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IMPERATIVE OF INVESTMENT METHOD IN THE VALUATION OF INCOME PRODUCING PROPERTIES FOR MORTGAGE PURPOSES IN NIGERIA

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ABSTRACT

Since after the introduction of the Structural Adjustment Programme (SAP) in September, 1986 in Nigeria, there has been doubts and confusion as to the applicability of the investment method in valuation of properties in the country. Some valuers are of the view that the investment method is no longer relevant within the context of the present inflationary Nigerian economy. Most valuers in Nigeria adopt cost method (used for valuing specialized properties) in determining open market values of income producing properties for mortgage purpose, resulting to over estimation of open market values of the properties. The paper examined and analyzed the recent market sales evidence of blocks of residential flats and their rental values in three neighbourhoods in Aba. It revealed that the use of investment method, applying appropriate yield (capitalization rate) derived from the analysis of recent market sales of comparable properties and their corresponding rental incomes gives an accurate estimate of market value. The study concludes that investment method is the most reliable method of achieving market price and should continued to be used in valuing income producing properties for mortgage purpose in Nigeria.

Keywords: mortgage valuation, open market value, market price, security, income producing property, investment method, yield, cost method.

1. INTRODUCTION

Mortgage is a transaction whereby a borrower, the mortgagor grants an interest in his property to a lender, the mortgagee as a security for loan. The transaction is always effected by a mortgage deed in which the mortgagor agrees to pay interest on the loan at a given rate percent (Olusegun, 2008). In Nigeria, most institutional lenders such as Banks usually require from the borrower, security in form of landed property before they can lend. If landed property is provided by the borrower as a security for the loan, the lender will usually seek for and obtain an open market valuation of the property. The valuation known as mortgage valuation is essentially required to provide the mortgagee with accurate assessment of the market value of the property so as to relate it to the amount of loan being sought for (Elekwachi, 1996 and Bello et al, 2012). It also makes it possible for the mortgagor to know the worth of his security and thereby eliminates the possibility of the lender under assessing it.

The mortgagee is not a prospective purchaser or developer and may not have seen the property before nor have knowledge of its intricate nature. There is therefore, the responsibility that the valuer should be non- partisan, that is, to be fair to both parties and protect the interest of the mortgagee by considering the marketability of the security before expressing his professional opinion (Olajide and Bello, 2003).

The reliability of his valuation will depend on the extent of his pre-valuation enquiries/ surveys, analysis of available sales evidence of comparables in the market and his experience on the type of property being valued. The valuation usually envisages a possible sale of the security in the open market or fi.fa at any time in the foreseeable future. Thus the market value arrived at should be realizable at any point in time if the mortgagee should recover the mortgage debt together with the expenses of sale, or which otherwise the mortgagee will suffer loss(Olayonwa, 2007). It is therefore imperative that appropriate method of valuation should be used in valuing the property offered as security (Bello et al, 2012). According to Ifediora (2009), market value is a measurement in money terms of the worth of property in exchange or its “exchange value” and the price or exchange value of a commodity is what it actually sells in the open market. An opinion of value therefore, should as much as possible represent what could be achieved from the market (Elekwachi, 1996).

In Nigeria, because of the current inflationary economy of the country, most Valuers prefer to use cost method when valuing income producing properties for mortgage purpose. They reason that the cost method of valuation would serve as a better proxy for market prices (Ogunba and Ojo, 2007), as the use of investment method, applying yield based on intuition or predetermined yield as was the practice in the past now gives relatively low market value than the actual market price. In Ogunba and Ojo (2007), a study carried out by Ogunba revealed that most Estate Surveyors and Valuers in Lagos considered the cost method more appropriate for open market valuation in Lagos. According to Ajayi (2009), the use of cost method in mortgage valuation is the cause of over estimation of market values of income producing properties in Nigeria, and this is why Banks are unable to recover mortgage debts secured by such properties when they are sold on foreclosure.

The aim of this paper therefore is to examine and analyse the recent market sales evidence of blocks of residential flats and their rental values in three nighbourhoods in Aba with a view to determining the appropriate yield (capitalization rate) which when applied to the valuation of comparable properties will give accurate estimate of market value that reflects actual market price

2. BASIS OF MORTGAGE VALUATION

According to Babawale (2007), one of the best known definition of valuation is that given by the International Valuation Standard Committee (IVSC, 2003), which defines valuation as the estimation of the amount for which a property should exchange on the date of valuation between a willing buyer and willing seller in an arm’s length transaction after proper marketing wherein the parties had acted knowledgeably, prudently and without compulsion.

