

CHAPTER – 3 BASIC APPROACHES OF VALUATION

3.01 Real properties can be classified under three basic groups, keeping marketability in view. A brief description of the same is depicted below.

(i) Income fetching and Marketable:

Most of the real estate properties fall in this category. Rented residential or Commercial properties, hotels, cinemas, malls, petrol pumps or industrial Properties leased out and fall under this group.

(ii) Non Income fetching but Marketable :

Actually it is a misnomer. A property which is not capable of fetching income or Yielding benefits cannot be sold in a market and hence cannot be marketable. Property in this category is such property that is capable of yielding income yet It is not let or put to income yielding purpose. Hence such property is marketable Though not fetching income. Owner occupied bungalows, flats, shops offices factories Freehold land (not leased) falls under this category.

(iii) Non Income fetching & Non Marketable :

Religious and public building like Temple, Church, School, College, Public building Museum, Town Hall, Fire station and Government buildings which are neither sold Nor let out, fall in this category. However, in certain urban areas Schools, Colleges Hospitals are run on commercial basis viz. As profit earning units and hence such Properties can be grouped with income fetching marketable properties.

3.02 Based upon different characteristics of the above referred three types of properties; three different approaches of estimating value of the property are evolved.

(A) Income Approach : This approach is generally useful to value income fetching Marketable properties like premises.

(B) Market Approach : This approach is generally recommended for all marketable properties, whether, whether income yielding or not. Land ownership flats, shops and offices (Not tenanted) are valued by this approach.

(C) Cost Approach : This approach is generally adopted for non income fetching And non marketable as well as marketable property. Schools, temple, bungalows, Factories are valued by this approach.

3.03 In addition to the three basic approaches, there are some other approaches available. One such approach is called the BENEFIT APPROACH. This approach is helpful to estimate the value of public properties like Dams, Bridges, Highways, etc. Under this approach benefit to the society as a whole is assessed to find out present worth of the property. Social benefit in terms of saving in time and man hours is considered in this approach.

3.04 One more approach, though not mentioned in any of the books on valuation is the COMMONSENSE APPROACH. This approach is most important approach of valuation. This approach comes to the rescue of the valuer whenever s/he is stuck up and does not find any clue to solve complex situation of a case. It is very much helpful to the valuer in deciding about methodology to be adopted in valuation and assumption to be made in solving complex valuation cases.

It is not that this method is novel. In every field whether technical or non technical, this method is of help in case of emergency. Even the court has supported this concept. In the case of Atmaram Properties (P) Ltd.¹ The Supreme Court held, 'Robust Commonsense, common knowledge of human affairs and events gained by judicial experience and judicially noticeable facts, over and above the material available on record – all these provide useful inputs as relevant facts for exercise of discretion while passing an order and formulating the terms to put the parties on. In the words of Chief Justice Chandrachud, speaking for the Constitution Bench in Olga Telis case², commonsense which is a cluster of life's experiences, is often more dependable than the rival facts presented by warring litigants.' What is true for legal system and judiciary is also true for the valuers in fields of valuation.

To understand the applicability of this method in field of valuation let us study one field example. In a small village with a population of 5000 persons; an industrialist constructed a palatial bungalow by spending a sum of Rs.70 lacs. This house was offered to a bank as security. The bank's valuer found that due to very poor paying capacity of local residents there were absolutely no buyers and no demand for said valuable property in the entire village. Rs.70 Lacs cost had to be heavily discounted. To find out discount factor he resorted to the commonsense approach. There was no demand for bungalow for personal use but the house had utility as rental house for which there was some demand. Hence, the valuer estimated rental income receivable for the house and valued the property on rental method rather than by cost approach. The discounted value came Rs. 7 Lacs only. That was

the market worth (only 10% of actual cost) of the palatial bungalow in a small village. Discount factor was as high as 90% in the said case.

3.05 The above three approaches to valuation are not exclusive of each other. In the Income approach fair market rent of property which is not let is estimated by rent comparison method i.e. market approach. Even let out property rent is compared with market rent instances to find out maintainability of rent. Similarly in the Cost Approach the value of a land is estimated by comparison of land sales which is a market approach. Building value is estimated by contractor's method which is a non market concept.

3.06 Basically all these methods are the tools of the Valuer to arrive at fair market value of the property. Depending upon the facts and circumstances in a given case, the valuer should decide about most appropriate method to value the property. There are no water tight compartments that rented property should be valued by rental method and ownership flats should be valued by Sales comparison method only. It is very likely that in a given case, only one method is required to be applied. It is also possible that in a case more than one method is required to be applied because owner of the property holds different rights in the different portions of the property. In some other case/s, perhaps, all three methods are applied to arrive at correct market value of the property.

