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Italian and international property valuation methods: A critical comparison

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Abstract: The article aims to outline the main features of the property valuation methodologies of the Italian tradition and to make a critical comparison with international procedures in order to indicate a possible path for the implementation of Italian property valuation standards. The study has been structured as follows: after an introductory overview in which the current needs and challenges of property valuation in the international context have been outlined, the characteristics of the Italian and international valuation methodologies are illustrated; then, a critical comparison has been proposed and the main results of this comparison have been discussed; finally, concluding remarks have been provided. The comparison of the Italian appraisal tradition with international methodologies showed strong analogies between the Italian practice and the international one, especially in terms of consistency with the theoretical and methodological principles of property appraisal; therefore, the need to align the Italian valuation practice with the needs emerging from the real estate market cannot mean the denial of the local valuation tradition. This study can represent a starting point for the definition of property valuation standards based also on the local valuation practice, by means of a bottom-up process involving all the representatives of the property valuation sector.
Keywords: *International appraisal methods, International valuation standards, Italian property valuation methods, Property valuation methods, Real estate appraisal.*

1. Introduction

The financialization and globalization of the real estate market, which have occurred in recent decades [1, 2] have meant that real property is increasingly considered an investment asset. In this context, property valuation has therefore assumed a key role in supporting the various real estate investment operations [3] and the market requires valuers to adopt internationally standardized appraisal methods and procedures [4, 5].

To meet these needs, various institutional and professional bodies have proposed real estate valuation standards using a common, shared and codified language [6, 7].

In 1981, the Asset Valuation Standard Committee – TIAVSC was founded; in 1984, the first valuation standards were published; in 1994, the International Valuation Standard Committee (IVSC) published the first edition of the International Valuation Standards (IVS) [8].

At European level, in 1981 the first European Valuation Standards (EVS), also known as the "Blue Book" [9] were published on the initiative of the TEGOVOFA (established in 1977, replaced in 1992 by the Euroval and in 1997 by the European Group of Valuers Associations -TEGoVA).

At national level, in the United Kingdom the Royal Institute of Chartered Surveyors (RICS) in 1976 published the first edition of the standards under the name of "Guidance Note on the Valuation of Assets", later known as the "Red Book" [10]; in the United States, the Appraisal Foundation published the first Uniform Standards of Professional Valuation Practice (USPAP) in 1987 [11].

It should be noted that full convergence of valuation methods at international level has not yet been achieved: the valuation methods indicated in the main valuation standards are influenced by

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consolidated practice at local level [12, 13]. The applicability of international valuation methods implies the existence of the same operating conditions in all countries, including the possibility of collecting real estate data.

In Italy, generally accepted and recognized real estate valuation standards do not yet exist. At the moment, only the proposals formulated by the Real Estate Valuation Code, published in 2000 by Tecnoborsa [14] and by the Italian Banking Association (ABI) which, in 2011, published its own Guidelines [15] can be mentioned. The Real Estate Valuation Code provides some minimum standard requirements necessary for the valuation; the ABI guidelines were drawn up on the basis of the indications provided by international valuation standards (IVS, RICS standards, EVS and USPAP) and by the Real Estate Valuation Code.

However, it should be highlighted that the Italian real estate market presents a series of specific characteristics (poor transparency of real estate prices, reduced competitiveness of some areas, poor integration with the securities market) which make it difficult to introduce valuation standards completely derived from international practice; these standards, in fact, were designed for real estate contexts other than the Italian one and, therefore, it is necessary to adopt rules and procedures that can fully adapt to the Italian context.

In relation to the valuation methods indicated in the Tecnoborsa Code and in the ABI guidelines, it should be noted that, in both cases, reference is made only to international valuation procedures, almost completely excluding all Italian valuation methods and practices, of very long tradition and, on closer inspection, not so dissimilar from the international ones, at least in the general conception, if fully from an operational point of view.

