# CRITICISM OF THE 'PROFITS METHOD OF VALUATION' WHICH IS USED TO EVALUATE LICENSED PROPERTIES (BUSINESSES)

By

**ZACHAROULA ZAGORAIOU KONSTANTINOU**

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# CRITICISM OF THE 'PROFITS METHOD OF VALUATION' WHICH IS USED TO EVALUATE LICENSED PROPERTIES (BUSINESSES)

**Dissertation**

***Advisor***

**Thomas Dimopoulos**

**&**

**Dr. Christos Volos**

***Program Director***

**Dr. John Politis**

# ABSTRACT

The purpose of this study is to examine the effectiveness of the profits method of evaluation when is used to evaluate licensed properties. At the beginning of the study there is a review of the current literature on the evaluation methods that are used internationally and in Cyprus using the key words profits method evaluation, licensed properties, real estate, market value. Subsequently the profits method is widely elaborated and analyzed. Furthermore, the research includes a case study in which a Cyprus listed company is evaluated using three different approaches.

The major findings indicate that the results of every approach significantly differ. In particular, the profits method findings approximate the income approach with the discounted cash flow analysis, while, on the other hand, the cost approach findings is significantly different.

In conclusion, the difficulty of the profits involves not only the correct estimate of the data used but also the correct estimate of the capitalization rate.

It is recommended that the valuer should possess great experience on the local property market, along with specific knowledge and skills in order to be able to choose the proper data for each valuation.



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# INTRODUCTION

The valuation of real estate is a central tenet for all business. Valuation is the determination of the amount for which the property will transact on a particular date. There is a wide range of purposes for which valuations are required. These range from valuations for purchase and sale, transfer, tax assessment, expropriation, inheritance or estate settlement, investment and financing.

The role of the appraiser nowadays is very difficult and complex. By June 2008 sales of properties in Cyprus fell dramatically compared to the previous years. In early 2010 property prices in Cyprus began to fall due to the global credit crunch. In previous years there had been a huge increase in property prices. The fall in prices continues until today with a negative impact on the economy. The appraiser is required to meet market needs under extremely difficult conditions in an unstable economic and social environment.

Although the review of the literature suggests that the profits method of valuation is used for the properties that produce profit we like to prove that the profit method can lead to unreliable results, especially when not given the required attention to the introduction of the available data. The data used should be checked both for reliability and for effectiveness, and some other method or methods of valuation should be used to check the result.

The aim of this study is to empirically examine the impact of the specific indicators that are used in the process of the profits method. The indicators are: the data used by the accounts of the particular business connected with the property, the scope of the valuation, the role of the business operator and the general economic conditions affecting the business and therefore its value.

**Hypothesis: Due to the large amount of parameters in the profits method of valuation, there is a lot of risk involved. Therefore, it should be better verified with another method. The difference between the valuation outcomes of the two approaches reflects the risks.**

# CHAPTER 1: METHODS OF PROPERTY VALUATION

The purpose of a property valuation is to estimate the capital value of an interest of property. Land and property are factors of transactions (buying and selling). The majority of valuations are prepared on the basis of market value, which is defined as:

> "The estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had acted knowledgeably, prudently and without compulsion." (RICS *The Red Book* 2007*)*

## 1.1. INTERNATIONAL VALUATION METHODS

The most ordinary methods used to value different types of property are three. The principal three methods which are used globally are the comparison, the investment and the contractor's or cost method. The valuer can generally choose from three approaches to determine the value. One or two of these approaches will usually be most applicable, with the other approach or approaches usually being useful. The valuer has to think about the 'scope of work', the type of value, the kind of property, and the quality and quantity of data available for each approach.

- **The cost approach**

In the cost approach method the value of a property can be estimated by summing the land value and the depreciated value of any improvements. The value of the improvements is often referred as 'reproduction (or replacement) cost new less depreciation' (RCNLD). Reproduction refers to reproducing an extra replica. Replacement cost refers to the cost of building the improvement which has the same utility, but using modern design, workmanship and materials.

In most cases when the cost approach is involved, the overall methodology is a hybrid of the cost and sales comparison approaches. For instance, the replacement cost to construct a building can be determined by adding the labor, material, and other costs. On the other hand, land values and depreciation must be derived from an analysis of comparable sales data.

The cost approach is considered most reliable when used on newer structures, but the method tends to become less reliable for older properties. The cost approach is often the only reliable approach when dealing with special properties (i.e., public assembly, marinas).

- **The sales comparison approach**

The sales comparison or market data approach in a real estate appraisal is based primarily on the principle of substitution. The valuer finds three to five (or more) properties that have been recently sold and are similar to the subject property. Sources of comparable data include real estate publications, public records, buyers, sellers, real estate brokers and agents, and so on. In the valuation report all of the important details are described of each comparable item. The valuer notes any dissimilar features and makes an adjustment for each of them. Adjustments may be made for the date of sale, location, style, amenities, size, etc.

The comparison method is used for the most types of property and where there is plenty of evidence of previous sales. The basic steps of the method are three.

1. Selection of the market comparables.
2. Analysis of the comparative sales or rental contracts.
3. Sale or rental prices adjustments for differences in location, age and condition, accommodation and market movements and finally the valuer estimates the market rent or the market value of the property.

- **The income capitalization approach**

The income capitalization approach is based on the net income, or investment return, that a buyer expects from the property. The method is used to value commercial and investment properties, where sufficient market data exists. The valuer evaluates the income stream in terms of quantity, quality, duration, and shape, and then converts it by means of an appropriate capitalization rate into an estimated present value. This estimate is the amount that a prudent investor would be willing to pay now for the right to receive the income stream produced by a particular property.

Alternatively, multiple years of net operating income can be valued by a discounted cash flow analysis model (DCF). The DCF model is widely used to value larger and more expensive income producing properties, such as large office towers or major shopping centers.

## 1.2. UK VALUATION METHODS

In the United Kingdom, valuation methodology has traditionally been classified into five methods. The five methods used in the UK are: the comparison, the profits, the residual, the contractor's and the investment methods.

