

# PRINCIPLES OF REAL ESTATE MANAGEMENT

By Marek Bryx and Others

Warsaw 2008

This manual is part of the Construction Managers' Library – a set of books related to the wide area of management in construction. The books were created within the Leonardo da Vinci (LdV) project No: PL/06/B/F/PP/174014, entitled: "COMMON LEARNING OUTCOME FOR EUROPEAN MANAGERS IN CONSTRUCTION". Warsaw University of Technology, Civil Engineering Faculty, Department of Construction Engineering and Management was the Promoter of the Project.

The following organisations were Partners in the Project:

- Association of Building Surveyors and Construction Experts (BE)
- Universidad Politécnica de Valencia (ES)
- Chartered Institute of Building Ireland (IE)
- Polish Association of Building Managers (PL)
- Polish British Construction Partnership Sp. z o.o. (PL)
- University of Salford (UK)
- Chartered Institute of Building (UK)

The objective of this project was to create seven manuals conveying all the information necessary to develop civil engineering skills in the field of construction management. The scope of knowledge presented in the manuals is meant to be the basis for assessing the managerial qualifications of civil engineers by the Association of European Building Surveyors and Construction Experts for the purposes of the European engineering professional card - EngCard.

The following manuals have been developed (in the brackets you will find an estimate of didactic hours necessary for mastering the contents of a given manual):

- M1: PROJECT MANAGEMENT IN CONSTRUCTION (100)
- M2: HUMAN RESOURCE MANAGEMENT IN CONSTRUCTION (100)
- M3: PARTNERING IN CONSTRUCTION (100)
- M4: BUSINESS MANAGEMENT IN CONSTRUCTION ENTERPRISE (100)
- M5: REAL ESTATE MANAGEMENT (100)
- M6: ECONOMY AND FINANCIAL MANAGEMENT IN CONSTRUCTION (240)
- M7: CONSTRUCTION MANAGEMENT (100)

The manuals created for the purposes of the library are available in three languages: Polish, Spanish and English. The manuals may be used as didactic materials for students of postgraduate courses and regular studies in all three languages.

Graduates from the courses will receive a certificate, which is recognized by all organizations – members of the AEEBC, association of construction managers from over a dozen European countries. Polish representative in the AEEBC is the Polish Association of Building Managers, in Warsaw.

More information about the LdV project see:

[www.leonardo.il.pw.edu.pl](http://www.leonardo.il.pw.edu.pl)

More information about the Polish Association of Building Managers:

[www.psemb.pl](http://www.psemb.pl)

**TABLE OF CONTENTS:**

**CHAPTER 1**  
**LIFECYCLE OF THE BUILDING AND INVESTMENT CYCLE.....7**  
**(M. BRYX)**

1.1. Place of the real estate management in both cycles .....7  
1.2. Technical and economic usage of the real estate, depreciation and  
amortization, methods of amortization ..... 11  
1.3. Characteristics of land property .....13  
1.4. Liquidation (demolition) ..... 14

**CHAPTER 2**  
**REAL ESTATE FUNCTIONS – ROLE OF THE REAL ESTATE .....16**  
**(M. BRYX)**

**CHAPTER 3**  
**REAL ESTATE MARKET .....21**  
**(M. BRYX, D. BRODOWICZ)**

3.1. Factors influencing/ affecting the real estate market .....21  
3.2. Concept of the real estate market .....26  
3.3. Real estate market segmentation.....31  
3.4. Real estate market participants .....33  
3.5. Real estate market characteristics .....34  
3.6. Supply and demand forces on the real estate market .....36  
3.7. Research and analysis of real estate market trends .....37  
3.8. Real estate market economic meaning: central and local approach.....39  
3.9. Providers of real estate market services: agency and brokers,  
appraisers, developers, property managers, notary and insurance  
companies .....40

**CHAPTER 4**  
**VALUE OF REAL ESTATE .....42**  
**(E. MAĆZYŃSKA)**

4.1. Theory and practice of real estate valuation .....42  
4.2. Functions and purposes of real estate valuation.....44  
4.3. Types of real estate values: open market value, replacement value,  
cadastral value, mortgage lending value .....46  
4.4. Procedures of real estate valuation.....50  
4.5. Basic sources on information in real estate valuation process .....51  
4.6. Methods and techniques of property valuation .....52  
4.6.1. General characteristic of valuation methods and extent of their  
use .....52

4.6.2. Comparative approach (price and comparative method) .....	53
4.6.3. Income-based approach (investment method, profit method).....	54
4.6.4. Cost approach (method of replacement costs, substitution costs)....	56
4.6.5. Mixed approach .....	56
4.7. Documentation of valuation. appraisal report.....	58
4.8. valuation report .....	59
4.9. Value versus price of real estate .....	60
4.10. Non-market factors influencing real estate price .....	61

**CHAPTER 5**

**OPERATING MANAGEMENT .....63**  
**(T. BRACH)**

5.1. Procedure of taking over management of real estate .....	63
5.2. Order regulations in use of real estate.....	65
5.3. Ways of drawing rents .....	71
5.4. Control of building and premises.....	74
5.5. Recovery proceedings and eviction .....	76
5.6. Supervision of building .....	77

**CHAPTER 6**

**GENERAL CHARACTERISTIC OF TREATMENTS**  
**CONSERVING TECHNICAL AND OPERATING EFFICIENCY OF**  
**REAL ESTATES.....79**  
**(G. KUBIK)**

6.1. Types and characteristic of routine processes, actions and conservation treatments relating to usual use; documentation and procedures of use .....	79
6.2. Planning and realization of current repairs, extent, procedures, implementation .....	83
6.3. Modernizations, reconstructions, rebuilding, general characteristics, decision making criteria.....	87

**CHAPTER 7**

**ORGANIZATION OF PROPERTY MANAGEMENT .....90**  
**(M. CICHARSKA)**

7.1. Managing a real estate company .....	90
7.2. Marketing management.....	91
7.3. Human resources management .....	93
7.4. Technical resources management .....	95
7.5. Company's operations management .....	96
7.6. Financial management .....	96

7.7. Office .....	99
<b>CHAPTER 8</b>	
<b>COSTS MANAGEMENT AND EFFECTIVENESS OF THE REAL ESTATE .....</b>	<b>102</b>
<b>(U. SŁOWIK)</b>	
8.1. The basis of cost formation and accounting, budgeting.....	102
8.2. The basis of effectiveness calculation.....	107
<b>CHAPTER 9</b>	
<b>EFFECTIVENESS OF EXPLOITATION AND COMMERCIAL BUILDINGS MAINTENANCE.....</b>	<b>109</b>
<b>(U. SŁOWIK)</b>	
9.1. Costs analysis.....	109
9.2. Income analysis.....	111
9.3. Effectiveness of operations .....	114
<b>CHAPTER 10</b>	
<b>PHILOSOPHY AND METHODOLOGY OF DRAWING UP A PLAN..</b>	<b>116</b>
<b>(L. KOWALCZYK)</b>	
10.1. Notion of real estate business plan.....	116
10.2. Functions of real estate business plan .....	118
<b>CHAPTER 11</b>	
<b>ANALYSIS PROCEEDING DRAWING UP REAL ESTATE BUSINESS PLAN .....</b>	<b>121</b>
<b>(L. KOWALCZYK)</b>	
<b>CHAPTER 12</b>	
<b>PROCEDURE OF BUSINESS PLAN CREATION .....</b>	<b>127</b>
<b>(L. KOWALCZYK)</b>	
<b>CHAPTER 13</b>	
<b>CONTENTS OF REAL ESTATE BUSINESS PLAN .....</b>	<b>131</b>
<b>(L. KOWALCZYK)</b>	
13.1. The components of the plan.....	131
13.2. Basic data on real estate .....	133
13.3. Description of real estate market .....	136
13.4. Financial analysis.....	138
13.5. Strategic analysis .....	140
13.6. Plan of realization of a chosen variant .....	142

13.7. Plan summary and final conclusions..... 145  
13.8. Annexes..... 145

**CHAPTER 14**

**EXEMPLARY MIXED- USE PROPERTY MANAGEMENT PLAN .....147  
(U. SŁOWIK)**

14.1. Introduction- aims of the management plan and owners  
    expectations ..... 147  
14.2. Basic information about the property..... 148  
14.3. Real estate market analysis ..... 156  
14.4. Current financial analysis ..... 162  
14.5. Strategic analysis ..... 169  
14.6. Options assessment ..... 176  
14.7. Evaluation of option i, ii and iii effectiveness..... 185  
14.8. Chosen option implementation with threats consideration ..... 186

**BIBLIOGRAPHY .....188**

# **CHAPTER 1**

## **LIFECYCLE OF THE BUILDING AND INVESTMENT CYCLE (M. BRYX)**

### **Abstract**

In the Chapter number 1 real estate management phase is presented in the context of the investment cycle. Also issues of technical and economic usage of real estate, depreciation and amortization methods as well as characteristics of land property and liquidation (demolition) are described in this chapter.

### **1.1. PLACE OF THE REAL ESTATE MANAGEMENT IN BOTH CYCLES**

Building developed on the plot, which is a part of property or is a separate real estate, usually is being exploit for many years in order to bring increments to the owner.

Lifecycle of each building could be presented in various ways. The basic one is to distinguish investment stage from the exploitation phase. Both stages could be divided into more specific and precise parts.

Investment phase is fundamentally different from the exploitation phase, which means that they have not only dissimilar aims but also methods to achieve these aims.

The goal of the investment phase is to construct the building, to be more

specific to finish the construction as soon as possible and to obtain a legal right of use. Methods used during investment phase have roots in:

- investor's strategy, position on the market, income. Aspiration of most investors is to be involved in the project which will not only bring income but also a comparative advantage on the market.
- in law, technical, economical and financial terms.