The purpose of valuation normally dictates the basis to be adopted (Salau, 2012). As noted earlier, valuation for mortgage usually envisages a possible sale of the property if the Mortgagor defaults in repayment of the loan plus accrued interest when legally demanded. Thus, the open market value determined by reference to the most recent sale of similar or comparable properties as well as by reference to listings and offerings of comparable real properties or forced sale value taken as a percentage of market value usually two third (2/3) of the market value as the case may be should be the basis of valuation (Babatunde, 2003 and Olusegun, 2008)

2.1 Open market value

Open market value or value in Exchange according to Olajide and Bello (2003) has been variously defined as;

The highest price in terms of money which a property will bring if made available for sale in the open market, allowing a reasonable time to find a purchaser who buys with the knowledge of all the uses to which it is adapted and for which it is capable of being use.

i. The price at which a willing seller will sell and a willing buyer will buy neither being under abnormal pressure.
ii. The money obtainable from a person willing and able to purchase an article which is offered for sale by a willing seller.

According to Ifediora (2009), open market value as defined by the RICS and adopted by The Nigerian Institution of Estate Surveyors and Valuers notes on valuation is intended to mean the best price at which an interest in a property might reasonably be expected to be sold by private treaty at the date of valuation assuming:

a. a willing seller
b. a reasonable period within which to negotiate the sale, taking into account the nature of the property and the state of the market;
c. values will remain static throughout the period;
d. the property will be freely exposed to the market;
e. no account is taken of an additional bid by a special purchaser.

The open market value adopted by the American Institute of Real Estate Appraisers is very close to the one above and according to Ifediora (2009) is defined as the highest price estimated in terms of money which a property will bring if exposed for sale in the open market, allowing a reasonable time to find a purchaser who buys with the knowledge of all the uses to which it is adapted and for which it is capable of being use; the price at which a willing seller would sell and a willing buyer would buy, neither being under abnormal pressure; price expected if a reasonable time is allowed to find a purchaser and if both seller and prospective buyer are fully informed.

3. METHODS OF MORTGAGE VALUATION

Valuation Surveyors adopt different valuation methods when valuing different types of properties for different purposes. When valuing for mortgage, the Valuation Surveyor, depending on the type of property accomplishes the task by using any of the two principal valuation methods:

i. Depreciated Replacement Cost Method.
ii. Investment Method.

3.1 The depreciated replacement cost method

This method is based on the basic principle of land economy that the alternative to an existing building is a new one. Therefore a purchaser of a particular property in making an offer to buy will consider what it will cost him to erect a similar building at an alternative site within the same or comparable neigbourhood. The basic theory of this method is that the market value of a property is equal to the market value of the site plus the cost of replacing the building less any necessary allowances for depreciation and obsolescence (Udechukwu, 2009). Also no prudent investor would want to sell below the cost of development. The value of the site is based on the market price of comparable sites, while the cost of erecting the building is derived from the prevailing construction cost rates in the building industry. The method seeks to equate cost with value and its application is restricted to specialized properties where there is no rental evidence, no sales and where there are no comparable alternatives. Such properties are Churches and Mosques, Public buildings and facilities, purpose built factories and specialized warehouses, petrol filling stations, cinemas, industrial plants, luxury residences, uncompleted buildings, specialized properties by reason of locational design, etc.

3.2 The investment method

The investment method of valuation is modeled after the income approach to value and is based on the discounting concept of time value of money. The basic theory of this valuation method is that no reasonable investor acting prudently will pay more for an income producing property than the present worth of the stream of future incomes or benefits derivable from the property, taking into consideration the risk in acquiring the property and the level of returns required. The method is traditionally used to value income producing properties and assumes that the owner-investor would surrender occupation for a periodic payment by tenants normally termed rent (Udechukwu, 2009). Thus, in valuing income producing properties the capital sum required to purchase the series of rents is determined by estimating the expected rental income of the property, with allowance for necessary outgoings in the nature of management, repairs and maintenance and the resultant net rental income multiplied using an appropriate multiplier called Years' Purchase (YP). The process is mathematically expressed as:

Net annual income X Years' purchase = Capital Value.

Years' purchase ordinarily could be taken to mean the number of years the income from the property would equal its present capital value. According to Idudu (1993) it is defined as:

"A multiplier derived from the rate of return which a reasonable investor decides he will require from a property that is the yield, which he requires to obtain". In Nigeria, it refers to the present value of N1 per annum (either in arrears or in advance) at a certain compound rate of interest for a number of years (Olusegun, 2008)

It is evident from the above definition that the yield is very important in the correct application of the investment method. It is more reliably determined by using the first principles to break locally established Y.P. in perpetuity figure thus:

$$\frac{100}{\text{Y.P.}} = \text{R or yield in percentage}$$

If the appropriate yield is known, the years' purchase can easily be derived as a reciprocal of the yield. Otherwise it is derived from the analysis of recent market transactions on comparable properties thus:

$$\text{Y.P.} = \frac{\text{Market Price of a comparable}}{\text{Net annual income of the comparable.}}$$

Gross rental income can be employed as the basis for determining market value when using the income approach to valuation, in which case the Y.P. is called Gross Income Multiplier (G.I.M.) (Elekwachi, 1996).