- **The comparison method**

The comparison method is used for most types of property where there is good evidence of previous sales. It is used not only as a method in its own right but also as a component of each of the other methods.

- **The residual method**

The residual method often used in valuation of development land (vacant land) or buildings that has potential to refurbish or changed the current use to a more profitable one. The basic calculation of the method is:

Land Value =
Gross Development Value
Less
Costs of development, including developer's profit

The input variables need to be well researched, analyzed and carefully considered, because most of them in the initial appraisal will differ from those that will actual occur during the development process.

- **The contractor's method**

The contractor's method is a cost method of valuation. The method is used when no active market exists for the particular type of property and there is no evidence of selling or letting transaction. These types of properties are usually non-profit making, public buildings and pri-

vate buildings that are designed, used or located for specific reasons of their owners. The basic formula of the method is

Value of property =
Value of the site
Plus
Adjusted replacement cost of buildings
The adjustments reflect the age of the existing buildings. The weakness of the method is the fact that land cost plus building cost does not necessarily equate to the value, because the value is determined by supply and demand and not by the production cost.

- **The investment method**

The investment method *(Blackledge, 2009)* is used for the most commercial and residential properties that are producing or have the potential to produce future cash flows through the letting of the property. The capital value of a property investment is estimated by multiplying the annual income flow by a multiplier, which is the cumulative present value factor and it is therefore usually termed as the *years purchase* (YP). The process is known as 'capitalization'.

- **The profits method**

The profits method has long been known as the profits principle *(Scarrett, 2008)* and there has been a tendency in recent years to adopt what is regarded as a more explicit title, namely the receipts and expenditure method, particularly where it is used to arrive at rating assessments.

The argument behind the profits method is that the value of the land is related to its earning capacity, the ability of the property to generate cash flow. Hence, the tenant cannot build or lease alternative premises, the landlord can demand a share of the profits as a rent payment.

An appraiser may use *(Armatys, John et al., 2009)* one or more, of the five methods of valuation to estimate either the market value (a capital value) or the market rent (a rental value) of a property. Valuers always prefer to use the comparative method for assessing market value or market rent. The other methods; profits, residual, contractor's and investment, are used when the comparative method cannot be used with full confidence because there is little, or no, evidence of comparable market transactions.

## 1.3. CYPRUS VALUATION METHODS

In Cyprus the method mostly used is the comparison method. This happens because it is linked directly to evidence of current market transactions and Cyprus acquires these elements through the Department of Land and Surveys. According to the manager of the valuation department the Land and Surveys Registry Department uses exclusively the comparison method. In cases of licenses properties (business) the method that it is mostly used is the cost approach method.

New evidences related to the ongoing economic crisis have created serious problems in the field of property valuation. Cyprus construction industry is suffering from the impact of the global recession and the continuing lack of liquidity. As a result the number of building permits continues to fall with no signs of soon recovery. According to the latest figures released by the Cyprus Statistical Service, the number of building permits in June (2012) has presented a decrease of 20% compared to the data in June last year. Furthermore, sales figures from the Cyprus Department of Land and Surveys indicated that the number of properties sold across the inland continues to fall dramatically with overall sales declining by more than a quarter (27%).

The situation described in the previous paragraph has been leading the valuation process in deadlock. The customers complain regarding the recent estimated value of properties which have as an impact the higher cost on transaction fees. Comparative evidence relating to sales prior to three years should be adjusted by 30% lower to reflect the current reality. This occurs largely based on the empirical methods rather than the scientific methods.

## 1.4. METHOD OF BUSINESS VALUATION

The most widely recognized valuation methods for business valuation, in scientific literature, are three.

- The cost (asset) approach values a company by accumulating the costs that currently are required to replace the asset. There are two distinct Cost Approach methods: Reproduction Cost and Replacement Cost. ‘Reproduction Cost’ is the level of expenditures needed to reproduce an exact replica of the asset. ‘Replacement Cost measures the expenditures necessary to develop an asset with similar utility. The premise of the

cost approach is that an investor would pay no more to purchase the asset, than would pay to reproduce the asset.

- The Income Approach considers future earnings by calculating the present value of projected cash flows at a reasonable present value discount rate. There are two kinds of methods of the income approach:

1. Methods of single period – dividend capitalization, earnings capitalization, cash flow capitalization.
2. Methods of multiple periods – analysis of discounted cash flows.

The main advantage of these methods is the indication of fair market value based on the expectations of the future company specific economic performance.

- The Market Approach values the business based on comparison of sales of similar businesses. Factors, such as the lack of recent sales data, the numerous insupportable adjustments that are necessary and the general inability to determine the true financial terms and human motivations of comparable transactions, often make the results of this technique questionable.

## 1.5. GOVERNING AUTHORITIES AND PROFETIONAL ORGANIZATIONS

- **International Valuation Standards Council**

The International Valuation Standards Council (IVSC) is an independent, non- profit, private sector organization incorporated in the US and with its headquarters in London. The IVSC develops and promotes technical and ethical standards for the conduct of valuation on which investors and other rely. The objectives of the IVSC are to strengthen the worldwide valuation profession by:

- Developing high quality international standards and supporting their adoption and use;

- Facilitating collaboration and cooperation among its member organizations;
- Collaborating and cooperating with other international organizations; and
- Serving as the international voice for the valuation profession.

The IVSC is a membership organization and is open to a wide range of stakeholders including professional institutes, valuation providers, standard setters, regulators of valuation services and academia. Members are provided with a forum for participation in the work of the IVSC which can advise the Boards on agenda priorities. The IVSC currently has 74 member bodies from 54 countries.

- **The European Group of Valuers' Associations**

TEGoVA is a pan-European association of professional bodies working for standards, ethics and quality in the real estate valuation market. TEGoVA is a non-profit organization established in Brussels, under Belgian Law. TEGoVA represents the interests of 46 professional bodies from 27 countries with the total of over 70.000 members and speaks with a common voice on valuation to European legislators and policy-makers. Its main objective is the creation and spreading of harmonized standards for valuation practice, for education and qualification as well as for corporate governance and ethics for valuers. It supports its member associations in the introduction and implementation of these standards. TEGoVA has been responsible for the publication of European Valuation Standards (EVS) since the early 1980s. The seventh edition was launched on 11 May 2012 at an international valuation conference in Krakow.