During investment phase investor has to make key decisions, which lead him to next steps of the process. First decision is strategic- to "start or not" the investment. Decision usually ends the preliminary stage of thinking over the matter. Next step leads to choice of designer (mostly the architect) who is responsible for putting together design and technical documents in order to obtain a construction permit. Usually that ends the preparation stage. Investor needs to find contractors- builders and managers of builders who turn ideas into physical form.

After construction process is completed next stage is the procurement of permit to use the building.

**Building operations** - during this stage most important is effectiveness. It means that income obtained from building day to day operations should be higher than exploitation/operating costs (costs include small repairs and amendments, as well as major overhaul in the long term).

Aims and objectives of owner during this stage of building lifecycle may be very ambitious- like possibly high income generation, growth of value, or even costs and loss decrease. Plans are usually executed by the property manager acting on the behalf of the owner.

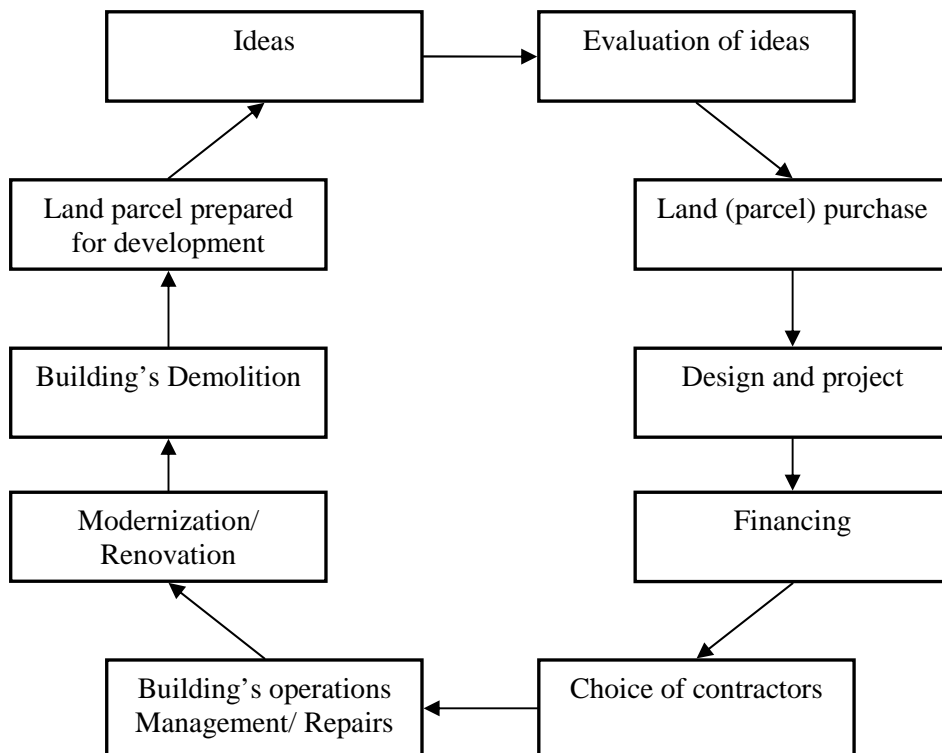
Aim to generate a profit is most commonly allied with commercial properties, which were developed in order to bring benefits to the investor and the owner. Therefore professional property manager not only tend to supervise day to day operations (administrate) but also to enhance property's market attractiveness.

Stages of building lifecycle described till now are closely connected with each other. Property's ability to create an income and decrease operating costs results from the basic investment aims.

Economic value of each property defined during the exploitation phase has an influence on owner's strategy and further operations.

Both stages together- investment and building operations, create a lifecycle of the building, see character below:





**Fig. 1.1. Lifecycle of the building**

Source: H. Hajduk, Zarządzanie przedsięwzięciem budowlanym, "Problemy rozwoju budownictwa" 1993, nr 2.

As presented on the diagram lifecycle begins with the concept of investment. Sometimes idea comes naturally, for example when investor already has a land parcel. Then after a process of: ideas inception, refinement, feasibility study, contract negotiations and formal commitment act, construction phase begins. After completion and formal opening, starts exploitation phase, and this ends with building's demolition. Phases differ significantly with each other, not only with aims, methods but also with duration time. Investment stage should not exceed couple of years, while exploitation stage last for decades or even longer.

Many of currently used properties, especially in Europe, were developed even centuries ago.

### **Good project characteristics**

Investment is a stage when building is developed, constructed; next stage is exploitation and it is closely connected with property management.

Decisions made during investment process determine quality and value of each property, and they have a crucial importance for property management.

Investment process is a stage when shape and physical attributes of the property are created.

Management is an art of work on already shaped material- property; of course changes are always possible (overhaul, reconstruction).

Therefore in many cases exploitation costs (and profitability) do not depend on property managers' decisions but on technical and technological solutions applied in the building.

Today exploitation phase (operations) is more commonly associated with property management in order to stress out change of approach from passive to active.

Exploitation stage simply means "use" of the building and facilities.

Usually owner's approach to property is passive, except for the attempts to decrease costs. Property management represents an active approach, which includes strategic planning to possibly prolong property's lifecycle, and also to find additional income source. In other words real estate is not seen as only a source of expenditures but income also.

Awareness in terms of managing income and expenditure balance is a very important issue on the property market. Following activities are strongly recommended:

- routine actions
  - concerning exploitation: conservation, overhauls, modernization, increase of utilities' price
  - concerning income level: rent collection
- non routine action aimed at: value growth, innovation, new source of income etc.

## **1.2. TECHNICAL AND ECONOMIC USAGE OF THE REAL ESTATE, DEPRECIATION AND AMORTIZATION, METHODS OF AMORTIZATION**

Technical and economic usage takes place during every day operations. Different aspects are connected with this issue.

Ageing of building is a natural effect of a time passage, even when is not utilized. But technical and economic usage of property is a result of exploitation process. Property elements do not use up evenly. Elements of building's construction are most durable, whereas furnishing is less durable. It is almost certain that during a long exploitation parts like sinks, taps, phone cables, lining etc. need to be replaced even couple of times. Simply their lifecycles are much shorter than building's. It means that exploitation costs (management costs) have to include costs of repairs and replacements of equipment. If building is supposed to bring income it has to be kept in a proper standard, without technical defaults and make a positive impression (aesthetic design).

Technical usage may also cause a devastation of the building, if it will be overexploited, or fixtures and replacement will not take place for a long time. Then only (major) overhauls may bring back the building to the proper standard.

Technical usage strongly influences economic side of property management. High exploit costs cause difficulties in generating a profit.

Economic usage is the effect of building's ageing. Most commonly it is associated with machines and devices, rather than with buildings. Technological progress brings new products and solutions to the market and use of old ones is no longer efficient- in case of properties changes are made thru modernization or adaptation.

During exploitation process basic importance has an issue of amortization (it shows how property is creating a new value for the owner).

Amortization is a price creating element, not a cost, while cost was already counted as investment expenditure. In other words- each unit price of service and product includes part to cover amortization cost.

Amortization is a source of constant, but not significant source of money for the company, which does not increase income, therefore does not increase a tax rate.

Amortization costs are calculated each month, amount depends on:

- period of amortization
- initial property value

Amortization period is regulated by the state. Machines and appliances are sorted in groups with similar period of physical and economic usage. In case of buildings and structures amortization period is defined between 40 and 50 years.

Amortization rate compared with initial value shows yearly amount of amortization. 1/12 of this amount may be calculated each month to company's operating costs, which decreases generated profit.

Amortization process leads to economic depreciation of buildings and other structures. Along with amortization, current value of building decreases. After amortization period ends (40-50 years) book- keeping value of property will significantly decrease. But due to:

- major overhauls, modernization, and so on initial value may change
- book- keeping value depreciation does not influence significantly an actual market value of property.

Described in this chapter method of amortization (constant rate applied thru the process) is best known and used one. Other methods are used much seldom:

- decreasing amortization (decreasing rate)
- progressive amortization (increasing rate)

Independently from used method, amortization needs to take place during the anticipated period and can not exceed initial value of the building (unless it was modernized and there was a value increase).

## 1.3. CHARACTERISTICS OF LAND PROPERTY

Most significant feature of each real estate is immobility. As a part of land it can not be physically destroyed, although buildings and edifices may be demolished.

Therefore most basic element of real estate concept is that a building can be a separate property or with can be a part of property together with the land parcel.

According to Civil Code:

“ Real estate is a part of land, which is a distinct property, also buildings or parts of buildings permanently connected with land, if from a legal point of view are properties separated from a land property (are not a part of land property)”.<sup>1</sup>

Therefore:

- Real estate is a part of the land and as a part of it is **immobile**.
- It may be divided into small parcels or joined into a bigger property.
- Parcels' **value may be increased** by development process- e.g. buildings.  
Buildings located on a parcel increase its attractiveness.
- Price and value increase when real estate gains additional functions and can be sold/ rent to a wider range of potential users.
- **Nonhomogeneity**, there are no exactly alike parcels of real estate. Types of buildings located on parcels are different, also sizes and shapes of properties, and so on. Even if two parcels seem to be exactly alike, actually they are different due to their unique location.
- Certainly property developers tend to standardise projects to lower costs, but even then properties differ.

Most commonly properties are divided into:

- Land properties
- Built-up properties (including buildings and other structures)

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<sup>1</sup> Civil code, art. 46

**Land property**, which includes not only a parcel as a part of surface of the earth, but also area below it and above it (air rights, surface rights and subsurface rights).

Land property is:

- Agricultural land
- timberland
- Land under lakes, rivers etc.
- Others

Most significant feature of land properties is that they are not used for buildings development, no matter is they are located in rural or urban area.

Development process can not take place on land property unless necessary permit is granted:

- There is a possibility to locate a small habitat on the agricultural land, but maxim size of it is regulated by law.
- Changes in spatial management plan may include options to build properties on the Greenfield land.
- Real estate law and local spatial plans may include such an option.