The annual income which the property is capable of generating i.e. the expected rent is determined taking in to account the actual rents passing on comparable properties. That is to say that the actual rent being paid by the occupiers of the property being valued may not necessarily be used in the valuation.

4. APPLICATION OF THE INVESTMENT METHOD

Since after the introduction of the Structural Adjustment Programme (SAP) in September, 1986 and subsequent introduction of certain fiscal measures aimed at revamping and restructuring the Nigerian economy, the country has been witnessing steady increase in prices and general illiquidity as a result of depreciation of the Naira. Cost of building construction has continued to skyrocket without corresponding increase in rental income from the development. Investment method of valuation, applying yield based on intuition as was the practice before 1986 now gives relatively low market value than the actual market price

This situation has therefore created doubts and some confusion as to the applicability of the investment method in Nigeria. Some valuation surveyors are of the view that the investment method is no longer relevant within the context of the present Nigerian economy and property market environment (Elekwachi 1996; Otegbulu, 2005). Consequently, most valuation surveyors now resort to the use of Depreciated Replacement Cost (DRC) method when valuing income producing properties for mortgage purpose (Otegbulu, 2005). Ajayi (2009) in Bello et al (2012) confirmed that the replacement costs are often unrelated to market prices and the use of costs method for mortgage valuation by some Estate Surveyors and Valures in Nigeria frequently provided over estimation of market values especially when the properties are income generating ones.

Ogunba (1997) in Bello at al (2012) linked the non performance of securities used as cover for loans on the valuers method especially the cost method which is adopted for virtually all types of properties in Nigeria.

For correct and proper application of the investment method therefore, the yield, must be derived from the analysis of recent sale prices of comparable properties and their corresponding rental incomes as shown in table 1 below

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Table 1: Market Sales Evidence of Blocks of Residential Flats In Aba

S/No	Property Location	Description	Nature of title	Price ₦	Rental Value ₦	Year of Construction	Date of Sale	Y.P.	Yield
1.	Umungasi	3 storey block of 6 Nos. 3 bedroom flats	Power of Attorney	25,000,000	1,080,000	1988	Dec. 2015	28.93	3.5
2.		2 storey block of 4 Nos. 3 bedroom flats	Power of Attorney	17,000,000	720,000	1990	Feb. 2016	29.51	3.4
3.		4 storey block of 8 Nos. 3 bedroom flats	Power of Attorney	38,000,000	1,440,000	1998	Feb. 2016	33.0	3.0
4.	Ogbor-Hill	3 storey block of 6 Nos. 3 bedroom flats	Power of Attorney	21,000,000	864,000	1986	May 2016	30.38	3.2
5.		4 storey block of 8 Nos. 3 bedroom flats	Power of Attorney	30,000,000	1,152,000	1990	April 2016	32.55	3.1
6.		2 storey block of 4 Nos. 3 bedroom flats	Power of Attorney	13,000,000	576,000	1985	April 2016	28.21	3.5
7.	Main Township	3 storey block of 5 Nos.3 bedroom flats, 1 W/H	Certificate of Occupancy	35,000,000	1,440,000	1990	Mar. 2016	30.38	3.3
8.		4 storey block of 6 Nos. 3 bedroom flats, 2 W/Hs	Certificate of Occupancy	45,000,000	1,920,000	1995	April 2016	29.3	3.4
9.		3 storey block of 4 Nos. 3 bedroom flats, 2 W/Hs	Certificate of Occupancy	36,000,000	1,440,000	1988	May 2016	31.25	3.2

SOURCE: Authors Field Survey, 2016

Using the information in table 1 above, the yield of a block of residential flat in Umungasi, Aba as at may, 2016 is derived thus:

3 Storey Block of 3 bedroom Residential Flats at Umungasi

Gross Rental income	N1,080,000.00
Less: Outgoings @20%	N216,000.00
Net Income	N864,000.00

$$\text{Years' Purchase (YP)} = \frac{\text{Sales Price}}{\text{Net Income}}$$

$$= \frac{N25,000,000.00}{N864,000.00}$$

$$= 28.93$$

$$\text{Yield} = \frac{100}{\text{Y.P.}}$$

$$= \frac{100}{28.93}$$

$$= 3.45$$

$$= 3.5\%$$

The market analysis of the nine properties in table 1 reveals a yield range of 3.0 -3.5 percent. Similar calculation can be developed for all classes of income producing properties. In valuing a block of 3 bedroom residential flats in Aba using the investment method the appropriate yield which will give an accurate estimate of market value that will reflect actual market price should be the range of 3.0-3.5 percent

5. CONCLUSION

This study has revealed that investment method is still the most appropriate and reliable method of valuing income producing properties for mortgage purpose in Nigeria. For the method to reflect actual market price, appropriate yield derived from the analysis of recent market sale prices of comparable properties and their and rental values must be applied.

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