- **Appraisal Institute**

The Appraisal Institute is a global membership association of professional real estate appraisers, with nearly 23,000 members in nearly 60 countries throughout the world. Its mission is to advance professionalism and ethics, global standards, methodologies, and practices through the professional development of property economics worldwide. Organized in 1932, the Appraisal Institute is the acknowledged worldwide leader in residential and commercial real estate appraisal education. As the world's largest publisher of real estate appraisal literature, the Appraisal Institute offers a wide range of books and other materials on subjects ranging from basic valuation theory and techniques to advanced applications.

- **American Society of Appraisers**

The American Society of Appraisers (the "Society) is a multi-discipline non-profit international organization of professional appraisers (valuers). Founded in 1936, the mission of the Society is to foster the public trust of our members and the appraisal profession through compliance with the highest levels of ethical and professional standards. The American Society of Appraisers:

- Helps the public and professionals find an ASA accredited appraiser
- Is the only professional valuation organization that accredits members in every appraisal discipline
- Works to grow the appraisal profession
- Foster professional excellence in its membership through education, accreditation, publication and other services with an emphasis on professional ethics to protect the public

- **Royal Institution of Chartered Surveyors**

The Royal Institution of Chartered Surveyors (RICS) is an independent representative professional body which regulates property professionals and surveyors in the United Kingdom and other sovereign nations. RICS provides education and training standards, protects consumers with strict codes of practice and advises governments and business. RICS provides expertise in matters involving fixed assets, including but not limited to land and real property. The RICS professional guidelines for valuers are published in what is commonly known as the 'Red Book'. The RICS Valuation Standards contains mandatory rules, best practice guidance and related commentary. *(from Wikipedia)*

# CHAPTER 2: THE PROFITS METHOD OF VALUATION

## 2.1. BASICS OF PROFITS METHOD

The profits method, which is sometimes referred to as the accounts method, the profits test or the receipts and expenditure method, is only used when it is not possible to value by comparison because reliable comparables are not available. This tends to be when the element of monopoly exists. The basic approach consists of using the final accounts or any other trading information to find the gross and the net profit. Allowances are then made for interest on the tenant's capital employed in the business and remuneration for the management expertise. With this method the capital or the rental value is related to the expenditures and receipts occurred and the profit from the business operation. The remaining amount (referred to as 'the divisible balance') is then assumed to be available for an equitable division between the tenant and the owner. The reason is to provide an adequate reward to the tenant for running the business.

The valuer uses figures derived for recent accounts to measure the sums involved in achieving the annual turnover and the level of expenses incurred before gross and the net profit are struck. It is important to consider a full year's figures because many businesses are seasonal and may, for example, have increased takings in the summer or in the run up to Christmas. If the accounts are for 14 months the valuer should take care to ensure that seasonal variations are allowed for and should not simply divide by 14 and multiply by 12. The valuer should beware of accounts drawn up for periods more than a year. If possible the valuer will look at the accounts for the three or five recent trading years.

In other worlds, if it is no feasible to accumulate the accounts, then the valuer himself has, to estimate the figures. When a capital value is required, this rental value can be then capitalized (multiplied by a Year's Purchase) at an appropriate rate (all risks yield), derived from comparable evidence.

## 2.2. WHERE PROFITS METHODS IS USED

The profits method is used in the particular type of business activity, where the other approaches would be unlikely to be satisfactory or there are no direct comparables. The types of property to which it is applied tend to be in the tourism, leisure, hospitality and entertainment sector, or where there is an element of monopoly involved in the premises or its location, thus making comparison difficult. For instance, there is a plethora of variables in the hotel industry and all of the above methods cannot be used accordingly.

According to *French & Edwards, (2005)* the type of property that could be referred to as specialised, are those properties that seem to have insufficient market data to value them by some form of comparison. In theory, all the valuations of specialised buildings are that they are valued on the assumption that the existing use of the building will continue. On this basis, there is a number of assets that could be described as specialised. These may be: Telecommunications, Mineral Extractions, Land Fill, Bars and Restaurants, Casinos and Clubs, Cinemas and Theatres, Hotels, Leisure Properties (private and public), Hospitals, Petrol Station.

The tenant's rental bid is based on the volume of trade expected. The best guide as to what level of trade can be expected in any given situation is the actual accounts of the actual occupier. But these must be treated with caution. It is advisable to use other approaches, such as indirect comparison or discounted cash flow, to check the value found from the profits method.

In the case of properties that are economically capable of occupation as licensed properties but are vacant, the same principles and approach should be applied, with appropriate adjustments and weighting attached to the various factors affecting the value. Based on the yearly accounts on similar businesses, it can be used to estimate licensed vacant properties and therefore extract the Market Value.

## 2.3. THE PROCESS OF THE PROFITS METHOD

For the process of the profits method RICS Practice Standards (RICS Practice Standards, *The capital and rental valuation of public houses, bars, restaurants and nightclubs in England and Wales*, 2010) suggests the following steps:

- Step 1: An assessment is made of the Fair Maintainable Turnover that could be generated at the property by a Reasonably Efficient Operator.
- Step 2: Where appropriate an assessment is made of the potential gross profit, resulting from the Fair Maintainable Turnover.
- Step 3: An assessment is made of the Fair Maintainable Operating Profit. The costs and allowances to be shown in the assessment should reflect those to be expected of the Reasonably Efficient Operator, which will be the most likely purchaser, or operator of the property if offered in the market.
- Step 4: (a) to assess the Market Value of the property the Fair Maintainable Operating Profit is capitalized at an appropriate rate of return reflecting the risk and rewards of the property and its trading potential. Evidence of relevant comparable market transactions should be analyzed and applied.