Decision changing land's qualification has a significant economic meaning for its owner. Greenfield land located near city area may be divided into small parcels and sold to investors/ developers for the price couple of times higher than the Greenfield was worth before development permit was obtained.

## **1.4. LIQUIDATION (DEMOLITION)**

Liquidation of building property is a result of owner's decision or administrative decision. Second option is possible in Poland when:

- If property is bought by the state in order to develop public use property. It may include existing buildings demolition, regardless of their technical condition.
- Demolition forced by law regulations due to poor technical condition of property.

- Demolition forced by law regulations if required development permit was not obtained, and investment was completed against the law.

In case when owner decides on his own to demolish existing building, usually follows economic rules. Sometimes land property, without old buildings located on the parcel is worth much more. Real estate owner while making decision about demolition needs to make sure that "cleared" from the buildings property will have a higher market price.

As presented on character 1.1 liquidation is a last stage in property's life cycle. Building "used itself", but a land parcel probably gained a value, while cities are spreading and need additional space. Parcel may be used for a new development, it is reasonable to demolish old building.

Corrections to the presented rule:

- Building can not be demolished if it is on the list of historical monuments. Conservator needs to make a decision and issue a permit to do so. Usually role of conservator is to preserve existing buildings and to find other solution than demolition. Major overhaul, modernization etc. are advised. In majority of countries state and local authorities participate in costs of such an investment. In Poland even half of investment's costs are returned to the owner if only process of modernization was conducted in cooperation with conservator.
- According to law building demolition needs to be conducted professionally, without threat to the third parties.

## **CHAPTER 2**

### **REAL ESTATE FUNCTIONS – ROLE OF THE REAL ESTATE (M. BRYX)**

#### **Abstract**

In the Chapter number 2 seven basic functions of real estate are described. Each of them results from real estate characteristics such as immobility, significant market value and so on, which cause that most of properties hold different functions like: income, pledge, location, fiscal, technical, profiteering and social.

As far as the role of the real estate is concern the utility value of each property is crucial. Real estate value is usually an objective category, measured by: usable floor space of the apartment, office or warehouse space, parking lot spaces and so on. So called usefulness of each property is being estimated by each market participant interested in buying or renting a space. Often market players while choosing a property take into consideration not only objective utility values, but also their subjective opinions.

Mainly because of its' utility values each property can be used during a period of time by many entities. Each real estate is a consumer good and can be for example sold/bought, rented, leased on the market like any other product.

Owner and real estate occupier could be the same person. But even when real estate is not presented on the market by the principal to be sold or rented it has a value. Due to that fact basically anytime real estate owner is able to make a decision to put his offer on the market and sell/lease his property.

Each property type responds to customers demand for different kind of surface



such as residential, commercial, and industrial. Utility value of real estate could be different for each market player and will depend mostly on needs and personal point of view.

Relatively high value of each real estate against other consumer good available on the market means that properties play a very important role among all assets. Properties belong to the fixed assets usually purchased for a long-term in order to gain profit and avoid depreciation. Gaining a profit on the real estate market would not be possible without the demand, which is affected by the role of real estate in our personal and business life. Significance of properties is caused by their:

- **Profit- making function**, which means that real estate, brings profits to its owner. It could be rented. Rent is considered as an owners benefit from the property. According to A. Doliwa “benefits obtained from a piece of property or from rights entitling to use this property in frames of properly functioning market should not lead to overuse and loss of benefits source”<sup>2</sup>
- Benefits obtained from a piece of property
  - Natural benefits, like agricultural products, mineral excavation.
  - Civic benefits, “ income created on basis of legal relation” may have a form of pecuniary profit or tangible goods.
- Benefits obtained from rights entitling to property use, which is simply an income created by these rights in accordance with social and economic rules.

All benefits created by the property belong to person entitled by law to collect them. It is a basic element of property law, and especially ownership law. Each real estate may be a source of income for its owner. If property owner use it only for own purpose them it does not bring additional income, but does not create alternative costs- for example costs of renting necessary space.

Income range may differ- it depends on factors like: location, size, physical condition, design etc. and current market situation, owners or manager’s skills and talent to negotiate prices, also exploitation costs.

- **Pledge function.** In order to secure loans and credits properties are often used as a subject matter of a pledge. Real estate immobility causes the fact that location of the property remains the same, it can not

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<sup>2</sup> Doliwa A.: Prawo rzeczowe, Wydawnictwo C.H. Beck, Warsaw, 2004, s.17

suddenly disappear or be stolen. It could be sold or rented on the market, which means that it is possible to get the cash back from the investment. Land and mortgage book, especially chapter IV, hold information about the mortgage which is a loan secured on real estate- usually a long-term loan.

Potential buyer is entitled to make sure by checking the book if real estate is being used as a loan security and to receive details concerning the mortgage, so that decision about buying or not would not cause unexpected cost such as a mortgage to be paid for the next 30 years.

- **Investment function.** Monitoring a long term real estate market trends we can observe an upward tendency in the growth of property and land prices. Real estate is often considered as a long term capital investment, which brings benefits to the seller. Especially when inflation rate is growing up real estate is being considered as a safe investment, against other forms such as stock exchange, gold and so on. Real estate is even more valuable during the recession period when it could be rented and brings a profit to the owner.

Current market trends and fast changing business environment requires from companies, especially those with significant assets, to review their strategic decision and often to invest on the real estate market during a long period of time in order to gain possibly secure profit.

- **Fiscal function-** real estate is a wealth of physical or legal person. Property ownership does not only bring benefits, also expenditures. Some of them are legally required. In every country property tax is a part of state (or local government) income. Taxes are:
  - Compulsory
  - Non- returnable
  - Gratuitous

Property taxes may have different forms and names. There is a group of income taxes calculated on basis of income created by the property; other group of taxes is calculated on property value basis.

In case of property value tax- it must be paid regardless of owner's actual abilities to pay it. Classic example is residential estate used by the owner, which does not generate an income.

In Poland property taxes is determined by size and type of property. Tax rate is calculated per square meter. Lowest rate is paid for residential space. Taxes paid for the parking space use may be couple times higher than paid for the housing space.

Separate property tax rates are calculated for each type of property. Rate multiplied by actual size of property (square meter) indicates amount of tax due.

It is important to stress out that in Poland property tax is a commune's income (gmina). **Gmina** is responsible for tax rate calculation, but the maximum level is regulated by the state.

Such calculated property tax does not have anything common with property value, therefore does not take into account **location factor**.

- **Technical function** of the real estate is connected with a possibility to use physical features of the property to be a shelter, place to rest or work or a piece of land to be used for agricultural activities/causes. From every day life point of view, real estate which is not only a land property but also includes buildings has a more significant technical meaning for users. Where the user and owner does not have to be the same person at all. At every stage of real estate life cycle it could be rented, modernized or extended to increase its technical usefulness.
- **Real estate speculations (profiteering)**. Many times purchase of the real estate is being made for profiteering purpose. Decision is usually made on the basis of prospective growth of real estate utility value as well as market value. For example when buying a an agricultural real estate on the outskirts of the city there is a possibility that this parcel will be qualified in the future as a land for commercial or residential estate, which leads to its significant price growth. Profiteering from the real estate could be risky, but no more than any investment on the other markets. What differs speculations on the real estate market from other markets is a relatively high cost and length of this process.
- **Social function**. Real estate market is important from the social point of view, because private and public properties play important role in our every day life. Privately owned properties are often residential real estate used for housing for individuals. Public properties like parks, theatres, swimming-pools, hospitals as well as roads, airports or highways are supposed to be used by society in general. Usually large groups of people have an access and right to use public real estate.

To sum up all property types could have many functions for the users. Basically it depends on the aims of the owner/ user of the property which function will be most important, more or less every real estate combines all functions mentioned above.

# **CHAPTER 3**

## **REAL ESTATE MARKET (M. BRYX, D. BRODOWICZ)**

### **Abstract**

Chapter number 3 includes basic information about demand and supply forces on the real estate market and also about main market players, trends and issues and principal rules crucial for each property manager in their work.

### **3.1. FACTORS INFLUENCING/ AFFECTING THE REAL ESTATE MARKET**

Characteristics of real estate markets results from the real estate features and property law, when they could have direct or indirect influence on the markets shape and operations. Among all real estate features, most important are:

- immobility, which causes that real estate transactions involve not buying/selling/renting the actual real estate (physically) but right to it.
- as a real estate owners and users we deal with many kinds of different rights and law regulations. That means for the real estate owner right to sell/ rent not only ownership rights but also other rights.

Real estate can not be produced in one place, where manufacturing costs are low and then be sold on the market which ensures highest possible return. Yet it is possible to enhance real estate utility value for potential clients by investment, extensive repair, and modernisation and so on. Real estate major

repairs and renovation can be so fundamental, that refurbished property could find totally different end users and value then before.

Articles concerning real estate law gathered in **civil code** indicate that buildings, lands parcels and so on are properties and therefore have a value and can be transferable like any other good.

In other words, real estate characteristics and property law cause that in many cases real estate market differs from other markets, but in fundamental matters concerning market mechanics operates very similar.

This means that real estate market is a place of information and goods exchange. Before ownership or other rights will be transferred to a new owner usually real estate has to be presented on the market to be sold, parties involved in the transaction negotiate with each other, when they reach the agreement transaction is being concluded.

Despite of real estate characteristics, among which most important is immobility, mechanisms like forces of supply and demand operate on the real estate market like on any other market, difference is that often characteristic features of real estate can disrupt mechanisms. Generally supply and demand forces on the real estate market solve for the equilibrium price.

Among real estate characteristics which have direct or indirect impact on shape of real estate market we should focus on immobility which causes invariability of geographical location of land and property. Once built real estate usually stays a part of a landscape for many years.

Economic and technological circumstances have to change significantly so that existing object could be replaced with new one. But even then location remains characteristic feature of property.