On the basis of the situation outlined, therefore, the article aims to illustrate the fundamental characteristics of the real estate valuation methodologies of the Italian tradition and to make a critical comparison with the international methodologies, in order to indicate a possible path for the implementation of the Italian real estate valuation standards. Therefore, the article is structured as follows: firstly, the characteristics of the Italian and international valuation methodologies are illustrated (Section 2); then, a critical comparison is proposed and the main results of this comparison are discussed (Section 3); finally, concluding remarks are provided (Section 4).

2. Material and Methods

2.1. Property Valuation Methods of the Italian Valuation Tradition

The appraisal method is the tool needed to express and logically motivate an opinion of value [16]. The method is unique and based on comparison; the valuation approaches, which descend from the unique method, can be distinguished into "direct" or "indirect".

In estimating the market value of a property, direct valuation approaches assume direct comparison between the characteristics of the property whose price is known and those of the property to be valued. The *single-parameter method* is based on the collection of recent transactional data of comparable properties; prices refer to a single parameter (square meter, room, bed, parking space, etc.); by comparing the characteristics of the property to be valued with those of the comparable properties, an opinion of value is expressed [17]. The *"punti di merito" method* is based on the analysis of the characteristics that affect the market price of properties. Operationally, starting from the highest price property found in the same real estate market area where the property to be valued is located, it is assumed that this property can be classified as optimal in terms of all the characteristics that identify it. Each characteristic is assigned a minimum and maximum incidence on the market price. By comparing the incidence on the market price of the characteristics of the two properties, an opinion of value is stated [18].

When the direct valuation approaches cannot be adopted due to the lack or insufficiency of comparable transactional data, the property can be estimated indirectly. The indirect approaches to market value appraisal are: a) *Income Capitalization*; b) the approach derived from *Development Value*; and c) the *Depreciated Replacement Cost*.

Income Capitalization of a property is based on the discounting of the net, future, ordinary, and predictable income produced by a property for a number of years tending to infinity at a market-determined capitalization rate [19].

The approach derived by *Development Value* is mainly applied for the valuation of land to be developed; it means establishing the theoretical price that an ordinary entrepreneur would be willing to pay to purchase the land in order to complete an ordinary development and sell the developed product. The value is measured as the discounted difference between expected revenues and development costs [17, 19].

The *Depreciated Replacement Cost* of a property is defined as the current hypothetical cost required to produce a substitute property for the existing one. The replacement cost of a building is the cost virtually incurred to produce a building similar to the existing one, albeit with contemporary construction techniques, technology and solutions, and reference to current prices, including the value of the building area as if it were vacant and according to its Highest and Best Use (HBU). Finally, the depreciation, which takes into account the expenses that would be required to bring the existing building back to be identical to the substitute building [16] is deducted from the replacement cost.

2.2. Property Valuation Methods in International Practice

For the estimation of a property market value, in the international practice different approaches can be employed. In the United Kingdom, traditionally, there are five valuation methods [20]:

- *Comparative method*, based on the comparison of the sales prices recorded in recent market transactions for properties similar to the property to be valued;
- *Investment/Income method*, the annual net income generated by a property is converted into market value by dividing it by a capitalization rate that takes into account the average annual yield of the property and the level of associated risk;
- *Accounts/Profits method*, used for special properties (such as hotels, sport centres, restaurants, etc.), on the basis of the net operating income of the business located in the property, converted into present value by dividing it by an appropriate capitalization rate;
- *Development/Residual method*, based on the difference between the market value of the output of the development (the gross development value) and the costs of development, including the developer's profit;
- *Contractor/Cost method*, through the estimate of the production cost of an equivalent building to the property to be valued, depreciated for age, state of conservation and obsolescence.

The valuation methods used in France can be assimilated, in some ways, to the British methods: *méthodes par comparaison directe (or méthodes par le marché); earnings methods; "professional" methods; replacement cost methods; "bilan-promoteur" or recovery foncière methods* [21].

