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## **The Real estate market: types of property and criteria for appraisal**

The increasing interest on the part of institutional investors in the yield potential of real estate assets highlights the importance of effective criteria for evaluation.

Each segment of real estate needs its own appraisal procedure, which is determined according to the intended use of the property: residential, tertiary/offices, special use property.

Special use properties are characterised by their individual nature, their particular intended use. They include university buildings, hospitals and barracks. These are all segments which are impossible to assess using criteria based on comparable sales or income capitalisation.

Institutional investors are now particularly interested in asset divestment by the State and public bodies. The low level of risk of this kind of investment is likely to be particularly attractive to institutional players and could represent a good opportunity to revive the real estate market.

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The interest that has been shown in recent years by institutional investors attracted by the potential of the real estate sector in terms of yield has led to the development of methods of evaluation that are becoming ever more complex and precise. The real estate asset is seen not only as a consumer good but also as an investment that can generate an income. The move from a floor-space market to an investment market has resulted in yield-based assessments being placed alongside standard valuations (using comparison criteria), based on dimensions and value per square metre. The type of real estate asset and its characteristics govern the choice of evaluation criteria that are most suitable to identify those variables that are the key in determining the value.

As regards the purpose for which the properties are built, we can differentiate three main asset categories: residential, tertiary/commercial and special purpose buildings.

In the real estate market in Italy the characteristic feature of residential properties is the tendency for homes to be bought for owner occupation. This tendency, which is deeply rooted in the culture and applies to about 80% of end users, leads to residential properties being classified as consumer goods, which in turn leads to comparison criteria being considered the most appropriate method of arriving at the fair value of the property.

Tertiary real estate comprises a variety of buildings that usually accommodate an economic activity, either production or service. The building therefore represents one component of the economic process of production and combines with

the other productive factors in the creation of the company profit. Generally companies, as the end users of the real estate asset, tend not to tie down their financial resources in the building but rather to invest more in the economic activity, whose yield is generally higher than investment in bricks and mortar. These premises are at the basis of the development of a rental market that is dynamic, and consequently of a market that considers the building as an asset that can generate a relatively stable annual income and a potential capital gain to be realised at the time when the asset is sold. Given the reason why investors decide to acquire this type of real estate asset, the methods considered most appropriate to determine fair value are yield-based criteria: direct capitalisation of the rental and discounted cash flow. The choice between the two yield-based methods depends on the internal and external characteristics of the asset being evaluated.

Special purpose buildings comprise all sorts of buildings that accommodate precise activities that are not particularly widespread. Their main characteristic is the fact that their distinctiveness. These properties make up a special segment of the real estate market that includes essentially public buildings, especially hospitals, military structures and universities. The lack of a real estate market to provide the information required for value assessment and the absence of an actual rental market (user/owner) mean that neither the comparative method nor yield-based methods can be used. The only criterion that can provide a plausible estimate of value for these types of buildings is one based on construction cost, which involves the use of appropriate coefficients of depreciation linked to the concept of obsolescence, both technical and functional.

## **Public buildings**

Despite the high level of uncertainty in both the economic and legislative fields, that characterises the current phase of the market, institutional investors are keeping a keen eye on public buildings, especially as regards divestments accompanied by the increased value of the asset. The public sector owns a huge real estate stock estimated at about 200 billion euro and divided into essential properties and non-essential properties. Both categories could be suitable for providing for the coffers of the State and various public bodies immediate liquidity through the process of divestment.

Essential public buildings that come with a suitable rental contract (market rent and a sufficiently long lease) could become particularly attractive assets for those who are looking for investments with a low risk profile.

Non-essential as well as disused public buildings represent an important resource both for the State or the public body that owns them and as a means of reviving the Italian real estate market.

Institutional investors are keenly watching the progress of the divestments of these assets and the process of value enhancement that goes with the sale. The strong interest shown in this sort of property arises from the high potential return, which in some assets is linked to a moderate level of risk. The unusual risk/

return profile is a result of the location, which is generally central, and of the certainty that the planning procedure will follow a predetermined time-scale and will make the transformation and value enhancement of the asset achievable.

The fair value of an operation of enhancement is arrived at by means of the transformation method. In actual fact the valuation is carried out through the use of a discounted cash flow model in which the returns are based on the market value of the type of building that will be achieved and on hypotheses regarding the time-scale of the sale, whereas the costs include all aspects of expenditure incurred in the realisation of the enhancement project.

### **Focus on barracks, universities and healthcare**

It emerged from research carried out by *Scenari Immobiliari* by means of interviews with the most important operators in the real estate and banking sectors that among the types of property most sought after by those investors who have a preference for medium/high risk we find:

- barracks;
- universities;
- healthcare structures.

These buildings offer important investment opportunities for the private sector and create value for the public sector.

Barracks make up a real estate stock that amounts to around 50 – 70 billion euro. The procedures for divestment and value enhancement for military structures that are no longer essential by means of co-ordinated plans have already been implemented in the recent past by a number of local authorities. An example of this is the PUV (Comprehensive Enhancement Plan) in the Region of Liguria, in which *Scenari Immobiliari*, in its capacity as leader of the RTI Group, has been directly involved through the production of appropriate feasibility studies. This envisaged the regeneration of 10 barracks, 11 forts and 23 other military structures (for example, batteries, firing ranges and logistical bases) located within the Region. The experience gained through participation in the divestment operation enables us to highlight both the possible limits of a plan as complex as this, involving, as it does, three levels of planning (municipalities, Provinces and Regions) and also the potential gains in terms of value creation and profit for the initiating body.

Up to the present the PUV in Liguria has not achieved a positive outcome in the phase of disposal of the assets that were to be redeveloped. This shows clearly the limits of a scheme that has great potential. Certainly the procedure offers the possibility of arriving at a significant streamlining of the phase that involves co-operation between the various planning levels, thanks to a convergence of interests (economic feasibility and social utility). The fact that the portfolio could not be disposed of is undoubtedly due to the current state of the market, which is

not in favour of divestments of real estate when they require huge commitments in economic terms (acquisition and development). Moreover a significant factor is the weakness of the initiating body during the sales phase, both as regards the promotion and marketing of the sites and also because of the lack of consistency during the operation of bringing the asset to market.

Despite these critical factors, which could be overcome through a better management of the sales phase of the operation, the redevelopment of such a huge stock of sleeping assets offers significant opportunities to the sector.

The second category of real estate assets viewed as attractive is made up of universities. They represent a building stock worth around 35 billion euro occupying an area of about 14,4 million sq.m. This real estate portfolio owned by universities can be subdivided into essential buildings and non-essential buildings. The first type provides a particularly significant investment opportunity for those investors averse to risk. In practice the investment would involve the purchase of an asset that generates a stable income over the medium to long term and which over time is likely to increase in value (capital gain), especially in the case of university sites close to the centre of cities.

The second type, made up of non-essential buildings, can represent an investment opportunity in terms of enhancement and conversion of the property. It goes without saying that key variables are the location and the planning laws in force.

Properties belonging to health authorities are of many different types and, unless they have become disused, they are entirely essential. Their extreme diversity is the result of the many functions that a hospital complex must fulfil: administration, research, wards and outpatients' clinics. Given the managerial complexity of a hospital, usually this operation, as is the case with essential university buildings, is suitable for risk-averse investors who are looking for assets offering a return and a low price volatility: they will normally leave both the day-to-day and the extraordinary maintenance to the body managing the complex.