Real estate characteristics directly influencing real estate market are there features which cause different than on the other markets sell/buy/lese solutions:

- Real estate market is local (globalization is an issue concerning capital flow and financial solutions on the property market, but not estate in particular).
- Decisions made on real estate market have a significant meaning, while price is relatively high and property's life cycle is long.
- uniqueness/ heterogeneity of each real estate without any doubt affects decisions (which are mostly subjective) of market participants.

Among indirect effects of real estate characteristics are:

- unique financial solutions on the real estate market,
- investment and development processes which differ from solutions adapted on other markets,
- consequences for the owners/ users and investors of indestructibility and fixity.

**Real estate finance-** practically every real estate has a high price in comparison to other consumer good. To become an owner most of the buyers incur a debt from a bank or use other sources to finance their purchase. Also gaining other right to the property, as well as real estate management and investment requires additional resources from the financial sector.

It is a common practice on the real estate market that almost all investors use credits to proceed with the investment. For many years bank and other financial institutions prepare products customised for individual and corporate investors on the real estate market.

Today's financial products and institutions are connected with the real estate market. Many of them exist and operate thanks to and because of real estate market. Financial institutions are generally active participants and have an influence on real estate supply. Real estate brokers/ sellers often compete for the same clients as well as financial institution to. For real estate investors financial products and options are equally important as property itself. Sometimes products like REITS offer more incentives than actual purchase of a real estate. Real estate market could not be decreased to transactions concerning property rights, role of financial instruments can not be overestimated, while most of the real estate transactions would not be possible without them.

**Second indirect effect caused by real estate characteristics is strong connection of investment process with the real estate market.**

Real estate supply presents only percentage of whole real estate stock, usually properties not presented on the market have owners and users. High sell and rent price of real estate per square meter attracts investors, new investments contribute to the growth of the real estate supply.

From the macroeconomics perspective investment is a process of transformation of cash flow into economic goods as a result of investment process (new real estate is developed, additional space is available)<sup>3</sup>.

Real estate investments contribute to the GDP growth; also have influence on utility and value of already existing properties and supply level on the market. When market looks attractive for investors- unit prices are high and there is a possibility of demand growth, often enterprises as well as individuals decide to pump money into local real estate market. Once the real estate development process starts it is predictable when it will be finished and new supply will be available on the market. Projections concerning future supply level have an influence on the price level of current real estate stock. Often real estate deals like sell or rent of space take place before investment process is being completed.

Also real estate marketing is a process which usually starts when decision about is being made. Residential properties are being often sold shortly after the construction permit is issued<sup>4</sup> and it is possible to present approved property plan<sup>5</sup>. In case of hospitality business before hotel starts to operate rooms are available for booking 6 months before opening, convention centres are available for booking 2 years ahead (or even earlier) before official opening.

It is possible to sell a property at any stage of the investment process, owner can change couple of times before process is finished, and it only depends on price and return rates. It means that during investment process not only real estate but also real estate market becomes part of the process. Both investment and real estate market influence each other even before real estate development is finished.

Even when investor and end user is the same person, investment has an influence on the market. Owner of the apartment/ house buying a new one leaves old one, often sales or rents it, also a company building a headquarter already occupies a space, which probably will be available on the market after construction of a new one will be finished.

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<sup>3</sup> From microeconomics perspective investment is also a transformation of cash flow into economic good, but it may be a purchase of already existing well.

<sup>4</sup> Or even before, and situation like his should not take place.

<sup>5</sup> Regardless developer takes payment from client, like in case of Poland, or is forbidden to take money.



No matter what kind of property is considered- real estate investment is not a process which takes place beyond the market- it is a part of market.

**Third indirect effect of real estate characteristics are consequences for the owners/ users and investors of indestructibility and fixity.**

Life cycle of property is usually longer than an average human life. Many years before J. Goryński stressed that it is an effect of technology and materials used during a real estate development. He also addressed real estate longevity as an issue which causes certain consequences. "They result from changes of preferences and users needs, on the other hand- from the need to maintenance the property in accordance to the safety regulations until real estate is occupied"<sup>6</sup>.

After over 40 years these assumptions are still up-to date. More often properties are not only considered as places to live in and work, but also as tools to make a profit. So that possibilities to extend a life cycle of real estate- technical and aesthetic become priorities for owners and property managers.

Real estate management is lately an important issue on the market, it includes: aims, methods, plans implementation and so on. It could be compared to a strategic plan which needs to be constantly updated. Real estate management also includes decisions about investments and renovations, financial options and possibilities to keep or sell a property.

Even when in the certain phase of time property will have couple of different owners, all of them will face similar management issues to use and exploit property according to their needs and plans.

In other words- real estate characteristics (like longevity) and market mechanisms and objectives (like profit making despite of building depreciation costs) require preparation of management and development plans.

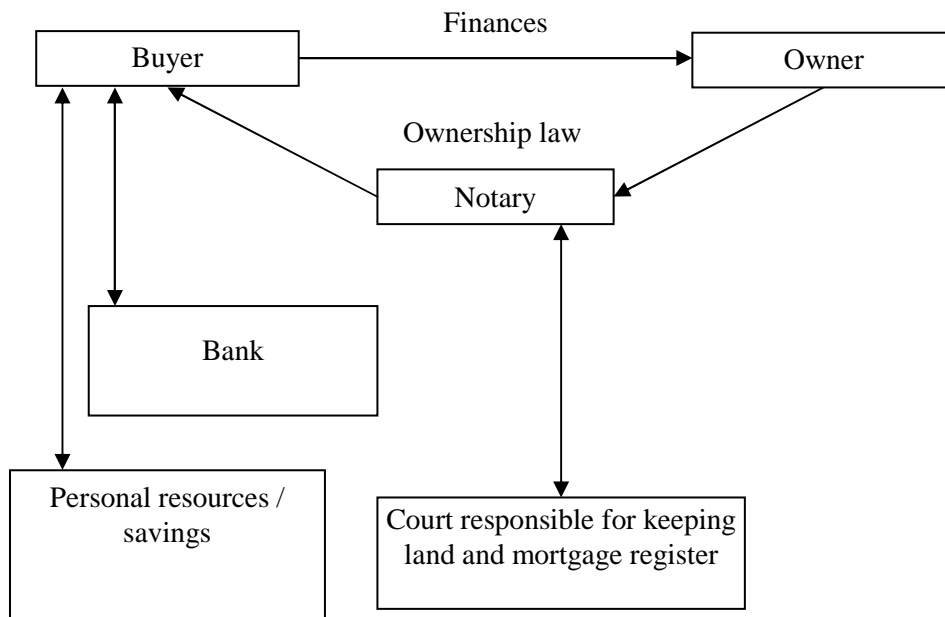
Real estate management has to be connected with life cycle of property; management process concerning a certain property also concerns a real estate market and affects both. Also market and properties localized on it are connected and have an indisputable influence on each other.

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<sup>6</sup> Goryński J.: *Ekonomika budownictwa i polityka budowlana*. PWE, Warszawa 1976, page 134

## 3.2. CONCEPT OF THE REAL ESTATE MARKET

An average real estate market participant, for example a person buying an apartment, usually identifies real estate market with his own activities on this market. From the market's point of view buying/selling residences is an important part of all transactions. Diagram below shows a model of real estate purchase.



**Fig. 3.1. Purchase of the property.**

Source: Own elaboration

Model of real estate purchase, most often a residential estate, presents transfer of any property ownership laws. It could also include following real estate market participants:

- real estate surveyor, if transaction requires data about property appraisal
- real estate restorer, if for example listed building is being sold and investor needs information about property in order to use it within the law.

- other parties, if participants of transaction will decide so.
- Also it is worth to mention that if transaction takes place on the social housing market, it involves subsidies from the public budget.

Summing up influence of specific real estate attributes and laws on real estate market coordination and operation it should be stressed up that this market is definitely more complex than it seems at first glance. It includes transactions like:

- real estate brokerage, which include sell of ownership and other property rights
- real estate investment taking place during different periods of real estate life cycle leading to utility and value growth
- real estate management, which aim is to keep the property in the same or improved condition- maintenance, redevelopment, build-up and so on.
- other services possible to be used on the market to increase profits from the real estate.
- also financial services or government subsidies.

Focusing on the real estate transactions market could be divided into submarket of:

- property brokerage, regardless what kind of property is being sold, who is the buyer/ seller.
- market of financial services and products- loan, insurance and leasing products concerning real estate in any phase of the life cycle. These financial products and services could have not only commercial character but also could be initiated by the central and local government. It also includes such ideas like mortgage backed securities.
- real estate value increase by investments, which lead to growth and modernization of real estate stock.
- other services, especially brokerage and real estate management.
- exchange of other property right

Above-mentioned division leads to the definition of real estate market as follows:

- 1) Supply part of the real estate market, which could be divided into:
  - a) Total number of properties offered to be sold or rented, which includes:
    - real estate supply e.g. transfers of real estate ownership rights to the owner.

- supply of space: mostly office, warehouse and living space which could be rented- usufruct rights.  
Including already developed properties, as well as under construction and renovation and so on.
  - Potential supply<sup>7</sup>
- b) Capital investments in the real estate, which aim at utility value increase  
that might lead to increase of property value and mostly to property space increase.
  - c) Financial products related and designed to increase potential demand and supply on the real estate market.
  - d) Real estate services market, first of all real estate management, brokerage, investment, property interior and exterior design, cleaning etc.
- 2) Demand side of the market is represented by:
- a) Demand for real estate, both in form of:
    - purchase of ownership law
    - purchase of right for perpetual lease and other property laws.
  - b) Demand for financial instruments enabling purchase of ownership rights to the property.
  - c) Demand for services related with growth of real estate value.
  - d) Demand for other services provided by broker, notary, and geodesist.
- 3) Real estate market operations, by which we understand law procedures and economic relations between different market segments in relation to market rules and real estate characteristics.

