

IRR Internal rate of return – a true measure of total investment return. The discount rate at which an investment's NPV is zero.

Lessee A tenant under a lease.

Lessor A person who grants a lease, a landlord.

LIBOR London inter-bank offered rate.

Liquid assets Assets which can be quickly converted into cash.

LOB Location of Offices Bureau.

M3 A statistical measure of money supply which includes notes and coins, and bank current accounts and deposit accounts.

Market risk Risk that results from trends in market prices and which cannot be avoided by diversification.

Market yield The rental yield of a property if let at its rental value. The all-risks yield.

MLR Minimum lending rate.

Money market The market in short-term deposits.

Moratorium An agreed postponement of the payment of interest or repayment of debt capital.

Mortgage A loan secured on property.

Mortgagee The party which lends money by mortgage.

Mortgagor The party which borrows money by mortgaging his property.

MPT Modern portfolio theory.

Normal profit A minimum profit sufficient to induce a firm to undertake business activity.

NPV Net present value – the discounted value of future cash inflows, less present and discounted costs.

ODP Office development permit.

OPEC Organisation of Petroleum Exporting Countries.

Opportunity cost of capital The expected return available from investments comparable with the one under consideration. A return foregone by making an investment.

Outgoings Recurrent annual expenses faced by a property investor, e.g., on repairs, insurance and management.

Par value The nominal value of a stock.

PEP Personal equity plan. A scheme enabling private investors in Britain to avoid taxation on a limited portfolio of shares.

Peppercorn rent A very small or negligible rent.

PE ratio The ratio of price to earnings per share.

Perfect market A market satisfying the notional concepts of perfect competition.

Prelet A property for which a lease is arranged before the development is completed.

Profit rent The difference between the net rent received by a head tenant and the head rent paid to his landlord.

Property bond An investment unit based on property, the performance of which determines the benefits paid out under a unit-linked life assurance scheme.

PSBR Public sector borrowing requirement – the capital which the government must borrow in order to finance the budget deficit.

Rack rent A property's rental value.

Rates A tax charged annually on the occupier of property in the UK, and based on the property's rental value.

Real return Return after adjusting for inflation.

Redemption yield The IRR to be received from a dated bond if held to maturity.

Rental value The annual rent that would tend to be paid for the right to occupy a property if offered to let on the open market.

Rental yield The yield on property, as distinct from the dividend yield on shares and the interest yield on bonds.

Retained earnings Equity earnings which are not distributed as dividends to shareholders.

Reversion The date at which the rent received by a property investor is reviewed, normally to rental value.

Reversionary property An investment in which the current rent received is significantly different from rental value and in which a rent review is due within a reasonable time.

RICS Royal Institution of Chartered Surveyors.

Rights issues An issue of new shares offered for sale to existing shareholders.

RPI Retail price index.

Sale and leaseback The sale of a freehold or long-leasehold investment, on condition that the vendor becomes the tenant.

Scrip issue Bonus issue – an issue of new shares to existing shareholders at nil cost.

Sensitivity analysis The analysis of the impact on the profitability of a development project of changes in the cost of determinant variables.

Sinking fund A fund established to accumulate to the sum necessary at a future date to repay debt or replace loss suffered by depreciation, especially to replace the value of a leasehold investment at the termination of a lease.

Specific risk Risk that can be avoided by diversification.

Sub-rent The rent paid by a sub-tenant to a head tenant.

Sub-tenant The lessee under a sub-lease granted by a head tenant.

Systematic risk Another name for market risk.

Target IRR The expected total return required by investors from an investment.

Treasury bill A short-term non-interest-bearing security issued by the government.

UBR Uniform business rate. A tax charged annually on the occupier of business property in England and Wales.

Uplift The capital gain deriving purely from the passage of time to reversion.

USM Unlisted Securities Market.

Years purchase The multiple by which the capital value of a property investment exceeds the net rent, which on a rack-rented property is the reciprocal of the rental income yield.

Yield to reversion An alternative name for the equivalent yield.

Preface

Aims of the book

The essential purpose of this book is to explain the determination of the value of business property and its performance as an investment. It is a book about the economics of the commercial property investment market placed in the context of the local, regional, national and international economies. It identifies relevant principles and concepts of economics, finance and investment, and uses them to explain property pricing and the operation of the property market. Although arguments are explained and developed in a practical market context, the book concentrates on principles and underlying forces determining value rather than on providing a comprehensive description of the market. The emphasis is on the immutable rather than the current, and on answering the question why? rather than what?

The book explains how property values are determined by the market, not how values are assessed by the valuer, though it contains many implications for valuation practice. It explains the operation of the price mechanism in the property market, but makes few judgements on the market's efficiency or about the justification for planning or government intervention. The book provides no solution to the problems of the urban economy, nor does it set out to explain patterns of urban land use, though incidentally containing much of relevance to these subjects.

The book is written primarily as a student textbook, and is intended to bridge the gap between 'pure' economics and property market studies such as valuation, development, investment and management. It is particularly appropriate for degree courses in estate management and land economics which lead to membership of the Royal Institution of Chartered Surveyors. However, it is also intended for experienced property practitioners, and will provide students and practitioners of architecture and town planning with a detailed insight into the operation of the property market. The analysis is also relevant to urban economists and to investment analysts specialising in the property sector.

While fulfilling the needs of students and practitioners, the book also extends the boundaries of existing property market theory. In many subject disciplines these functions might conflict, but the theory of property market behaviour is relatively underdeveloped, and there is scope for presenting advanced material alongside the elementary without confusing the reader.

Although it is assumed that the reader has some elementary knowledge of economics, algebra and discounted cash flow (DCF), the principal theories and concepts are explained from first principles. Mathematics and complex graphics have been restricted to the minimum as, too frequently, they tend to

obscure the argument rather than enlighten the reader. However, some passages may not be easy for those studying the subject for the first time, and when difficulty is encountered it is frequently best to read on and return later to the troublesome section. The reader should be prepared to read certain passages two or three times. The book follows a logical sequence and is intended to be read sequentially, however, most chapters and Parts should be comprehensible if read independently.

Second edition

The sequence and structure of the first edition have been retained, and the number of chapters and most of their titles are the same. However, the text has been reappraised, updated and amended to improve clarity and readability. Development of the theory of the determination of yields and rental values has necessitated the rewriting of certain chapters in Parts II and III, 'bullet point' summaries have been extended to all Parts, and the last chapter is new.

The new edition has been written near the bottom of perhaps the worst-ever property market slump in Britain. With a cyclical market, it is inevitable that fluctuating interest rates and yields can quickly outdate examples and illustrations. So, rather than adopting the unprecedentedly high yields current at the time of writing, examples have been based on yields in more stable times.

The first edition evolved from my lectures and tutorials to the BSc in Land Economics students at Paisley College over 1972–83, and this second edition owes much to the stimulus gained from subsequent teaching at City University and the University of Paisley. I apologise for any errors or passages which are confusing or turgid, and invite criticism from the reader.

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