3.07 In the Bank Nationalisation case³, the Supreme Court discussed these methods in the following words.

The important methods of determination of compensation are:

- (i) Market-value determined from sales of comparable properties, proximate in time to the date of acquisition, similarly situate and possessing the same or similar advantages and subject to the same or similar disadvantages. The market value is the price the property may fetch in the open market if sold by a willing seller unaffected by the special needs of a particular purchase.
- (ii) Capitalisation of the net annual profit of the property at a rate equal in normal cases to the return from gilt-edged securities. Ordinarily value of the property may be determined by capitalising the net annual value obtainable in the market at the date of the notice of acquisition.
- (iii) Where the property is a house, expenditure likely to be incurred for construction a similar house and reduced by the depreciation for the number of years since it was constructed.
- (iv) Principle of reinstatement, where it is satisfactorily established that reinstatement in some other place is bonafide intended, there being no general market for the

property for the purpose for which it is developed (the purpose being a public purpose) and would have continued to be devoted, but for reasonable cost of reinstatement.

- (v) When the property has outgrown its utility and it is reasonably incapable of economic use, it may be valued as land plus the breakup value of the structure. But the fact that the acquirer does not intend to use the property for which it is used at the time of acquisition and desires to demolish it or use it for other purpose is irrelevant.
- (vi) The property to be acquired has ordinarily to be valued as a unit. Normally an aggregate of the value of different components will not be the value of the unit.

The court further stated, "These are, however not the only methods. The method of determining the value of property by the application of an appropriate multiplier to the net annual income or profit is a satisfactory method of valuation of lands with buildings, only if the land is fully developed, i.e. it has been put to full use legally permissible and economically justifiable and the income out of the property is the normal commercial and not a controlled return depreciated on account of special circumstances. If the property is not fully developed, or the return is not commercial the method may yield a misleading result.

Thus the court discussed all principle methods of valuation in the above case.

About applicability of these methods the Supreme Court expressed view in the Bank Nationalisation case by stating the following terms. "The science of valuation of property recognises several principles or methods for determining the value to be paid as compensation to the owner for loss of his property: there are different methods applicable to different classes of property in the determination of the value to be paid as recompenses for loss of his property. A method appropriate to the determination of value of one class of the property. If an appropriate method or principle for determination of compensation is applied, the fact that by the application of another which is also appropriate, a different value is reached, the court will not be justified in entertaining the contention that out of the two appropriate methods, one more generous to the owner should have been applied by the legislature."

3.08 In case of V.C. Ramcharan⁴, the Karnataka High Court stated, "The market value of a building like the one with which we are concerned in this case, would be the possible price it would be the possible price it would fetch, if the assessee were to sell the property to a willing purchaser. Market value of such property has to be estimated in each case. But such an estimation has to be on the basis of well-settles principles and the market value estimated must be a reasonable one and cannot be arbitrary. The market value of each land

and building varies from the other. It depends upon variety of factors, such as (1) Size, the nature and the quality of construction (2) the locality in which the building is situated including its environment: and (3) the open space available apart from the built area, i.e. whether there is further scope for utilisation of land in a more beneficial and profitable manner and several other advantageous or disadvantageous factor found to exist in a given case.

It also depends on the fact as to whether it is tenant occupied and if so, the rent which is being paid and whether the enhancement and eviction of tenant is statutorily controlled, because the restriction on enhancement of rent and on the securing of vacant possession, certainly deter a willing purchaser from offering a better price. Therefore, in order to estimate the value of a building two well-known methods of ascertaining the market value of a building to well-known methods of ascertaining the market value of a building which have come into existence are the 'Rental Value method' and the 'Land and building method' of valuation. But which of the method is appropriate in a given case must always depend upon the facts and circumstances of that case. Even two or all of the methods may be taken into account, in arriving at a reasonable value. If there are more than one valuation of same property, the one which is reasonable and nearer to the correct market value, having due regard to all the relevant facts and circumstances of the case alone should be accepted".