Background for such a definition of the real estate market are needs, which combined with a purchasing abilities create a demand side of the market.

Above presented definition of the real estate market is rather a “functional”. It is based on demand and supply function and it tends to define all participants as entities exposed to market mechanism- it includes majority of participants and operations taking place on the real estate market. Presented definition is only a proposal and can not be treated as the only one possible.

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<sup>7</sup> Properties use by their owners, who may put them on market to sell or lease. It is a part of already existing stock which may increase supply on the market.

It is worth to emphasize that market participants on the demand and supply side are private persons and legal entities, which make decisions about their market activities based on own needs, abilities and expectations for growth/ expansion, as well as current and expected market position, economic and law system, economic situation and other factors. It seems obvious that factors which have positive or negative influence on market players also influence market itself and determine its progress.

To briefly sum up real estate market may be presented in the form below.



**Fig. 3.2. Diagram of the real estate market**

### 3.3. REAL ESTATE MARKET SEGMENTATION

Real estate market is a complex and complicated structure, which consists of number of many and related with each other segments. Specialists form the real estate filed treat this market as mostly local. It means instead of talking about one global real estate market deal with many local and characteristic for each region/ country markets.

There are many differences between real estate markets in the developed countries like the USA or EU countries and local markets in countries like Brazil, Russia, India or China called together as BRIC countries.

Real estate market segmentation simply depends on adopted criteria. Following systematic approach from the chapter 9.2 one can distinguish following sub-segments of the market:

- Real estate brokerage
- Real estate investments
- Real estate management
- Real estate financing

Real estate brokerage is supposed to bring together parties (like buyer and seller or landlord and tenant) in the transaction on the real estate market. The broker (who holds a licences) mostly acts as an agent on the behalf of his client or clients in negotiating the price

Another important and essential for the real estate market operations is **investment segment**. Usually real estate investment is money used to develop new or purchase a property for the sole purpose of holding or renting/ leasing it for income.

Also major overhaul, which aim is to improve standards and usefulness of the property is considered as an investment

**Real estate/ property management** market became a very important part of the real estate market lately. Often properties owners (especially of office buildings and large apartment's complexes, as well as shopping malls) do not have time and expertise to manage their buildings on the daily basis. Usually they hire a licensed specialist to manage the property on their behalf and to

maximize the income from rent, lease and others, and to maintain the values of property, as well as to find tenants.

Last but not least segment is **real estate finance**. A purpose for the finance sector is to provide funds (usually commercial bank loans, also savings associations, real estate investment trusts) for the development or purchase of a property. Significant and unique for real estate finance is a fact that most often properties involved in that kind of process are pledged as collaterals for the loans, usually through a mortgage or trust deed.

According to G.R Cortesi<sup>8</sup> real estate market could be divided according to property's classes into:

- Residential real estate market, which includes family houses units, apartments, mobile homes, as well as dwellings used for holiday homes.
- Commercial real estate market includes shopping malls, office buildings, cinemas, and so on.
- Industrial real estate market consists of warehouses, factories, and so on.
- Agricultural real estate market includes among others farms, ranches and timberlands.
- Special purpose properties market. It consists of churches, government buildings, schools.

Above presented segmentations are not only one and valid. Real estate specialists and institutions monitoring the market tend to build and use their own and specific segmentations. Urban Land Institute often presents property market as:

- Retail
- Hotels
- Mixed- Use Properties
- Office
- Industrial
- Residential

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<sup>8</sup> Cortesi G.R.: Mastering Real Estate Principles, Real Estate Education Company, Chicago, 1999, page 10



## **3.4. REAL ESTATE MARKET PARTICIPANTS**

Participants of real estate market are usually licensed specialists who represent one of the submarkets but actually being active and influencing most of the aspects connected with properties. Group of the participants is very diverse and specialised.

Demand and supply play a very important role important role and influence decisions made by participants. Most of them could be divided into following groups:

- representing demand side
- representing supply side  
group of participants responsible for providing services – brokers, appraisers, property managers.
- others

First group participants could be local or even international players who represent demand side of the market. Individuals, small companies or even international corporations seeking for a place to rent or buy are creating demand and have a large influence on the market.

Among group representing supply side M.Bryx<sup>9</sup> distinguishes:

- Developers, who seek for the possible high return with a minimum commitment of money and time usually by developing properties which will be sold or rented,
- Firms as well as individuals investing in developments for their own use, which usually sell or rent occupied space.
- Property owners who put their sale offer on the market.
- Property owners/ managers who put a rent offer on the market, also those who extend space of existing properties.

Additionally to the supply group belong participants who bear personal and professional responsibility for their activities on the real estate market, such as: brokers, appraisers, architects, and attorneys.

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<sup>9</sup> On basis of Bryx M.: Rynek nieruchomości system i funkcjonowanie. Poltext, Warsaw, 2005, page 78 and further.

During last couple of decades parties involved in financial products distribution became very important players. For instance commercial banks, investment trusts, saving associations offering loans, mortgages and many other products, which are funds for the development and purchase of the estate.

Also architects, planners, landscape architects or contractors involved in space extensions, overhauls have an influence on size of the supply stock.

**Participants responsible for providing services** are legal entities like courts responsible for land and mortgage register (Land and Mortgage Registers Department), Internal Revenue offices responsible for collecting property taxes.

Also building inspectors who issue building permits for construction of new properties or altering existing ones, as well as certificates of occupancy required before property may be occupied.

Group classified as **other participants** represent those who take part in “non-market transaction”, like inheritance. Basically by signing documents they can transfer property ownership rights on the third party.

It is often a case that real estate market participants can play various roles and be engaged in different project in one time, as well single project may require engagement of many entities at ones. For example one development process involves architect, developer, engineer, construction workers, and often commercial bank lending money.

Presented in this chapter market participants division is not only one binding, but it is a frame which groups entities involved in activities on each real estate submarket.

### **3.5. REAL ESTATE MARKET CHARACTERISTICS**

Real estate market characteristics are directly connected/ result from the characteristics and rights to each property. As any other market good real estate can be sold and bought. By investment and proper management worth of each

property may increase. Real estate market is simply a place where mentioned processes take place and engage various participants at once. Price, demand and supply play a significant role as on any other known market.

Most significant feature of property which has a significant influence on the market is immobility, which means that geographical location of the property stays constant. Furthermore heterogeneity (there are no two exactly the same properties), fixity or long durability of real estate cause that this market is specific and different from any other markets of goods.

Real estate market is considered as **local**. Property can not be “produced” in one place and sold somewhere else in order to gain higher profit due to real estate immobility. Developers can not move/ transport property. Once located building usually becomes a part of the local landscape for a long time. Even among one city real estate market may be divided into couple of smaller and characteristic local markets.

Real estate market does not react immediately to changes of demand and supply level; it is **less flexible** to exterior factor than for example stock exchange. It is basically a case of fixed amount of land properties available for new developments, high cost of investment process, or long life cycle of an average property.

It is worth to mention that **government** controls and appears as one of the participants on the real estate market. While properties play a significant role in everyone’s life being a shelter, place to relax, live and work local and central governments needs to make sure that by forcing the regulations and rules they address social needs which can only be fulfilled by the property.

Housing regulations- especially affordable housing and rent regulations, also infrastructure, spatial planning, nature and historic monuments conservation and many other aspects connected with the build environment and real estate in particular are in hands of governments

## **3.6. SUPPLY AND DEMAND FORCES ON THE REAL ESTATE MARKET**

Supply and demand forces along with price are major factor having influence on activities taking place on the real estate market.

On the other hand properties supply as well as demand is conditioned by the real estate and real estate market characteristics.

Prices of properties are significantly high among other consumer goods.

Relation between price and demand level looks quite different than on other markets. Property price is not only indicator forcing buyers to make a purchase decision.

As mentioned before real estate plays different roles in everyone's life (being shelter, place where work can be performed, place to relax, do shopping and so on). It is almost impossible to find a substitute for a real estate. That is why unit price, although important, is often not a critical factor influence buy/sell/ rent decisions.

Especially during a short term, while demand and also supply are not flexible and do not adjust automatically to the price change.

It is mostly a case on the real estate market that demand growth leads to decrease of number of unoccupied units first. Price growth is an after- effect, while supply can not put on the market new units automatically due to the length of development process.

During long term corrections of demand and supply level influenced by the unit prices are more visible.

W. Cortesi<sup>10</sup> presents following rules of the demand, supply and price level on the real estate market:

- Property price increases when demand increases or supply decreases.
- Price decreases when demand decreases or supply increases.
- When supply and demand increase together, price remains constant.
- When supply and demand decrease together, price remains stable.

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<sup>10</sup> Cortesi G.R.: Mastering Real Estate Principles. Real Estate Education Company, Chicago, 1999, page 12.

Demand and supply level are affected by number of factors. Supply<sup>11</sup> is mostly influenced by physical and economic factors, while demand more by social and economic ones. Real estate market is considered to be local, and local changes will influence a single local market more than a global trend. Most significant factors are:

- Population: number, age, gender, family structure.
- Occupation, income level.
- Savings, credit ability, mortgage interest rate.
- Unit price per square meter, percentage of not rented space
- Property taxes and tax relief
- Amount of parcels destined for new developments.
- Technical condition of existing property stock.

**Government especially local authorities** can represent both demand (as owner and prospective owners) and supply side, especially being responsible for land use regulations and development/ building permits.

**Demand side** of the market is mostly affected by local factors, directly related with the area where property is situated. Demography- population number, structure are parameters indicating what kind of properties, how many square meters and so on is needed and will be required in the future to meet property needs of local community. Also employment rate, average income level determines significantly purchase abilities and influence demand for housing units/ office space/ retail space etc.