In the United States of America, three approaches to value are mentioned [22, 23]:

- *Sales Comparison Approach* (SCA), assuming that the market value of a property is a function of a series of characteristics and that two identical properties in all respects, in the same market area, on the same date will have the same sale price;
- *Income Capitalization Approach* (ICA), assuming that the value of a property is related to the stream of income produced during its economic life, appropriately discounted by a risk rate derived from the market; the market value can be obtained by Direct Capitalization (directly converting the income of a single year into market value using an appropriate capitalization rate or a multiplier) or through Yield Capitalization (the discounted sum of the net cash flows generated by the property during a holding period);
- *Cost Approach*, based on the cost to rebuild a substitute property.

In the United States, the *Profits method* and the *Residual method* are not mentioned as autonomous appraisal methods, but are considered special cases in the ICA. A further difference between European and US practice is the distinction, within the ICA, between Direct Capitalization and Yield

Capitalization. The latter derives from the financial analysis of investments and is absent in traditional European valuation methods.

3. Results and Discussion

With reference to international valuation methods, it can be observed that the Italian valuation tradition does not present substantial differences; it can be said that most of the valuation approaches are also present in the Italian tradition. The Italian valuation practice has many aspects in common with the European valuation practice; as for the latter, even in the Italian tradition Yield Capitalization is absent; in fact, it derives from the field of investment valuation and the financial world and not from the practice of real estate valuation. Operationally, the international methods present some specific characteristics that derive from the traditions and local conditions of the individual countries; therefore, the differences with the Italian valuation procedures are mainly based on these elements.

On the basis of a critical analysis and comparison, the analogies and main differences between the Italian valuation procedures and the main international approaches are indicated below.

3.1. Direct Valuation Methods

The SCA, in its assumptions, is substantially similar to the Italian direct valuation method; both are based on the comparison between a property to be valued and comparable properties recently sold in the same market area. The SCA generally considers a broad spectrum of transactional data; in contrast, the Italian single-parameter valuation, due to the difficulty in finding a large amount of recent sales data, is based on a limited number of comparable properties. In the "points of merit" method, reference is made to a single comparable property, generally the one with the highest price recently recorded in the same market area as the property to be valued.

As well as for the Italian methods, the SCA recognizes the difficulty in finding perfectly analogous properties, given the high degree of differentiation of this type of goods; to estimate the market value of a property, therefore, the comparable sale prices are adjusted in order to identify the price that the comparable property would have had if it had been perfectly identical to the subject property. It should be pointed out that some types of adjustments are also used in the direct methods of the Italian tradition:

- In the single-parameter method, the comparative analyses that lead to the identification of the asset with greater analogies with respect to the subject property can be traced back to the qualitative adjustments used in the SCA;
- The "merit points" method is a multiparametric approach based on the assumption that each characteristic can be attributed an impact on the market price; the comparison is made between the specific characteristics of the subject property and the unit of maximum market price taken as comparable sale; the attribution of percentages, through which the degrees of impact of the different characteristics on the price of the two properties are expressed, can be considered a quantitative adjustment technique expressed in percentage terms [19].

It should be noted, however, that the "merit points" method adopts an empirical approach and leaves much to the discretion of the valuer to define the impact of the characteristics on the price and, therefore, some scholars believe that this method does not respect the estimative principles of an objective and generally valid valuation, reproducible by all and based on effective market evidence; the application of this method, moreover, would lead to an estimate of the market value that is only approximate.

In summary, the main differences between the SCA and the direct Italian real estate valuation methods concern the systematic use, in the former, of monetary quantitative adjustments. Thanks to the possibility of collecting market and cost data more easily than in Italy, the use of market analysis and cost analysis in North American practice is very widespread to obtain quantitative adjustments. It should be considered, however, that the SCA also provides for the adoption of qualitative techniques for

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those elements of comparison for which it is not possible to derive a monetary quantification in a reliable and correct manner.

