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The pitfalls of valuing vacant developable land

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The valuation of a substantial track of developable vacant land with the potential for township establishment poses special challenges to property valuers.

This is so because no two such properties are identical. Karen Scott, head of valuations at Rode & Associates, says valuers should essentially arrive at a value through synthesis of the following three methods:

(i) Comparable-sales method,
(ii) Expert-panel method, and
(iii) Residual-land-value method, also known as the developer's method.

Although our courts tend to prefer the first approach, the obvious pitfall of this method is that truly comparable sales need to be found, and these are often as scarce as hen's teeth.

Thus, even in the best case, the valuer ends up with an exceedingly small sample of 'comparable' sales, which would make any statistics professor's remaining hair stand on end.

Often the net for looking for comparable sales needs to be cast very wide, also geographically.

These potential comparables need to be analysed to determine the parallel characteristics with the subject property.

Once that has been done, one needs to establish to what degree the comparables' sales prices need to be adjusted to compensate for the dissimilarities.

For instance, factors that could be major value differentiators are:

- the size of the comparable tract of land relative to the subject property,
- how far down the road of getting development rights the comparable property was when it was sold,
- what price class of house the comparable land was assumed to be suited for at the time of sale.

For instance, raw land only suited for give-away ("RDP") houses might reflect, at most, the value of agricultural land. On the other hand, a vacant tract of land in or near an upmarket suburb might be very valuable.

The second method mentioned above, the expert-panel method, is rather self-explanatory. Here the valuer interviews as many experienced and relevant property players as possible to gauge their opinion on value.

These people would typically be those who are intimately involved in the development of land, or the sale of land for development. Often they express value per opportunity (erf), which implies one preferably has to have a proposed development plan for the subject land in order to calculate the expected number of opportunities that will be manufactured by the developer.

The final approach is the residual-land-value method. Although this method is often overlooked, it is becoming crucial for determining the market value of land. This is largely due to the absence of quality comparable sales in today's tepid market.

In terms of this method, the valuer puts herself in the shoes of a prospective developer that conducts a viability study. In essence, the approach is that the present value (PV) of expected inflows (including the developer's profit margin) less all outflows, equals the maximum that the developer can afford to pay for the land. This "residual" then is the implied market value.

Again, research is key for this method to deliver a meaningful result. This is so because the magnitudes of many of the critical variables will need to be researched and verified – even where a cash-flow is provided by a client.

Examples of these critical variables are: the assumed sell-out time, the retail sales price of opportunities (erven), the assumed growth rate of retail sales prices of opportunities over the sell-out period, costs for installing engineering services, marketing costs and consultancy fees.

Thorough research here is what differentiates the amateurs from the pros.

In practice, the residual value is used as a proxy for market value of the land even though it could more accurately be called a fundamental or intrinsic value.

Where the various approaches deliver widely divergent outcomes, the valuer has to establish why, before coming to a final conclusion.

Source: Rode & Associates