### **3.7. RESEARCH AND ANALYSIS OF REAL ESTATE MARKET TRENDS**

Property market is a challenge for analytics. It consists of significant number of characteristic local markets, often influencing each other. Single market may be

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<sup>11</sup> Considering determinants of supply it is important to stress out that amount of land is fixed. It can not be produced like other goods.

further divided into segments- residential, commercial, industrial, and agricultural.

Market prognosis is usually based on data about: prices, demand and supply level. Information about size and condition is also taken into consideration while creating forecasts.

**Transaction price** on the real estate market is usually kept in secret by parties involved in process. Information about it is confidential and there are now law obligations to publicise it. Therefore analytics working on prices prognosis often have to use approximate amounts instead of transactions data.

**Statistical data** about real estate is often gathered and kept by the statistical offices. Also offices gather information about population, living conditions, incomes of population, prices, and services and so on. All of them may be used by researcher in order to make forecasts about expected demand and supply level.

Also real estate brokers, property managers, local authorities, Internal Revenue offices, public notaries have knowledge about market transactions.

None of them is legally obligated to publicise data about transaction in which they participated, but they may share information.

In many cases market researchers and analysts have to **act like reporters** hunting for data. Facing information and knowledge age one should be aware that data has a significant value. Those who own it are ahead of everyone else.

Prognosis often used by decision makers is a powerful tool. Firms and international companies use forecasts while making investment decisions, which in case of property market are long term. Also households, local communities, governments and other market participants' use and are influenced by the predictions about future prices, available stock and often adjust their decision about purchasing/renting/ selling a property on their basis.

### 3.8. REAL ESTATE MARKET ECONOMIC MEANING: CENTRAL AND LOCAL APPROACH

“The most common definition of real estate is the national stock of buildings, the land on which they are built, and all vacant land. These building are used either by firms, government, non profit organizations, and so on, as workplaces, or by households as places of residence. When defined this way, the value of all real estate makes up the largest single component of national health”<sup>12</sup>.

Considering role of real estate stock on central and local level it is important to emphasize:

- their part in creating GDP
- participation in local budgets- income from property taxes
- number of workplaces created by whole real estate industry
- amount of investments on real estate market
- role and influence of property market on each household, while expenditures on real estate purchase and exploitation are usually highest among all expenses.

Data from the last 15 years present that 6-8 % of GDP level in Poland is created by new real estate investments every year, whereas in the USA more or less it is 12 %.<sup>13</sup>

**Real estate tax** collected every year is usually one of the most significant income sources for the local government. Property owner is also obligated to pay tax when buying- selling/ renting transaction takes place.

S. Belniak evaluates that in Poland income created by the real estate taxes amounts around 11 % of all local revenues.

Market and real estate industry in general create significant number of **workplaces**. Not only development processes, but also investment, management, brokerage and others engage specialists from different fields.

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<sup>12</sup> DiPasquale D., Wheaton W.C.: Urban Economics and Real Estate Markets. Prentice Hall, 1996, page 2

<sup>13</sup> Belniak S.: Rozwój nieruchomości w Polsce na tle krajów wysoko rozwiniętych. Wydawnictwo Akademii Ekonomicznej w Krakowie, Kraków, 2001, page 80.

Generally around 5-7 % of all employees (professionally active) in Poland perform their jobs on the real estate market.

In terms of creating and maintaining a value of national stock investments are crucial. Not only new developments but also existing buildings kept in the proper technical condition are important in every economy. About 50% of all investments in Poland are money allocated in properties developments, overhauls and so on.

Also social role of real estate, especially residential real estate in life of every citizen is crucial. Therefore governments tend to interfere in it especially by creating laws, organizations, structures and financial tools to support citizens, and especially those who can not afford buying or rent a place (usually by Affordable Housing Programs).

### **3.9. PROVIDERS OF REAL ESTATE MARKET SERVICES: AGENCY AND BROKERS, APPRAISERS, DEVELOPERS, PROPERTY MANAGERS, NOTARY AND INSURANCE COMPANIES**

**Agency and real estate brokers**, their main aim is to bring parties representing demand and supply side together. Broker and agency contact clients in negotiating a sale, purchase, exchange, and rental. In many countries it is required by law that broker has to hold a license to perform his duties on the market- whether it is purchase, rent or other transaction.

**Appraisers**- their job is licensed and regulated by law and basic aim of it are estimations of property value. Property appraisals are required and needed in many real estate activities. Valuation professionals are usually hired by owner or future to provide an expertise, while data about property's worth is crucial to: obtain a loan, assess property tax, insure property, negotiate a sale/ purchase transaction price.



**Developers** are engaged in a process of making improvements to real property, which increases its value. Developer may be an individual, but in most of cases partnership, Limited Liability Company is created to conduct a process. In most of cases<sup>14</sup> they acquire a land parcel in order to construct building projects, which will be sold, or sometimes retained as assets to produce cash flow via rents

**Property managers**, also hold licenses required by the law in order to represent clients. Main objectives of their activities are:

- Physical management (also facilities management)
- administration activities along with preparing budgets
- marketing activities, such as finding new and maintaining current tenants

**Notary** plays important role as a witness of transactions on the real estate market and it entitled to authorise agreements in form of **notary's deed**.

**Insurance agents** on the real estate market offer product which aim is to secure transactions, investments, developments, also loans, and properties alone in case of natural disaster like flood, earthquakes, and so on.

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<sup>14</sup> Building developers vs. land developers

# CHAPTER 4

## VALUE OF REAL ESTATE (E. MAĆZYŃSKA)

### **Abstract**

Chapter number 4 concerns theory and practice of real estate valuation. Functions and all types of property values are described in this chapter, as well as procedures of real estate valuation, all methods and techniques of property valuation, the documentation of valuation and issues concerning value versus the price of real estate dilemma and non - market factors influencing on real estate price.

### **4.1. THEORY AND PRACTICE OF REAL ESTATE VALUATION**

The issue of valuation is exceptionally complex and therefore it is often source of controversies. By no means is there something like the one and only proper value of the real estate. *Value* is an ambiguous term, understood and defined in various ways, depending upon disciplines and spheres of life. In accordance with the most general definition, value reflects desired and esteemed by the interested parties' characteristics of the structure being subject to valuation. However, what is valuable from the point of view e.g. of an artist, ecologist or doctor does not have to indicate value in economic sense. In addition, the conflict over value is not a rare thing (e.g. when economic arguments and criteria collide with ecological ones, being sometimes at odds, at least in the short term).

The real estate valuation, by natural course of things, concentrates on the value in economic sense. The existing various theoretical achievements on the issue of value indicate its complexity. In spite of various experience in the issue of valuation, especially in the countries with well developed market economy, neither theory nor practice does come up with **unequivocal** answer to the question about how much the real estate is worth. Depending on the attitude assumed in the valuation, the value can be either **subjective** or **objective**.

**The subjective value of a real estate** is a value estimated by a party of the purchase and sale transactions, taking into account their individual preferences (including tax preferences) and alternative possibilities of the capital investment (e.g. for a contracting party interested in eliminating competition from the market or getting rid of problematic neighbourhood, the value of the real estate, purchased for this purpose, can be higher than for other contracting parties). The subjective valuation is based on various and individual preferences and intentions relating to the future use of the real estate, as well as on individual assessment of the present functional characteristics of the real estate .

**The objective value of a real estate** is a value verified by the market that is, obtained through comparing it with the prices of similar civil structures existing on the market. The valuation is not based on individual preferences of the buyer or seller but on the market prices of similar structures.

As far as the company valuation theory is concerned, there are three main streams:

- absolutist,
- relativist,
- Mixed.

According to the **absolutist** stream, the only proper criterion of real estate valuation is the civil structure's capacity to generate income (income-based value). In this concept, the valuation is content-wise and methodologically subordinate to the investment theory and calculation of investment effectiveness. According to this theory, each investment is a choice between various ways of investment and consists in adoption of such a solution (including purchase of an enterprise) that in a given period guarantees the investor optimal profits.

According to the **relativist** stream, the object of investment can represent many different values, whereas **mixed** stream allows various methods of valuation. On one hand, it is theoretically assumed that object of investment is worth as

much as the contracting party interested in it is willing to pay. On the other hand, it is stressed that in practice it is not often possible to assess the market value. That is why methods other than the market one are applied, based on various foundations .

Despite the fact that in theory and practice there are differences in approach to the real estate valuation, some common characteristics and trends can be distinguished:

- the purpose of valuation is always clearly specified, and choice of approach, method and technique of the real estate valuation is well-founded.
- the dates relating to carrying out of valuation are always provided
- the value determined on the basis of the real estate's capacity to generate profits (income-based approach) gains on meaning in the course of the development of the capital market, that is, in the course of increase in alternative investment opportunities.
- liquidation value, applied when structure, being subject to valuation, is destined for liquidation, is usually treated as the lowest of possible value levels.
- the value of property is distinguished from its price

Purchase and sale transactions are daily bread in the developed market economy. In practice they are treated as **important wealth indicator**, under the assumption that the more transactions being concluded on the real estate market, the richer being a region or a country.

## **4.2. FUNCTIONS AND PURPOSES OF REAL ESTATE VALUATION**

The necessity of the real estate valuation arises in relation with actions of various legal, economic, economic and financial, social, accidental and other reasons. The purpose of valuation results from owner, manager's and control functions, among others, from record and fiscal functions as well as different official functions.

According to *Law on real estate management* of 21 August 1997, the determination of the real estate value is indispensable in the following cases:

1. sale and purchase of state and communal property (property with public character),
2. execution of some official activities, conditional upon value of real estate (real estate integration, division, right of pre-emption),
3. expropriation, compensation for real estate expropriation,
4. establishments of fees in connection with increase in the value of real estate (among others settlement of re-zoning fee and betterment levy<sup>15</sup>),
5. purchase of the real estate in favour of the Treasury or municipality,
6. return of expropriated real estates ,
7. enfranchisement, privatisation, revindication claims, etc.