RICS Practice Standards provides definitions of the "Fair Maintain Turnover" as "the level of trade that a "Reasonably Efficient Operator" would expect to achieve on the assumption that the property is properly equipped, repaired, maintained and decorated", and the "Reasonably Efficient Operator" as "a concept where the valuer assumes that the market participants are competent operators, acting in an efficient manner, of a business conducted on the premises". The "Reasonable Efficient Operator involves estimating the trading potential rather than adopting the actual level of trade under the existing ownership, and it excludes personal goodwill. RICS Practice Standards also introduced the so-called "Personal Goodwill" as "the value of profit generated over and above market expectations that would be extinguished upon sale of the trade related property, together with financial factors related specifically to the cur-

rent operator of the business, such as taxation, depreciation policy, borrowing costs and the capital invested in the business".

The Fair Maintain Turnover in this approach is an estimate of the valuer and not only by calculations of the actual results of the business. Therefore, there is an uncertainty in the assessment of this item. Then there is an assessment regarding the Fair Maintain Operation Profit, which is calculated under an uncertainty too. Finally, the appropriate interest rate that is used to assess the Market Value is estimated according to the data that the valuer will use. On balance, in the process of applying the profits method principle, the valuer has to acknowledge three consecutive estimations in order to reach an overall final estimation of the Market Value. It therefore, accentuates and justifies the initial hypothesis.

The basic calculation *(Blackledge, 2009)* undertaken for the profits method is:

Gross receipts
Less purchases
= Gross Profit
Less adjusted working expenses (exclude rent, rates and certain other items)
=Net Profit or Divisible balance
Less tenants or proprietor's share (their income/profit for running the enterprise) including interest on their capital
=Balance for rent + rates
Less rates payable
= Market rent

Gross receipts are found in business accounts and consequently entail hazards, such as camouflaging the real business revenue by not giving receipts and accumulating more profit than the actual account provided; therefore avoiding to pay the appropriate tax. Regarding less purchases it can also be stated that a similar procedure is applied. For example, irrelevant personal purchases are presented into the company's account as a result less gross profit is calculated. As far as concerns working expenses there is an additional cost on the company's accounts such as demonstrating wages and salaries and various entertainment expenses that relate people who are not included or associated by anyway to the company's personnel. Over-

all, the final accounts evidence given does not posit validity towards the real profit of the company.

- **Profit**

The aim of every business is to make profits at the end of a given financial period. Business people keep themselves motivated and driven by setting targets for a given financial period. Calculating the estimated gross profit at the end of a given financial period is one way to set a target for yourself at the same time keeping you motivated. Gross profits give the figure expected to be the profit before any deductions are made.

- **Gross Profit**

Gross profit is expressed on a company's income statement. Some expenses are deducted to arrive at a company's gross profit, but not all of them. All other company expenses, including items such as overhead, depreciation on company assets and other expenses, are subtracted from gross profit to arrive at net profit. Net profit tells you what the company really earned after all expenses are deducted.

- **Purchases**

By the term purchases usually refers to the cost of the goods bought in by the business for manufacturing and/or resale, excluding VAT. The category of 'purchases' cover the 'raw materials' used in the business, for example, for a restaurant it will be the food ingredients and drink purchases.

- **Working expenses**

The working expenses *(Armatys, et al., 2009)* include wages, services (electricity, gas, water, drainage, telephone and internet service provider), insurance, renewal of fixtures, fitting and equipment, advertising and business rates (unless valuing for rating) and any other costs to the tenant associated with running the business, but not rent. Rent is excluded because this is the figure that the calculation is trying to find, and rates are excluded in a rating valuation for the same reason.

Working expenses provide scope for argument over what items of expenditure should and should not be included. Distinction must however be made between repair (which is carried

out to maintain the property in its present stage) and improvement, which will tend to increase the value of the property and it is not allowable as an annual expense being a capital expenditure. Repairs and insurance cover should be carefully checked to see if they are adequate and reasonable. Neglecting repairs could enhance short term profits, but the accumulative dilapidations will have an adverse effect on value in the long term. On the other hand, excessive repair costs could indicate the work is more in the nature of renewal and improvement. *(Blackledge, 2009)*

- **The net profit**

The net profit is sometimes referred to as EBITDA (Earnings before Interest, Tax, Depreciation and Amortization). Any borrowings are added back and the tenant's capital employed in the business is reflected at an appropriate rate of interest. If the proprietor's wife is paid for nominal work to avoid tax this amount should be added back. Any private expenses for the business and the depreciation are normally added back.
The result is the Divisible Balance and it is the amount which is available to be share between the tenant and the landlord. The tenant's share represents the reward for the entrepreneurial of the company and the landlord's share represents compensate for making the premises available.

- **The Divisible Balance**

The Divisible Balance is usually divided equally but there are cases that tenant should keep a larger proportion of the available balance, for example 60 per cent. The tenant's share consists of interest of his capital, his remuneration for the work in the business and an amount that reflects the risk. The interest on capital is a commercial rate that is taken on the value of plant and machinery, fixtures and fittings, equipment, vehicles, and working capital (stock, cash in hand and bank current account). For many businesses it is usual to estimate the working capital by assuming that the stock is of three weeks purchases and therefore allowing for cash in hand and in the bank of three weeks expenses. No allowance is made for the value of land and buildings. Tenant's remuneration is a reasonable allowance for the work of the tenant including an amount to reflect risk and enterprise. The tenant's share is often about half the divisible balance, although if the market for the property is good the hypothetical tenant may be pre-

pared to pay a higher proportion of the profit as rent, while if there is little demand the hypothetical tenant will pay less.

The tenant's share should also be considered as a monetary amount, to ensure that is enough to provide a satisfactory livelihood for the proprietor and give a proper return for the tenant's efforts and for the risks being carried. An alternative way in taking a proportion of the divisible balance is to estimate the tenant's share as a percentage of the gross earning.

- **Market Value**

The amount remaining (after deducting the tenant's share) is the payment for rent and rates. The profit method finds a rental value. If a capital value is required the market rent found by the method capitalized when using the investment method is to calculate the capital value of the land and building. Alternatively, a multiplier can be applied to the net profit in order to calculate the market value. The second approach includes the value of the business carried out on the premises in addition to the value of the land and the buildings.