3.2. Income Approach

The Italian version of the ICA is almost identical to the international approach called Direct Capitalization: a method for directly converting a single year's income into the market value of the property either by dividing the net operating income by an appropriate capitalization rate or by multiplying it by an income multiplier. The version that involves the use of a multiplier is little used in current Italian professional practice, but finds some application in the field of land registry valuations and for calculating property taxes. The main differences between the Italian and international approach basically concern the method of estimating the capitalization rate:

- In the Italian tradition, the rate can be determined through a direct market survey, deriving the capitalization rate by the ratio between income and the sale prices of similar properties, or indirectly, starting from an average capitalization rate, adjusted on the basis of appropriate deductions or additions deriving from specific ascending or descending influences that affect the average rate;
- In international practice, the methods for deriving the capitalization rate include, in addition to the possibility of referring to comparable sales, the use of techniques in which the capitalization rate attributable to the components of a real estate investment are weighted and combined to derive an average rate attributable to the property (band of investment).

Yield Capitalization, on the other hand, is based on substantially different hypotheses compared to those of Direct Capitalization:

- The period of analysis of the income produced by the property is limited (it coincides with the holding period);
- It is not based on the income of a single year, but on a future income stream pattern, which can be constant or variable in a regular or irregular way;
- The valuer must forecast income, vacancy, expenses over the ownership period;
- It is necessary to estimate the reversion, i. e. the resale market price of the property at the end of the projected period;
- The estimate of the yield rate is based on the physical, economic and financial characteristics of the investment, considers the predictable risks and the level of return expected by investors in the period of time considered.

Yield Capitalization comes from the investment assessment sector and has only in recent years been used also for the purposes of real estate appraisal, following a growing financialization of the real estate market: real estate investment has increasingly taken on the specific characteristics of other types of investment. In order to be used for property appraisal, however, the method has required some adjustments: in fact, investments in the real estate sector are generally medium or long-term (10-15 years), while in other sectors investments have a short duration (5-10 years), and the final resale price of the good is generally very low or zero.

Just for this aspect, some critical issues, regarding the application of Yield Capitalization for real estate appraisal, concern the possibility of reliably predicting the trend of the income stream for such a long period of time, given the high instability of current real estate markets [24]; furthermore, the impossibility of referring to current conditions and the need to formulate a series of hypotheses would lead to the estimate of a subjective value, not consistent with the estimative principles of an objective and generally valid opinion of value [25].

The Profits Method, based on the conversion of a single year's income into market value by applying an appropriate risk rate, can be traced back to the Direct Capitalization. In fact, the Italian tradition does not recognize this approach as a specific appraisal procedure, but considers it a particular case of Income Capitalization: the rental value to be capitalized is not derived from ordinary market rents of comparable properties to the subject, but represents a portion of the divisible balance (net profit) of the business that takes place in the property to be valued; it is assumed that such part can be attributed to the owner of the property as annual rent. However, since the income is inferred from specific data of the business and not from ordinary values found in the market for similar properties, there may be limitations with respect to consistency with the appraisal principles of objectivity and the identification of an ordinary value. Therefore, the Profits Method should be used only for the appraisal of special properties and in exceptional situations, where it is not possible to apply other appraisal procedures.

3.3. Development Value and Residual Method

The procedure derived from the Development Value used to estimate the market value of production factors (e. g. undeveloped land, land with obsolescent or unsuitable building, etc.), in the European context, corresponds to the Residual Method; the residual value of a site represents the amount available for land purchase, found by deducting the development costs (including the developer's risk and profit) from the gross development value. There are significant elements of analogy between the European and Italian procedures:

- The gross development value is estimated as the market value of the property after development, taking into account its HBU and forecasting the predictable market situation at the end of the development process;
- The development costs include all the expenses that the developer incurs for the realization of the developed land (construction costs, professional fees and charges, lettings, short-term finance, agency fees);
- The developer's profit represents the compensation for the risks of production and an incentive for investment; it is considered as a cost to be derived from the gross development value and, in general, can be estimated as a percentage of the capital value of the completed development or a percentage of the overall development costs; its amount varies according to the complexity of the development process, the level of risk and the expected market conditions.

