Valuation and Underwriting

Interview preparation summary · RE track

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INT.EV.1.a · Income and value

Build net operating income from rent, recoveries and costs, and turn it into a yield on price that can be compared between properties.

Net operating income (NOI) is the cash a property earns before financing, tax and capital expenditure. Start from contracted rent and deduct an allowance for vacant space and unpaid rent. Add the service charge or operating expense recoveries billed to tenants, then deduct the property costs: the recoverable ones net against recoveries, while the non-recoverable ones stay with the owner, such as cost on empty units, landlord insurance, ground rent and management fees. The lease form decides the leakage: on a full repairing and insuring lease almost every cost passes to the tenant, on a gross lease the landlord carries them. Yield is NOI divided by price, and in markets that quote a net initial yield the denominator also includes purchaser's costs, so one property can read 7.0% or 6.6%. Interviewers ask this to see whether you find the leakage, keep capex out of NOI but inside the return, and state your convention. The usual mistake is dividing headline rent by price.

WORKED EXAMPLE: KESTREL PARK: FROM RENT ROLL TO NET INITIAL YIELD

Kestrel Park is an invented multi-let industrial estate offered at 44.0m. Rent receivable after voids is 3.35m a year. Tenants are billed 0.42m of service charge, against service charge costs of 0.46m, of which 0.04m relates to empty units and cannot be recovered. The landlord also bears 0.12m of insurance and ground rent and 0.10m of management fees. Purchaser's costs are 6.8% of price. Calculate NOI, the simple yield on price and the net initial yield, and say what you would tell an interviewer.

Answer: NOI is 3.09m, a 7.02% yield on price and a 6.58% net initial yield after 6.8% purchaser's costs. Capex is excluded from NOI and belongs in the return.

> **Interview tip:** Say which denominator you use. Offering both the yield on price and the net initial yield shows you know the market convention and the leakage, and it avoids a mismatch with the interviewer's number.

INT.EV.1.b · Income and value

Distinguish going-in, reversionary and exit yields, and use a cap rate that reflects risk, growth and the rate environment.

A capitalisation rate (cap rate) is NOI divided by value, the inverse of an income multiple. Going-in or initial yield uses passing income at purchase. Reversionary yield uses the estimated rental value (ERV) once rents reset to market, so it exceeds the initial yield on an under-rented asset and falls short of it on an over-rented one. Equivalent yield is the single rate that discounts the whole income stream, passing and reverted, to price. Exit cap rate is the rate a buyer will apply when you sell, and the sensible default is at or above the going-in rate, because the asset is older and the lease shorter by then. A cap rate can be read as a risk-free rate plus a spread for illiquidity, tenant and obsolescence risk, less expected growth. Interviewers want you to say that a lower exit cap rate than entry is a bet on the market, not on your business plan. The usual mistake is applying the exit cap rate to the wrong year of income.

WORKED EXAMPLE: WICK LANE WAREHOUSE: THREE YIELDS AND AN EXIT VALUE

Wick Lane Warehouse is an invented distribution unit let to one tenant at a passing rent of 2.00m, on a lease where all costs pass to the tenant, so NOI equals rent. The estimated rental value is 2.50m. The price is 32.0m, and for simplicity ignore purchaser's costs. The ten-year government bond yields 4.0% and your house spread for this asset is 2.25 percentage points. You plan to sell in five years, after the rent has reset to 2.50m. What is the going-in yield, the reversionary yield, a defensible exit value and the effect of a 100 basis point rise in rates?

Answer: Going-in 6.25%, reversionary 7.81%, exit value 37.0m at 6.75% and 34.5m if rates rise 100 basis points with a constant spread. Rent growth is not enough to offset yield expansion.

> **Interview tip:** Always say which year of income you capitalise. Then separate what the business plan delivers (the reversion) from what the market must give you (the exit yield).

INT.EV.1.c · Income and value

Choose and reconcile the main valuation methods for a property: income capitalisation, discounted cash flow, comparables and replacement cost.

Four methods answer different questions. Income capitalisation divides stabilised NOI by a market cap rate and suits a let, stable asset. Discounted cash flow (DCF) values a specific income stream, so it is the right tool when leases expire, rents revert, or capex falls unevenly. Sales comparables price per square foot or per unit against recent deals, a quick cross-check that ignores lease quality and condition. Replacement cost is land plus build cost, fees and a developer's profit, and works as a soft ceiling because high prices attract new supply. Run at least two and reconcile: a large gap means an input differs, usually the cap rate, the rent assumed or the treatment of vacancy. Weight methods by asset type: income and DCF for investments, comparables for liquid, homogeneous stock, replacement cost for new or specialised buildings. The usual mistake is averaging four numbers without asking why they differ.

WORKED EXAMPLE: HARBOUR QUAY: FOUR METHODS AND A RECONCILIATION

Harbour Quay is an invented 80,000 square foot office let on long leases, with stabilised NOI of 3.00m growing 3% a year. Market evidence supports a 6.0% cap rate. Recent comparable sales average £580 per square foot. Replacement cost is land at 10.0m plus build at £380 per square foot, with fees and finance adding 15% of build cost. For the DCF, use a five-year hold, exit at 6.5% on year six NOI, selling costs of 1.5%, a 7.0% discount rate and year-end cash flows. Give a range and a view.

Answer: A range of about 46m (comparables) to 51m (DCF), with a point view near 50m from the income approach, and a flag that replacement cost of 45m caps how far above cost the price can rationally go.