The valuer then needs to form a view on how to capitalize the sustainable profit of the enterprise. This may simply be capitalized, or it may be considered desirable to separately identify rent for capitalization at a different rate from the multiplier applied to profit after rent. It is very important for the valuer to be able to explain and justify the chosen basis.

## 2.4. ISSUES WITH THE PROFITS METHOD

The weaknesses *(Armatys, et al., 2009)* of the profits method include:

- There can be problems over the disclosure of the occupier's accounts. The lease may require the tenant to produce the necessary information, which will often be regarded as confidential (and therefore should not be quoted either in a report which may be public or when providing details of comparables in any later valuation). The valuer must then make an assessment of how reliable the figures provided are. If there are doubts about the accuracy of the accounts the valuation report should recommend that the information be verified before the valuation is relied on or published, and that an opportunity be given to revise the report if there are any material discrepancies.

- The valuer's judgment on the share of the profit that goes to the tenant has a critical effect on the figure for rent.
- While valuers cannot anticipate all future trading trends, they need to be aware of the history of the premises and general trends in the business concerned, including changes in legislation which may affect trading potential.
- The profits method is normally applied to properties which require specialist knowledge and skill. The valuer must be very familiar with the market for the type of property concerned, the likely purchasers and tenants, the anticipated levels of trade, current and likely future levels of competition, and any other risks involved.
- The valuation report should include an assumption that all licenses, consents and other approvals necessary for a business to continue to trade from the premises will be renewed.

## 2.5 THE ROLE OF THE OPERATOR

With references to the above, in most types of property, the amount of profit made is dependent much more on the skills and business acumen of the tenant rather than the characteristics of the property in association to the management. It is difficult to separate the personal compared to the intrinsic value of the business and premises. It is therefore illustrated that the operators role is of vital importance in conducting the real property value.

The 'personal goodwill' (International Valuation Standards GN 12) (of the current operation) is defined as:
"the value of profit generated over and above market expectations that would be extinguished upon sale of the trade related property, together with financial factors related specifically to the current operator of the business, such as taxation, depreciation policy, borrowing costs and the capital invested in the business".

A 'reasonably efficient operator' (International Valuation Standards GN 12) is defined as:
"A market-based concept whereby a potential purchaser, and thus the valuer, estimates the maintainable level of trade and future profitability that can be achieved by a com-

petent operator of a business conducted on the premises, acting in an efficient manner. The concept involves the trading potential rather than the actual level of trade under the existing ownership so it excludes personal goodwill".

Property management is significant for the property. Good property management (Edington, 1997) not only keeps the property in a good condition, but also minimizes the operating cost and provides a positive image to the property. In addition it is a business that can create wealth by adding values to other related business.

When actual accounts are used to assist in the formulation of an estimate on future trading potential, they will show only how a property is trading under the particular management at the time. Current and past performance is no guarantee for the future profit when is attributable solely to the personal circumstances or skill, expertise, reputation or brand name of the existing operator. It is well known that a business operated by a celebrity, for example, a famous chef or an Olympic athlete is likely to attract additional successfully by association with the well-known name. That element of value is a unique and cannot be transferred to another person.

The role of the operator has a significant relationship with the property management quality. If the quality of the property increases not only the value of the property increases, but also attracts potentials buyers. The property quality management has to do with the good condition of the buildings, security, hygiene, cost saving and many aspects that provide a positive image to the property in the eye of the potential buyers. These are elements that a valuer should take seriously into consideration for the final valuation of the property.

## 2.6. UNCERTAINTIES

It is obvious that even if there is sufficient evidence for the particular property, always some inconsistencies may affect the future profitability of the business. These factors cannot be predicted or sometimes can be hidden intentionally. It is important to consider these factors, which they usually have nothing to do with the particular business, to the value process. Some of these factors are:

- The global economic crisis with the cascading effect, creates an environment of instability, and hence affect on the economic development of the business. The uncertainty in the current and future market conditions postulate into an uncertainty with the estimated value price.
- The global climate changes and the impact on an asset can affect on the property value. The storm impact, the effect of sea level rise and other factors may create some secure locations more desirable and some others undesirable as a result to affect the property value.
- Changes in competition can have a dramatic effect on profitability, and value. Sudden growth in the region, where the property is located, leads to increasing competition. New entrants in the industry can affect the competition. Great rivalry can positively or adversely affect the value of the property.
- Outside influences, such as the construction of a new road, changes in relevant legislation or changes of urban planning zones can also affect the trading potential and therefore the value of trade related property.
- Last but not least, trends normally affect the property value and most property purchases are promoted through advertising and general interest compelled either by the local or the global market. For a period of time a structural bubble frame is created thus establishing stability and once reaching its potential it instantly drops, losing its great interest and eradicating the trend itself.

## 2.7. THE ROLE OF THE VALUER

The valuer can only provide his opinion of value based on the available data and on his own experience. The valuer is required to possess the competence and sufficient knowledge of the particular market to undertake the related valuation. Assistance from other technical experts must be sought by the valuer on matters outside the valuer's area of expertise.

The valuation of property assets must be prepared by an independent valuer who meets the following minimum requirements:

- Relevant university degrees and professional experience in property valuation;

- A missing university degree might be compensated by a longer period of professional experience in the property business and/or in property valuation;
- Submission of property valuations (valuation reports) covering different types of properties. (European Valuation Standards 2012)

In the "RICS Valuation Standards" all the above applies and additional:

- Membership of a professional body, demonstrating a commitment to ethical standards;
- Compliance with any state legal regulations governing the right to practice valuation

A valuer is independent where either he or any of his partners or directors or employees of the client or have a significant financial interest and the client does not have a significant financial interest in the valuer's firm.

The valuer must not accept any engagement to conduct valuation for the corporation in cases where there may be an actual or potential conflict of interest.