Typical situations that require real estate valuation are among others: change of the owner and gain of additional sources of capital provided by entities interested, above all through taking real estate loans.

The purposes of valuation project on the choice of methods and procedures of its carrying out. Therefore an indispensable element of each valuation is a question or an answer what for and for whom (by order of whom) the valuation is performed. It is connected with basic functions associated with one another, which form the basis of valuation. The most important are functions of:

- information and advice,
- decision making ,
- negotiations,
- solution for conflict of interests arising between contracting parties

**The function of advice and information** is based on taking into account all the possible factors (both internal and external) that project on the result. The knowledge of these factors is an indispensable element for the rationalization of investment decisions.

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<sup>15</sup> betterment levy is a fee fixed due to increase in the property value, caused by construction of technical infrastructure appliances with participation of the Treasury or territorial self- government bodies or by integration or division of the real estate – compare. Whereas re-zoning fee results from change in the real estate value caused by setting or change in local plan of real estate development. The law of 21 August , 1997 on real estate management – uniform text- Jornal of Laws of 2000 year, no. 46, position 543 (Law on real estate management with latest changes)

**Functions of decision making** are based on providing information, for parties interested in purchase and sell transaction, that are indispensable for making decisions regarding purposefulness and effectiveness of the investment, choice of investment variants and sources of their financing, taking into consideration alternative solutions.

**Functions of negotiations** are equal to providing arguments for interested contracting parties (as well as in the case of a loan agreement) that justify valuation proposed in the transaction.

**Solving conflicts of interests** appears when owner of the real estate has different view of its value than prospective buyer or lender. This situation may be a source of conflicts. One of the main conditions of their avoidance is the clarity of the assumed rules and methods of real estate valuation as well as an early identification of reasons for prospective controversies.

### **4.3. TYPES OF REAL ESTATE VALUES: OPEN MARKET VALUE, REPLACEMENT VALUE, CADASTRAL VALUE, MORTGAGE LENDING VALUE**

In accordance with regulations in force, the real estate valuation shall be conducted through determination of it's:

- open market value
- replacement value
- cadastral value

**Open market value** is determined for real estates that might be subject to market trade, whereas **replacement value** – for real estates that, due to current use, are not or cannot be subject to market trade, or when special regulations are required (e.g. regarding protection of historic monuments, assets insurance and others). **Cadastral value** is determined for real estates that are subject to the ad valorem tax.

In accordance with *Real Estate Management Law* (article 151), **open market value of the real estate** is an expected price that can be achieved on the market with consideration to the transaction price and upon meeting the following conditions:

- contracting parties being independent, not acting against their will and aiming to sign a contract,
- the time indispensable for both exposition of the real estate on the market and for the negotiations of the contract terms, being expired.

Among the valuation standards, binding for real estate surveyors, the following kinds of market value of a real estate can be distinguished:

- Market value for a way of designated use (MVU) – defines market value understood as above, on making additional assumption of property being used according to the way of its designated use
- Market value for an alternative way of use (MVA) – defines market value reflecting forward use of a real estate for purposes different than at present, in the cases where there are possibilities of change in the designated way of use (destination) of the real estate.
- Market Value for Optimal Use (MVO)- is determined under assumption of the best and most effective use of a property, that is real, legal, physically possible and resulting in the optimal value.

**Replacement value of the real estate** equals to costs of its replacement, with consideration to the degree of consumption. During estimation of the replacement value, the value of land and value of components (buildings) is determined. In this case cost approach is applied.

**Cadastral value** is connected with the real estate cadastre, that is formal, standardized set of information on land real estates, building real estates and housing real estates, their respective owners and managers, as well as on the real estate values that serve as a base for tax determination for respective real estates.

Besides tax function, cadastre performs other important functions:

- all together with Land and Mortgage Register system formulates conditions for protection of property right ,
- provides official data on real estates, both in individual and in statistical depiction,

- is a basic and uniform data base of characteristics creating the open market value of a real estate and real estate prices, i.e. it is used as a source of data for individual valuations and determination of cadastral value that can serve for the tax purposes and other official functions, which require knowledge of the real estate value.
- is a data base that is indispensable for real estate management, reasonable spatial economy management and land use (including integration, division, land reclamation)
- serves for protection of interests and creation of security of real estate sale parties, as well as creates conditions for development of the real estate market,
- is a basis for activation of the capital gained from real estates, including mortgage development.

In accordance with *Law on real estate management*, **cadastral values** shall be used to determine tax base of the real estate tax, as well as to determine value of real estates belonging to the Treasury or municipality or while performing official activities, for the performance of which the real estate value is indispensable. *The cadastral values, determined in a general property taxation process shall make allowance for differences between various real estates and proximity to market value, possible to achieve only upon application of the methods assumed for the mass valuation (art.162)*

The property valuation is significant in the case of real estate loans. The effects of the valuation determine the level of safe credit and, therefore, influence on risk borne by the borrower and lender. They imply necessity to determine value of a real estate used as collateral and determine so called **mortgage lending value**.

Mortgage lending value is used, above all, to determine safe amount of loan provided by a bank and the collateral that is mortgage for mortgage bank, established on the real estate being subject to perpetual usufruct or belonging to persons or bodies. The mortgage lending value is a value of a real estate being subject to mortgage securing loans, which can be refinanced from the funds obtained as a result of mortgage bonds issue. Therefore, category of mortgage lending value was introduced in Poland in the year 1997, by Law on mortgage bonds and land mortgage banks, according to the article 2 thereof the value is "determined, in accordance with provisions of the law, value that, according to land mortgage bank, reflects the level of risk relating to real estate being subject to loan collateral". According to paragraph 22 of Law, determination of mortgage lending value shall be conducted zealously and diligently, in



particular with consideration to these characteristics of the real estate and income related thereto, that, under the assumption of reasonable use, can be stable and that can be achieved by every owner of the real estate.

Mortgage lending value of a real estate is determined by the mortgage bank, on the basis of expert analysis. In accordance with *Law on mortgage bonds and mortgage banks*, mortgage lending value does not have to be determined by surveyors. The regulations of the law only recommend their service.

In the face of requirements to be met by the valuation of mortgage lending value, none of the methods mentioned in *Law on real estate management*, which was not approved by banks as sufficient, does not guarantee sufficient reliability, which is required in the case of mortgage bonds' issue. Therefore, additional regulations and procedures, favourable to reliability of the collateral valuation and accuracy of price estimation, are indispensable.

To standardize the principles and methodologies of valuation, European Mortgage Federation prepared conception of *European Mortgage Lending Value – EMLV*, based on the following principles :

- careful assessment of the prospective sale opportunities
- determination and elimination of speculative elements
- reflection of typical and local conditions on the market
- admission that long term aspects of the real estate keeping are of the first-rate importance
- consideration of current and alternative methods of the real estate use
- transparent and clearly specified methods of valuation
- valuation carried out by surveyors with proper qualifications that, on carrying out the valuation, apply special rules, specific for a country where the valuation takes place.

According to the recommendation of the National Bank of Poland, the mortgage lending value shall be determined „after conducting analysis of results obtained on use of income and cost approach (calculated separately). In the case of divergence between results obtained on the use of income and cost approach (replacement costs method), on determining the mortgage lending value the following results are of fundamental significance:

- result obtained through application of income-based approach for a real estate with economic destination (in this case result obtained through application of cost approach is usually of secondary, information significance),

- result obtained through application of cost approach for real estates with housing destinations (in this case result obtained through application of income-based approach is usually of secondary, information significance).

The mortgage lending value of a real estate shall not exceed its current open market value (transactional price) in the time of valuation or its credit allowance. On this basis it can be assumed that the term of the mortgage lending value refers, in some respect, to definition of the open market value, however, the idea of the mortgage lending value additionally takes into account what can be called as “smoothing” of the market prices trends, rents revenues and profitability indexes.

## **4.4. PROCEDURES OF REAL ESTATE VALUATION**

The procedures of the real estate valuation are based on law regulations and surveyors' standards. The real estate valuation is regulated by separate regulations stipulated in *Law on real estate management* of 21 August 1997 and Decree of the Ministry Council *on real estate valuation and preparation of appraisal report*. According to *Law on real estate management* (art.67), **the valuation of real estate belonging to the Treasury or municipality can only be carried out by surveyors.**

In Poland, there had been no precise regulations that would concern principles of valuation or status of surveyor, by the year 1997. The *Law on real estate management*, in force since 1 January 1998, set forth principles of occupational activity in this area. The status of surveyor has been subject to regulations through determination of:

- rights,
- duties,
- liabilities (including sanctions),
- principles of occupational activity insurance.

Regardless of law regulations, procedures and principles of real estate valuation are precisely specified in the occupational standards of real estate valuation. These standards have been developed on the basis of international standards, but, in the course of their evolution, national standards are also being gradually modified and prepared for publication, as well as general national principles of valuation. The latest form of occupational standards, is directed at resignation from their previous instructional form, which at the same time means increase in the liability of surveyors that conduct valuation. It is not enough to just comply formally with „operation manual”, that is, with what previous occupational standards used to be.

## **4.5. BASIC SOURCES ON INFORMATION IN REAL ESTATE VALUATION PROCESS**

The real estate valuation requires information and data on constructions being subjects to valuation. However, domestic system of information on real properties and their prices is far from perfection. It is some kind of heritage after the previous, non-market economic system, where real estate sales were, in the nature of things, highly limited. Currently the work is being done to put in order statistical and census systems. Despite the fact that in *Law on real estate management* a special chapter was devoted for official research of the real estate market (chapter 3), the system of collection of data on real properties is still in a phase of creation. Therefore sources of information are dispersed and their range and quality do not completely meet requirements of the valuation.