In the North American context, the Residual Method is not indicated as an autonomous approach to value, but is traced back to the Discounted Cash Flow - DCF analysis. By applying the subdivision development analysis, the market value of the finished lots, the length of development and marketing periods, and the absorption rate are estimated; then gross income and expenses are distributed over time, identifying the annual cash flows; the cash flows are finally discounted to arrive at the indication of the value of the land; the discount rate takes into account the developer's expected profit and the risk associated with the transformation operation.

3.4. Depreciated Replacement Cost and Cost Approach

The Cost Approach is an appraisal procedure which estimates the market value of a property by adding the land value and the cost required to reconstruct the existing building, eventually depreciated to take into account the progressive loss of value of the property generated by physical deterioration, functional obsolescence and external obsolescence. The value of the land is estimated as though vacant and available for development according to its HBU; the replacement cost is the cost that would be incurred to construct a building similar to the existing one (in terms of functional utility, location and size), at current prices as of the date of the appraisal, with modern construction techniques and materials, and current design and layout. This approach corresponds to the Italian procedure of the Depreciated Replacement Cost.

The main differences between the international procedure and the Italian one concern above all the methods used to estimate the depreciation. In the Italian tradition, the depreciation caused by age and physical wear on the building is estimated considering to the cost necessary to restore the building to its original condition, often represented by mean of depreciation curves that relay the percentage of depreciation of the building with the variation of its physical age; to estimate depreciation due to functional obsolescence, if curable, reference is made to the cost to cure the obsolescence or the criterion of amortisation quotas is followed for incurable deficiencies. The external obsolescence component is almost never considered.

In international practice, the depreciation can be estimated by using the market extraction method, the economic-age life method or the breakdown method. The first two methods are used to estimate the total depreciation of a property and are simple to be applied; the breakdown method, on the other hand, is more elaborate and allows to examine in detail all the depreciation items (physical, functional and external) separately, estimating how each of them affects the total depreciation of the building. The estimate of external obsolescence (produced by economic, market or location factors) assumes particular importance and can be carried out on the basis of the loss of income induced in leasing the property.

4. Conclusions

In order to outline a possible path for the implementation of Italian property valuation standards, the critical comparison of the Italian appraisal tradition with international methodologies showed strong analogies between the Italian practice and the consolidated international practice, especially in terms of consistency with the theoretical and methodological principles of real estate appraisal.

As emerged from the comparative analysis carried out, the need to align the Italian valuation practice with the needs emerging from an increasingly globalized and financialized real estate market cannot mean the denial or excessive simplification of the local valuation tradition. The valuer's activity at a local level, in fact, must deal with the operating conditions present in each country and some conditions that make international methodologies applicable are not fully found in Italy. It is clear that identifying rigorous valuation approaches, from a theoretical and methodological point of view, and consistent with very different market and operational situations, especially with regard to the possibility of acquiring relevant information data, is a very complex operation. Therefore, the definition of valuation standards should be based on a bottom-up process, involving all the representatives of the world of valuation, at local and international level, which, on the basis of the different operational and professional needs, allows for a shared choice, of broad convergence and fully accepted by operators in the real estate sector.

Finally, it should be emphasized that, although the proposal of standard methods responds to harmonization needs, it is not sufficient to resolve other problems related to real estate valuation, as it represents consolidated and non-innovative practices, based on real estate contexts and market conditions different from the current ones.

Transparency:

The author confirms that the manuscript is an honest, accurate, and transparent account of the study; that no vital features of the study have been omitted; and that any discrepancies from the study as planned have been explained. This study followed all ethical practices during writing.

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