Valuers must at all times conduct their duty with high standard of professionalism and due diligence. They must maintain the strictest impartiality and objectivity when providing independent advice.

## 2.8. PURPOSE OF VALUATION

Although, the preferred method of valuation should not be dependent upon the purpose of valuation, sometimes is the purpose of valuation that determined what method will be used. ( *French & Edwards, 2005)*

- **Market Value - Sale report**

The most common purpose for requesting a valuation is for sale. Although, this is often referred to as a valuation, it is actually seems a marketing advice as normally the estimate of price is given for a future date after the property has been fully marketed.

- **Market Value - Accounting Purposes**

A more correct use of the term valuation is the value of property as reported in company (or public) accounts. The majority of property owners have to prepare valuations of their properties for the purpose of their accounts. This is a statement of the company's wealth on a particular date. Thus, the value of the property element within the business is an estimate of the Market Value on the date of the accounts.

- **Market Value - Loan Security**

Banks and other lenders commission the valuation of property acting as collateral for a loan. They want a market value on which they can judge the amount of the loan based on a "loan to value" ratio. They are attempting to manage the risk of the loan by ensuring that the property has sufficient value to act as security for the amount lent.

- **Market Value - Minimum Price or Auction Reserve**

Often when a company or public body is selling its assets by tender or auction, they are obliged to only accept offers in excess of their valuation of the asset. Thus, a Market Value has to be determined as a guide. Similarly, in cases where the owner has a property that is unusual or where there are special circumstances pertaining to it, the valuer may be instructed to place a reserve value on the property for auction.

- **Market Value – Insurance**

All property must be insured in the case of replacement – but this is really unconnected to the sale price – which of course includes the land. For insurance purposes the normal basis of valuation adopted will be the cost of replacing the building in the event of destruction or partial destruction.

- **Market Value – Taxation**

Valuers frequently have to value property for tax purposes. The principal taxes fall into groups: capital and revenue. Often these valuations are formula based and diverge from normal market value calculations.

- **Market Value – Compulsory Purchase**

Often public schemes involve the purchase of land and this acquisition is subject to a compulsory order. The principal basis of compensation for the land and buildings taken is based on open market value. This is often a case where the valuer has to deal with specialized property such as churches, schools and the like.

# CHAPTER 3: METHODOLOGY

## 3.1 CASE STUDY

In this case, a Cypriot listed company (in the Cyprus Stock Exchange) is studied. The company is therefore titled 'Aphrodite', an imaginary name given to secure the proprietor's anonymity. Aphrodite operates 10 hotels at the moment, out-of-town four star hotels, the freeholds of which are owned by Aphrodite. Aphrodite's owners are interested for an estimated amount that someone would offer as a new operator for the particular business or as an initial bid for an acquisition process with another company.

Below, there are information concerning the accounts of the company and at the same time other data by the accounts is provided. For the valuation of the particular property three different valuation methods are used: the Profits Method, the Depreciation Replacement Cost approach and the income approach method. In the third method, the Investment Method with the Discounted Cash Flow (DCF) analysis will be used.

The table below indicates the company's' data and the necessary assumptions. The company has requested that three different evaluations are made for her perusal. The evaluation was conducted by the DRC approach in November 2010. DRC is the last resort method and it is used when there is either lack of comparable evidence or no income resources from renting properties and deficiency of any business activity. In this case the hotels are operating as business, so according to the RICS and TeGoVa Standards the Profits Method of Valuation has to be used. Finally, the Investment Method will be used to verify the previous results.

## 3.2. VALUATION OF APHRODITE LTD

### The Cost Approach Method (Depreciated Replacement Cost)

The Cost Approach to valuation is known under the alternative names of contractor's basis or depreciated replacement cost (DRC) method and it is the 'last resort method'. The value of property is equal to the sum of its part. Depreciated replacement cost (DRC) defined in the RICS *Red BOOK* (RICS 2007d) and a separate Information Paper (RICS 2007e). DRC is 'the current cost of reproduction or replacement of an asset less deductions for physical deterioration and all relevant forms of obsolescence and optimization' (RICS 2007d: 5) In contrast to the income based approach, which require the valuation professionals to make subjective judgments about capitalization or discount rates, the Depreciated Replacement Cost approach is relative objective. Pursuant to accounting convention, most assets are reported on the books of the subject company at their acquisition value, net of depreciation where applicable. These values must be adjusted to fair market value wherever possible. The value of a company's intangible assets, such as goodwill, is generally impossible to determine apart from the company's overall enterprise value. For this reason, the depreciated replacement cost approach is not the most probative method of determine the value of going business concerns. In these cases, the asset based approach yields a result that is probably lesser than the fair market value of business. However, the depreciated replacement cost approach may be used as a 'sanity check' when compared to other method of valuation, such as the profits method and comparison approach.

| | **Land** | **Depreciated Replacement Cost** | **Market Value** |
|---|---|---|---|
| **Hotel 1** | 850,000 | 5,500,000 | 6,350,000 |
| **Hotel 2** | 1,680,000 | 6,200,000 | 7,880,000 |
| **Hotel 3** | 975,000 | 3,750,000 | 4,725,000 |
| **Hotel 4** | 830,000 | 3,630,000 | 4,460,000 |
| **Hotel 5** | 2,050,000 | 6,500,000 | 8,550,000 |

| | | | |
|---|---|---|---|
| **Hotel 6** | 1,845,000 | 5,500,000 | 7,345,000 |
| **Hotel 7** | 2,500,000 | 6,800,000 | 9,300,000 |
| **Hotel 8** | 830,000 | 4,950,000 | 5,780,000 |
| **Hotel 9** | 1,780,000 | 3,250,000 | 5,030,000 |
| **Hotel 10** | 1,245,000 | 4,200,000 | 5,445,000 |
| | **14,585,000** | **50,280,000** | **64,865,000** |

**Market Value (say) €65 million**

**The Profits Method**

In November 2010 the valuer had the income statement of 2009 to use for the application of the profits method. In this case the information provided is minimal. The valuer should need to make further investigation to discover the full accounts and notes and finally make an estimate for the gross profit. In most cases, and where there is evidence of three years, the valuer should use the average of the figures to reach his final result. Perhaps he should make predictions about future profits if those of previous years are negative.