> **Interview tip:** Name which method you trust for this asset and why, then use the others to challenge it. An unexplained average is weaker than a reasoned range.

INT.EV.2.a · The lease and the cash flows

Analyse a rent roll: weighted average unexpired lease term, reversion, rent reviews, break options and tenant covenant strength.

Lease analysis tells you how secure and how reversionary the income is. The weighted average unexpired lease term (WALT) weights each lease's remaining years by its rent, and should be shown to expiry and to first break, since a tenant with a break is only committed to the earlier date. Compare passing rent with ERV for each unit: under-rented space offers reversion, over-rented space is a risk, because the tenant may negotiate down, leave or demand incentives at expiry. Check the review pattern: open market, fixed uplift, inflation linked, or upward only, and whether caps and collars limit the upside. Tenant covenant, the tenant's ability to pay, shapes the cap rate: a strong, diversified rent roll earns a lower yield. Look at concentration, with the share of rent from the largest tenant and from leases ending in the next three years. Interviewers want a rent roll read as a schedule of risks, not as one number. The usual mistake is quoting WALT to expiry and ignoring breaks.

WORKED EXAMPLE: BRINDLE HOUSE: RENT ROLL RISK

Brindle House is an invented office building with three tenants. Alder Ltd: 40,000 square feet, passing rent 1.20m, ERV 1.40m, expiry in 8 years, tenant break in 3 years. Birch plc: 25,000 square feet, passing 0.90m, ERV 0.85m, expiry and no break in 4 years. Cedar LLP: 15,000 square feet, passing 0.45m, ERV 0.60m, expiry in 2 years. Calculate rent-weighted WALT to expiry and to first break, the reversion, and the share of rent at risk within three years.

Answer: WALT is 5.5 years to expiry but 3.2 to break. Rent is 11.8% under-rented overall, though Birch is over-rented, and 65% of rent can leave within three years.

> **Interview tip:** Lead with WALT to break, then give the share of rent that could leave soon. Offering both numbers shows you read leases as risks.

INT.EV.2.b · The lease and the cash flows

Convert headline rents into net effective rents after rent-free periods, tenant incentives, leasing costs and capex, and underwrite re-letting.

A headline rent is the number on the lease; the cash the landlord keeps is lower once incentives are paid. Rent-free periods defer income, capital contributions or tenant improvement (TI) allowances fund the tenant's fit-out, and leasing commissions and legal fees are paid to brokers and lawyers at signing. Net effective rent spreads the total over the term: rent actually paid, less incentives and leasing costs, divided by lease years. Underwriting adds the other costs of re-letting: a void between tenants, a probability of renewal against re-let, and capex to keep the building competitive, shown below NOI as a reserve or line item. Valuers deduct unexpired rent-free and top-up from price, since the buyer inherits an income that is not yet cash. Interviewers use this to test whether you compare deals on a like for like basis. The usual mistake is choosing the higher headline rent when a lower headline with a short rent-free gives more cash.

WORKED EXAMPLE: TWO OFFERS ON A 20,000 SQUARE FOOT UNIT

An invented unit of 20,000 square feet has two ten-year offers. Offer X: headline rent £40 per square foot, 12 months rent free and a £25 per square foot tenant improvement allowance. Offer Y: headline rent £36 per square foot, 6 months rent free and no allowance. Leasing commission is 10% of one year's headline rent on either. Ignore discounting and any difference in tenant covenant. Which is better and by how much?

Answer: Net effective rent is £33.10 per square foot for X and 33.84 for Y, so Y wins by about £0.74 per square foot on an undiscounted basis. Discounting would probably favour Y further, because X has the larger up-front allowance and its extra headline rent arrives later.

> **Interview tip:** Quote the net effective rent and say you ignored discounting. Mention that incentives paid up front hurt more once discounted.

INT.EV.2.c · The lease and the cash flows

Build a short discounted cash flow for a property and show which assumptions (exit cap rate, rent growth, capex, timing) drive the return.

A property DCF lays out annual NOI, below-the-line items such as capex, TI and leasing costs, and a sale at the end of the hold. The sale is the exit year's forward NOI divided by the exit cap rate, less selling costs, and it often accounts for well over half of the present value, so the exit cap rate is the dominant assumption. The unlevered internal rate of return (IRR) is the discount rate at which the cash flows equal the price. Present the base case, then a sensitivity grid of exit cap rate against rent growth, because these two move value most, followed by capex and the void between tenants. Keep conventions explicit: annual periods, year-end cash flows, forward or trailing NOI at exit, and whether costs are in the price. Interviewers want you to say how much of the return depends on the exit yield, and what breaks the deal. The usual mistake is a smooth base case with no sensitivity and an exit cap rate below the entry rate.

WORKED EXAMPLE: CORVIN RETAIL PARK: UNLEVERED IRR AND SENSITIVITY

Corvin Retail Park is an invented property bought for 60.0m all in. Year one NOI is 3.9m, growing 2.5% a year, with capex of 0.3m a year. Sell at the end of year five at 6.75% on year six NOI, with selling costs of 1.5%. Year-end cash flows, no leverage, no tax. Find the unlevered IRR, the share of value from the sale, and the effect of exit cap rate and rent growth.

Answer: Base unlevered IRR is 7.6%. About 75% of the price is recovered at sale, and a 50 basis point wider exit cap rate takes the IRR to 6.3%, so the deal needs a view on the exit yield.

> **Interview tip:** Give the base IRR, say how much depends on the sale, and name the one number that breaks it. Then say what you would do in diligence to reduce that risk.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.