3.09 Similar view was expressed by the English court while considering Base stock method or Market value method of accounting principles. In case of *broadstone Mills Ltd*⁵, the English Court held, "Thus, I read Lord Loreburn as having said there may be one or two or three methods of arriving at the profit for the relevant period. The one which shows most accurately the position between the revenue, on the one hand, and the tax payer, on the other, is the one which ought to be adopted. In other words, it is not sufficient to say that a particular system of accounting is a well-recognised system of accounting and satisfactory during normal times if the contention of the other side is that system does not give true result for the particular year, the accounting year." Thus court stated that all methods have to be examined and most appropriate method applicable in the given case to be adopted.

3.10 In the case of *Subhkaran Chowdhury*⁶, Calcutta the High Court held, "Valuation of fully tenanted property should be made on the basis of capitalisation of rental method."

3.11 In the case of Wenger & co. ⁷, Delhi High Court. Held, "District Valuation officer adopted two method to value the property. For owner occupied portion he calculated the value on the basis of what were the rates prevalent for sale of commercial flats in Connaught place extension area. For the tenanted portion he capitalised the rental value. It is well-known fact that giving possession of buildings, though previously rented out, fetches better market price. It cannot be assumed that the hypothetical purchaser would let out the self-occupied portions which he buys from the hypothetical seller or would let out such portions in the condition in which he buys them. The method adopted by District V.O. and his approach is not only acceptable but also in accordance with the principles of evaluation." Thus the court approved comparable sales method of valuation for owner occupied portion of the building and Rental method of valuation for tenanted portion of the same building.

3.12 All these court judgements throw a good deal of light on methodology to be adopted by a valuer while estimating value of the property.

3.13 It is seen that some valuers use the word 'Approach' and word 'Method' interchangeably. It is important to note that both have different meaning.

'Approach means to advance near to a point aimed at and Value is the point aimed at.' On the other hand meaning of word 'Method' is a way of doing things or step by step procedure. In this context, approach is a broader concept and method is a narrower concept. Hence there can be many methods under a single approach.

3.14 Under these approach three approaches there are several methods available to the valuer so that property can be valued by selecting appropriate method of valuation. Details of these methods are as under.

3.15 INCOME APPROACH

- (i) Rental Method of valuation (also called Yield method)
- (ii) Profit method (Capitalisation of earnings method)
Profit method is also known as an investment analysis method.
- (iii) Discounted Cash Flow Technique

3.16 MARKET APPROACH

- (i) Belting Theory of Land Valuation
- (ii) Hypothetical Plotting Scheme Method of Land Valuation
- (iii) Front foot rule Method of Land valuation
- (iv) Sales Comparison Method (Direct market comparison method).

Comparison of ownership premises for valuation by this method is also known as 'Composite method' of valuation.

- (a) Adhoc Comparison Technique (Hedonic Pricing Model)
- (b) Adjustment grid Model
- (c) Price Quality Regression Technique
- (d) Weightage Score System
- (v) Development Method (Residual Technique / Abstractive Method)
 - (a) Actual sales basis (Owner occupied)
 - (b) Actual Sales Basis (Tenant Occupied)
 - (c) Hypothetical Building Scheme Method (Ownership concept)
 - (d) Hypothetical Building Scheme Method (Income Concept)

3.17 COST APPROACH

- (i) Land and building method (Also known as Physical Method OR Contractors Method OR Cost summation method)
- (ii) Book value method of Building Valuation
- (iii) Cost Index Method of Building Valuation
- (iv) Cost Index Method of Building Valuation
- (v) Quantity survey method of Building Valuation

3.18 Throughout the world Market approach is most favoured and popular approach to value a property. Even in India courts have considered it as the best method of valuation. Particularly in all Land Acquisition cases this method is invariably used. Courts have however said that cost approach should be adopted as a matter of last resort to value the property. Thus normal order of preference is :

- (i) Market Approach
- (ii) Income Approach
- (iii) Cost Approach

However, in India more than 50% of the housing stock consists of old rent controlled developed properties. Next comes factories and bungalows which are pledged as security with banks and most of the bank valuers invariably value all these assets as per cost approach and not by Income approach or Comparable sales method (Market Approach). It is interesting to know that in U.S.A. most of the valuers estimate bungalows by sales Comparison Method and not by Cost approach. However, in India it is extremely difficult to estimation under Income Tax Act (to find out true investment of assessee in a property), cost approach as a method of last resort. It is equally important method of valuing the property.

Whichever is most appropriate method should be adopted for value estimation. Land and ownership premises are obviously valued by applying Sales Comparison Method i.e. by Market Approach.