**Income statement for the year ending 31 December**

| | |
|---|---|
| | 2009 |
| | €000s |
| Revenue | 47,600 |

| | |
|---|---|
| Cost of sales | -32,700 |
| Gross profit | 14,900 |
| Operating expenses | -5,000 |
| Profit from operations | 9,900 |
| Profit before tax | 9,900 |
| Tax | -2,000 |
| Profit for the period for continuing operations | 7,900 |

**Valuation of Aphrodite Ltd – Profits Method**

| | |
|---|---|
| gross receipts | 47600000 |
| cost of sales | 32700000 |
| gross profit | 14900000 |
| working expenses | 5000000 |
| | |
| estimated annual net profit | 9900000 |
| | |
| divisible balance | 9900000 |
| | |
| Less proprietors' share @30% | 2970000 |
| | |
| balance for rent and rates | 6930000 |
| | |
| rates payable @6% | 415800 |
| market rent | 6514200 |
| | |
| × YP perp @7.5% | 13.33333333 |
| | |
| Market value | 86856000 |

**Market value is €86,856,000**

## The Income Approach Method

The income approaches determine fair market value by multiplying the benefit stream generated by the target company times a discount or capitalization rate. The discount or capitalization rate converts the stream of benefits into present value. There are several different income approaches, including capitalization of earnings or cash flows, and discounted future cash flows (DCF) which is applied. The result of a value calculation under the income approach is generally the fair market value of a controlling, marketable interest in the subject company, since the entire benefit stream of the subject company is most often value, and the capitalization and discount rates are derived from statistics concerning public companies.

## Selection of an Appropriate Discount Rate

The interest rate used in discounted cash flow analysis to determine the present value of future cash flows. The discount rate takes into account the time value of money (the idea that money available now is worth more than the same amount of money available in the future because it could be earning interest) and the risk or uncertainty of the anticipated cash flows (which might be less than expected).

Discount rates vary among particular types of business and from one period of time to another. Discount rates are expressed as a percentage and represent the risk of receiving the benefit stream over time. The more speculative or higher the risk, the higher the discount rate; conversely, the less speculative or lower the risk, the lower the discount rate. The discount rate is built by summing up the following factors: the risk-free rate of return, the common stock equity risk premium, the smaller size premium, the industry risk premium and the company specific premium. If interest rate of banks remain as they are now the assumption of 10% as the annual discount rate seems reasonable.

## Notes

1) During 2010 a charge of €1 million as a provision for a claim against 'Aphrodite' following the collapse of part of a hotel that injured several guests.
2) The discontinued operation related to a major warehousing and office unit which was sold in late June 2010 for €4 million cash, which was equal to its currying amount at that day. This facility had been used to store foods and other goods for 'Aphrodite', but it also generated a significant revenue stream as cold storage space was rented out to third parties. The contract to sell the facility has been signed in December 2009.
3) Property, plant and equipment consist of ten hotel buildings which are owned.
4) In 2010, current assets include cash of €4 million from the sale of the storage facility. The asset was presented as held for sale at 31 December 2009.
5) Fixtures and fittings after the accumulated depreciation at 31 December 2010 worth €2 million.
6) The company has not made any dividend payments.
7) The average rate per night is €150 for the four-star hotels.
8) The current occupancy is 70%
9) The four star hotels have 100 rooms.
10) The hotels have an estimated total fair value at 31 December 2010 of €65 million.
11) In this valuation the income statement for the years 2009 and 2010 are used.

**Other Assumptions**

Average room rates per night will increase at 10% per annum compound for two years then they will be constant.

Occupancy would increase to 80% immediately after a take-over for all hotels, partly as a result of a €500,000 a year extra advertising spend. Also, due to the lack of capital expenditure, some of the hotels are in poor condition internally and externally. Capital expenditure (CAPEX) will therefore need to increase to €3 million per year to achieve the revised occupancy levels. However, most of this expenditure is on hotel buildings, which is not allowable for tax.

The depreciation has to be smaller or equal to capital expenditure. For this reason we consider that the amount of €2 millions has a sustainable relation with CAPEX.

Tax rate is 33%

Growth rate is 8% for the year 2012 and then constant and resulting from the increasing average room rates (10%) plus an extra income that is equal to 8% to the revenue from the room rates.

**Income statements for the year ending 31 December**

| | | |
|---|---|---|
| | 2010 | 2009 |
| | €000s | €000s |
| Revenue | 45,900 | 47,600 |
| Cost of sales | -34,400 | -32,700 |
| Gross profit | 11,500 | 14,900 |
| Operating expenses | -6,000 | -5,000 |
| Profit from operations | 5,500 | 9,900 |
| Profit before tax | 5,500 | 9,900 |
| Tax | -500 | -2,000 |
| Profit for the period for continuing operations | 5,000 | 7,900 |