Whatever may be the preference or order of the court in selection of the valuation methods, suffice to state that all methods are equally useful to the valuers. Most appropriate method should be selected by the valuer considering facts and circumstances of the given case, as mentioned by the Karnataka High court in the V.C. Ramchandran's case⁴.

Valuation methods under these three basic approaches are discussed in detail in the subsequent chapters.

3.19 It will not be out of place to add here in brief, some fundamental basics concerning the immovable properties which govern applicability of different methods of valuation. There are two basic aspects concerning the property. One is ownership aspect and the other is occupancy aspect. Valuer is required to study both in every case so as to arrive at proper method of valuation.

3.20 Ownership of the property could be of several types.

It is necessary for the valuer to understand different types of ownership.

- Individual or Sole Ownership: Only single persons own 100 % rights in property.
- Joint ownership : There are two or more owners of the property holding the property jointly. This means that if out of two joint owner dies, his rights will go and merge with the right of the surviving joint owner.
- Co-Ownership: (It can be by two or more persons. This is also called tenants in common). Rights as Co-owner are quite different from the rights as joint owner of the property. If out of two co-owners one co-owner dies, his rights goes to the Legal heirs of the deceased co-owner. Rights of the surviving co-owner or all other co-owner. Rights of the surviving co-owner or all other co-owners remain unchanged.
- Ownership held by firm: Firm though a legal entity, for the purpose of ownership it is known as ownership held by the individual partners of the firm & not itself.
- Ownership by Limited company: Directors represent the company.
- Ownership by the Trust: Ownership of the trust vests with the trustees.
- Ownership by Hindu Undivided Family (H.U.F) : Karta of H.U.F manages the property.
- Government or Municipal ownership : Designated officer or commissioner.

- Ownership by Co-operative society: There are two types of society : Tenant OWNERSHIP society and Tenant CO-PARTNERSHIP Society.

In tenant ownership, society purchases land and leases out land to tenant members Of the society who erects buildings on the plot leased to them. Sometimes, society also erects the building and recovers cost from tenant members.

In the case of Tenant co partnership society, the builder constructs the building and sells it to the individual flat purchasers who subsequently form a society for maintenance and management. In both types of the society, Chairman and Secretary of Society perform management roles and treasurer handles finance part of society.

- Ownership by a Condominium : Control of Directors of the Board of Management.
 - Ownership of WAKF property : As per Mohmedan belief, WAKF property vests in 'ALLAH' through Mutawali. We can say Wakf is Mohmedan trust for beneficiaries and Mutawali is like a trustee or a manager.
 - Ownership by Temple board or religious trust : Nationally Ownership of temple property could be by Hindu Deity, Similar to the ownership of Allah in Wakf property. However the property is deemed to be managed and vested in 'Sherbait' or 'Mahant' of Hindu temple. He may be manager cum representative or agent of Deity.
 - Ownership by Military : Ownership of Cantonment area in city or town is always Military or Central Government. Cantonment Board manages the affairs of development and transfer of property in Cantonment Area. There are both civil lines area and Military Area in the cantonment Area. However ownership and possessory rights in both these areas differ considerably.
 - Ownership by State Government Development Board : Industrial Development Corporation of the State develops and leases land for Industrial purpose. Similarly, Housing board of the state acquires and develops land and leases plots for residential development.
 - Ownership By Mortgage : It may be legal or equitable ownership.
 - Vested or contingent Ownership : Life interest holder can be both owner and occupant. He may be only occupant depending upon settlement deed.
- Valuer may have to consider all the above ownership aspects while selecting valuation methods because applicability of acts (Say Rent Act/Transfer of Property Act) affecting valuation may not be same in case of each of above stated ownership.

3.21 Like different types of ownership, possession of property are also of different types. Depending upon the type of possession the value changes.

- Physical Possession : Owner or occupant is in actual possession of premises.
- Symbolic Possession : Here physical possession is with litigant and court's officer or authority like court receiver takes names sake symbolic possession for management till case is finally decided.
- Juridical Possession : Here the possession is taken by owner pursuant to the final order of the court. Physical possession may be still with the litigant.
- Legal Possession : Physical possession is in accordance with law.
- Illegal Possession : Occupant's physical possession is contrary to law. He may be encroacher or trespasser or person whose rights are terminated in accordance with legal provisions.
- Adverse Possession : Person in physical possession claims ownership rights over the property due to unobstructed actual possession of more than 12 years.
- Constructive Possession : Physical possession is with 3rd party occupant claiming occupancy rights. Property belongs to mortgagor and mortgagee bank takes token possession of property due to default in payment by the mortgagor.