**TABLE 1: DISCOUNTED CASH FLOW (euro 000s)**

| | Historical | | Projections-For Financial Year Ending | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Terminal Value |
| **Total External Revenue** | 47600 | 45900 | 57737 | 62099 | 66791 | 72134 | 77904 | 78372 |
| Growth Rate(%) | | -4% | 26% | 8% | 8% | 8% | 8% | 1% |
| **Total Cost of Sales** | - 32700 | - 34400 | - 43303 | - 46574 | - 50093 | - 54100 | - 58428 | -58779 |
| % Total External Revenues | 69% | 75% | 75% | 75% | 75% | 75% | 75% | 75% |
| **Gross Profit** | 14900 | 11500 | 14434 | 15525 | 16698 | 18033 | 19476 | 19593 |
| %Total external Revenues | 31% | 25% | 25% | 25% | 25% | 25% | 25% | 25% |
| **Total Operating Expenses** | -5000 | -6000 | -5000 | -5000 | -5000 | -5000 | -5000 | -5000 |
| % Total External Revenues | 11% | 13% | 9% | 8% | 7% | 7% | 6% | 6% |
| **Earning Before Interest & Taxes** | 9900 | 5500 | 9434 | 10525 | 11698 | 13033 | 14476 | 14593 |
| % Total External Revenues | 21% | 12% | 16% | 17% | 18% | 18% | 19% | 19% |
| **Taxation** | -2000 | -500 | -1793 | -2153 | -2540 | -2980 | -3457 | -3495 |
| %profit before tax | 33% | 33% | 33% | 33% | 33% | 33% | 33% | 33% |
| **Net Operating Profit After Tax** | **7900** | **5000** | **7641** | **8372** | **9158** | **10053** | **11019** | **11098** |
| **Depreciation & Amortization** | 4000 | 4000 | 2000 | 2000 | 2000 | 2000 | 2000 | 2000 |
| % Total External Revenues | 8% | 9% | 3% | 3% | 3% | 3% | 3% | 3% |
| **CAPEX** | 0 | 0 | -3000 | -3000 | -3000 | -3000 | -3000 | -3000 |
| Working Capital | 900 | 2400 | 4132 | 5995 | 7999 | 10163 | 12500 | 14851 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Change in Working Capital(Dec)/Inc** | 1.428 | 1.500 | 1.732 | 1.863 | 2.004 | 2.164 | 2.337 | 2.351 |
| % Total External Revenues | 3% | 3% | 3% | 3% | 3% | 3% | 3% | 3% |
| **Free Cash Flow** | **10472** | **7500** | **4909** | **5509** | **6154** | **6889** | **7682** | **7747** |
| | | | **1** | **1** | **1** | **1** | **1** | |
| | | | **0,5** | **1,5** | **2,5** | **3,5** | **4,5** | |
| | | | **0,95** | **0,87** | **0,79** | **0,72** | **0,65** | |
| **Present Value Of Free Cash Flow** | | | **4681** | **4775** | **4849** | **4935** | **5003** | |

**TABLE 2: EQUITY VALUE (euro 000s)**

| | |
|---|---|
| Terminal Year Cash Flow | 7747 |
| Discound Rate (k) | 10% |
| Long Term Growth Rate(g) | 1% |
| Capitalization Rate(k-g) | 9% |
| Terminal Value | 86076 |
| Present Value Factor | 0.65 |
| PV Of Terminal Value | 56055 |
| Plus: Sum of Present Value of Free Cash Flows | 24243 |
| **Business Enterprise Value EUR** | **80298** |
| **Equity Value EUR** | **80298** |

**Investment Value is €80,298,000**

# DISCUSSION and CONCLUSIONS

The different results found among the three valuation methods, arise firstly from the different valuation methodologies used and secondly from the different evidence of the business that every method uses. Consequently, the profits method brought about a promising result. The DRC method gave the lowest price of about 25%. On balance, the investment method has to be used. It is therefore illustrated that the profit should not be used as the only indicator when evaluating a property. For instance, there are companies which premise their businesses in luxurious properties but end up having a great loss. This of course does not mean that these properties have no value at all.

There is a difference between 'market value' and 'investment value'. Market value is the expected price at which the property can be sold in the current property market. For example, if a property is up for sale, there is uncertainty on what sort of price it will offer. Partly, it depends on who will be the buyer to close the deal with. There could be someone who is particularly enthusiastic about the property, or, on the other hand, end up having to deal with a really tough negotiator. The market price can be considered as the most likely price at which one may have a deal, prior to a deal actually being done. The second definition of value is what is referred as the investment value. The investment value of a property is the value which has a particular owner, the one who owns and operates the asset for a long period of time. The investment value is defined with respect for each investor, and investors differ in their ability to generate and use potential future profit, so investment values may differ for different investors

even for the same property at the same time. When the profits method of valuation is used, an investment value for a particular operator must also be calculated, for the operator who has managed the business over the last year. Probably, the investment value differs for someone with a burning desire about the property to someone who just wants to invest his money.

Valuers compute the estimated market value, by using the three classic methods such as the cost approach, the sales comparison approach, and the income approach. The market-derived capitalization rate is a hybrid approach because it uses the income approach to value the property with the capitalization rate derived from comparable sales. On the other hand, investors wish to estimate investment value, which includes the effects of income taxes, the investor's unique cost of capital, and other investor specific conditions.

As with all valuations, it is the market that determines price and/or rent. A valuer of trade related property needs to fully understand the trading aspects of the type of property to enable:

- Proper understanding and comparison of physical characteristics, e.g. location, size, configuration, relevant and surplus accommodation, etc.,
- Analysis of actual trading results of the incumbent operator, where available;
- Analysis of actual trading results of similar business, where available;
- Assessment on the effect of the terms of trade (particularly if there is a wholesale supply tie); and
- Assessment of trading potential, profitability and market demand.

*(RICS Practice Standards)*

The valuation of licensed properties (business) is a complex analysis including an immeasurable number of variance, subjective processes, estimates, and assumptions. Some indicators that may have a significant effect on value are not reflected within the business accounts.

Generally, it is difficult to assess the accuracy of valuations because each valuation could be influenced by the practical knowledge of the corresponding valuer. It has been said that the valuation is more an art than a technique that produces subjective outcomes. The talent of the valuer has a key role in the process of valuation.

Another very important aspect is the scope of valuation. A different value may be calculated if a property is to be sold reasonably quickly under the current market conditions and a dif-

ferent value will be given to a property that is not likely to be sold for a long time and must be mortgaged. Good market comparisons can be compelling evidence of the value of a business.

For a more complete and reliable valuation, other than the accounts of the particular business will be taken into consideration and data from similar business wherever possible. For example, when the business subject is a hotel, a number of similar hotels in the same area must be chosen and their appropriate data concerning the profit must be investigated. The occupancy and the economic characteristics posit the situation in the nearby market. This will allow the valuer to decide if the accounts of this company are accurate or if there are problems with the management on the company. The valuer should also take into consideration the contribution of the particular operator on business performance and if he increases or not the businesses' profit.

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