3.22 Similarly, occupancies in the property are also of many types. Each of these occupancies are governed by different Acts and hence may call for different treatment in valuation of the property. Knowledge of type of occupancy of the premises is also very vital for the valuer. There could be many types of occupancy the premises as detailed below. Details of acts applicable are also given.

3.23 Premises could be in occupation of the owner himself holding 100 % right in the occupied property.

3.24 Premises could be occupied by one of the co-owners holding only 25% undivided share in the property. Other co-owners of the property holding 75% share stay elsewhere.

3.25 Premises could be occupied by the tenant who is protected by various provisions of Rent Control Act.

3.26 It could be occupied by occupant related to legal tenant of premises.

3.27 It could be occupied by License who has entered into Leave & License agreement, for 11 months or more, with the owner, i.e Licensor.

3.28 Occupant could be lessee company having 3 or 5 years lease contract with the owner of the premises.

3.29 Occupant could be a trespasser who by force entered into vacant premises.

- 3.30** Occupant could be a tenant not protected by provisions of Rent Control Act, like exempted tenancy, u/s. 4(1A) of Gujarat Second Amendment Act of 2001 or under section 3 (1) (b) of Maharashtra Rent Control Act. 1999.
- 3.31** Occupant of premises could be a person holding life interest in the property. (Life Tenant or Lessee for life)
- 3.32** Occupant may be holding only "Occupancy rights" i.e. Holder of Occupancy Rights (H.O.R) in the property falling in the Military Cantonment Area of the town.
- 3.33** Occupant may be tenant in society. He holds only proprietary lease in premises which gives him occupancy rights but title and ownership of land and building vests with the society.
- 3.34** Occupant may be free owner of premises in condominium and he would be tenant in common of all areas like hallways, stairs and lift etc.
- 3.35** Each of above stated occupancies is governed by different Acts. Hence different treatment for valuing the property is required in each of these cases. Relevant sections of different Acts defining different types of 'occupancy' are as under.
- 3.36** Section 5(3) of Gujarat Amended Rent Control Act of 2001 and Section 7(3) of Maharashtra Rent Act 1999 defines term 'Landlord'.
- 3.37** Section 5(11) of Gujarat Amendment No. 27 of 2001 and Section 7(15) of Maharashtra Rent Act defines term "Tenant".
- 3.38** Section 105 of Transfer of Property Act defines 'Lessor' and Lessee'.
- 3.39** Section 24 of Indian Easement Act defines 'Licensee'.
- 3.40** Section 24 of Transfer of Property Act prescribes rights of Life Tenant (Life Interest holder).
- 3.41** Section 44 of Transfer of Property Act defines rights of co-owner holding undivided share.
- 3.42** Section 2 (12) of Code of Civil Procedure lays down the basis to work out claim for damages from 'Trespasser' occupant who is in illegal and wrongful possession of the owner's premises.
- 3.43** Different methods of valuation for different types of occupancies could be as under.
- 3.44** Owner occupied premises could be valued by Comparable Sales Method.
- 3.45** House property occupied by the co-owner could be valued by Rental Method as well as by Comparable Sales Method depending upon the situation. Under Section 44 of T.P Act, outside purchaser is not entitled to joint possession, if house is owned by H.U.F.
- 3.46** Premises in possession of trespasser could be valued by estimating "Mesne Profits", and by income approach.
- 3.47** Premises occupied by 'Life Tenant' could be valued by deferring value for period equivalent to future life expectancy of 'Life Tenant as per Mortality Table.

3.48 Premises occupied by Lessee should be valued as per lease terms and reversion provisions.

3.49 Premises occupied by 'Licensee should be valued by Income Approach for licensed period and Reversionary value of premises should be added thereto.

3.50 Premises of protected tenants should be valued by Rental Method.

3.51 Premises in Military area may be valued ignoring land value as only occupancy rights in building are held by occupant.

3.52 It will be interesting to know that yield rate for rent controlled property, yield rate for licensed property (Leave & Licence) and yield rate for leasehold properties are quite different and they vary to a great extent.

3.53 It is very likely that considering the real estate market, the valuer may be inclined to adopt following rates of capitalisation for different types of occupancies.

- For rent controlled properties, 9% yield rate may be considered proper.
- For licensed properties 4% yield rate may be considered appropriate.
- For leased out property 6% to 7% yield rate may be enough.

These aspects are discussed and illustrated in greater detail in the subsequent chapters.