The basic sources of information on real properties are of official, legally regulated character. Such sources include: the Land and Mortgage Register or collections of documents for real estates with no Land and Mortgage Register, land and buildings registers, tables and appraisal maps, basic maps, geodesic register of land service infrastructures network, local plan of land development, public geodesic and cartographical stock, estimated rates of land and lists carried out by Tax Office. In the case of real estate valuation, additionally, the use is made of information on transactional prices achieved on local markets as well as of statistical data registers, including above all the Central Statistical Office of Poland. The significant sources of information are collections of unit

price indexes and specialized catalogues of material expenditures in the construction industry, technical and design documentation, collection of data belonging to insurance companies, banks, etc.

Local plans of land development have a significant influence on the real estate value and its changes. The base of local plan is to determine study of circumstances and directions of land development of the municipality. The local plan of land development is one of the main factors taken into consideration during the preparation of the appraisal report. The legal basis for the local plan of land development is Law of March 27, 2003, on land planning and development (Article 14): “ The difference in the real estate value before and after establishing such a plan is, so called, planning income that appears with the increase in the real estate value. Such an income is paid to the municipality by the owners (up to 30% of increase in value), if they decide to sell it in the period of 5 years upon plan establishment. However, if there is decrease in land value after plan establishment, the owner can claim compensation, equal to the amount of loss, from the municipality ”.

## **4.6. METHODS AND TECHNIQUES OF PROPERTY VALUATION**

### **4.6.1. GENERAL CHARACTERISTIC OF VALUATION METHODS AND EXTENT OF THEIR USE**

The real estate valuation is based on specification of **value of property rights or other rights to real estate , including right of perpetual usufruct**. The real estate valuation is carried out with consideration to its specificity, purposes and availability of the market data.

The approaches, methods and techniques used in the real estate valuation are specified in *Decree of the Ministry Council of November 27, 2002 on detailed principles of real estate valuation and principles and procedures of preparation of appraisal report*. In accordance with the regulations, in real estate valuation methodology (as distinct from company valuation), one can distinguish two

**approaches** that comprise proper **methods** that, in their turn, comprise **techniques of valuation** as detailed procedures used in property valuation.

**Table 4.1.**

Approaches, methods and techniques used for property valuation

<i>APPROACH</i>									
COMPARATIVE			INCOME-BASED		KOSZTOWE		MIESZANE		
<i>METHOD</i>									
Of in-pair comparison	Of average price correction	Of market statistical analysis	Investment	Of profits	Of replacement costs	Of substitution costs	Of liquidation costs	Of estimated land indexes	Residual
<i>TECHNIQUE</i>									
			1) Of simple capitalization	- detailed					
			2) Of discounting	- of self-contained elements					
				- index					

Source: Own preparation on the basis of Mączyńska E., et.al.: How much is your property worth?, Poltex, Warsaw, 2003.

#### 4.6.2. COMPARATIVE APPROACH (PRICE AND COMPARATIVE METHOD)

**The comparative approach** is applied in the **open market value** estimation. It is based on specification of real estate value, assuming that the value corresponds to prices achieved for similar real estates, subject to market sales. Such an achieved value needs to be corrected taking into account the characteristics that distinguish the real estates, as well as changes in price levels resulting from passage of time and period between valuations. While applying comparative approach, it is necessary to know transactional prices of real estates that can be compared to the real estate being subject to valuation, taking into

account such characteristics of the real estate that can have significant influence on its price level.

In the case of comparative approach, methods of in-pair comparison, average price correction or statistical analysis of market are applied. In the **method of in-pair comparison** the real estate, which is subject to valuation and the characteristics of which are known, is compared one by one with similar real estates. In the case of **method of average price correction**, similar real estates from the local market are accepted for comparisons, taking into account location of the real estate, in the number of at least dozen or so, which have been subject to market sales and transactional prices, terms of a deal and the characteristics of which are known. The value of real estates being subject to valuation is determined through the correction of average price of similar real estates - correcting factors taking into account differences in the particular characteristics of these real estates. On the other hand, in the **statistical analysis of the market**, set of transactional prices is assumed, to determine value of representative real estates, applying methods for statistical analysis.

#### **4.6.3. INCOME-BASED APPROACH (INVESTMENT METHOD, PROFIT METHOD)**

**The income-based approach** consists in the determination of the real estate value, assuming that its purchaser/buyer shall pay price, the amount of which will depend on the expected income that he/she hopes to obtain from the real estate in the future. This method is applied in the case of real estate that already generate or may generate income in the future. It is necessary to know the amount of obtained income or rent possible to obtain.

In the income-based approach **investment method** is applied, if real estate generates income from rents, and its amount can be determined through analysis of development of market lease and rental rents.

On the other hand, the **income-based method** is applied through determination of value of real estate generating income, but from sources different than rents. In this case, the income shall be determined in the amount equal to the share of real estate owner in profits, obtained from economic activity, in the course of the use of the real estate. In both methods techniques of simple capitalization and money stream discounting are applied.

While applying technique of simple capitalization, the real estate value is determined as the product of annual income and capitalization factor, indicating period of return on investment. The factor is one of the way of determination of the rate of return on investment in real estate and period of return on expenditures for purchase of real estate (return achieved by income generated by real estate). The amount of the capitalization factor is determined on the basis of real estate market research as mutual relation between transactional price paid for the real estate and annual income possible to obtain from this real estate.

**Capitalization factor** equals to the reverse of **capitalization rate**, that, in turn is, quotient of gross annual income and investment expenditure. For example, if annual income amounts to 1000 PLN and investment expenditure to 10 000 PLN, capitalization rate amounts to 10% (1000/10 000), whereas capitalization factor 10, which means that ROI amounts to 10 years.

The capitalization rate compared to income from a given investment (real estate) enables consideration of price claimed in the background of its open market value. Whether real estate price is overestimated or not, it depends on rate of income obtained from similar real estates on the same market that is on market rate of ROI. The important disadvantage of valuation method based on capitalization rate is that, as a rule, it appeals to operational gross income only for the first year (thus invariability of annual income is assumed), what is more, it does not take into consideration profit obtained from increase in property real estate.

The determination of the real estate value with the use of technique of **money stream discounting** consists in calculation of sum of discounted money streams of expected income from real estates in particular years of its use. The sum is increased by **residual (final) value** of the real estate, that is its value after the passage of last year of the forecast assumed for discounting of the money streams. **Discount rate** in these calculations shall reflect minimal, liminary required pay off rate from investment and reflect relation between yearly income obtained from the real estate and expenditures paid for its purchase<sup>16</sup>.

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<sup>16</sup> If there is increase in prices on the real estate market and, as a consequence, decrease in investment risk in this sectors, discount rate assumed in the real estate valuation is usually lower than discount rate assumed in the valuation of companies.

#### **4.6.4. COST APPROACH (METHOD OF REPLACEMENT COSTS, SUBSTITUTION COSTS)**

**Cost approach** is applied through determination of the replacement value. It consists in determination of the real estate value, under the assumption that such value corresponds to costs of its replacement, diminished by value of the real estate consumption. The cost of purchase of land and cost of replacement of its components (e.g. buildings) are determined separately. In the case of cost approach the **methods of replacement and substitution costs** are applied.

**The method of replacement costs** consists in determination how much it would cost to replace real estate components through application of the same technology that was used to its construction or coming into being. The method of substitution costs just enables determination how much it would cost to replace these real estate components with structures with the same function that is at present exercised by the structures being used, if they were made by use of currently applied technologies and materials.

In both methods **detailed technique, technique of self-contained elements and index technique** can be applied. The detailed technique consists in determination of type and extent of indispensable building works to be carried out and their respective unit prices. In the case of index technique the starting point consists in respective indicators for particular works or structures, made on the basis of comparison with other structures.

#### **4.6.5. MIXED APPROACH**

**In the mixed approach** the residual method, the method of liquidation costs or method of estimated land indexes are applied. **The residual method** is applied in the case when there are changes to be carried out in the real estate which is subject to valuation (development, extension, modernization). Then the value of the real estate after such changes is estimated, and from such an estimated value costs of changes are subtracted, with consideration to profit obtained by the investor.

If expenditures, indispensable to bring the real estate back to condition in which it can be subject to use, are higher than value of the real estate without necessity of such expenditures, **the value of the real estate can be negative.**



**The method of liquidation costs** consists in determination of the value of post-partition material, diminished by costs of structure demolition or its liquidation. The detailed techniques are applied.

**Method of estimated land indexes** applied to determine the value of the real estate designated, according to local plans, for agriculture purposes or used for such purposes. Then the real estate value is determined as a product of estimate rate of 1 ha of land and determined by separate regulations price of 1 diction (quintal that is 100 kg) of rye, specified in accordance with regulations on classes of quality classification land and on agricultural tax .

The choice of method and approach shall be adjusted to the type and function of the real estate, valuation purpose and data availability. The example is **value of perpetual usufruct of land**. The category is defined in the Civil Code (art. 231-244). The detailed principles of determination of value and fees relating to right of perpetual land usufruct are stipulated in *the Civil Code, Decree of the Ministry Council on detailed principles of property valuation*. It results from the regulations that only lands of the Treasury and lands belonging to municipalities or their associations, can be subject to perpetual usufruct, for in advance set forth period, that is 99 years, although it is admissible to shorten the period to 40 years (art 236 of the Civil Code). This right is paid, transferable and hereditary. In *Law on real estate management* the issues of fees resulting from **perpetual usufruct of land property being subject to perpetual usufruct** are treated separately. While determining open market value of land property as a subject to right of perpetual usufruct, the comparative approach is applied, assuming that transactional prices obtained by land, not built-up, real estate sale as a subject to the right of perpetual usufruct , with consideration to amount of percentage rates of annual fees and non-used period of duration of the right of perpetual usufruct.

If on the real estate market, proper due to location of the real estate , there are no sales of real estates being subject to the right of perpetual usufruct , but there have been sales of real estates subject to proprietary right, open market value is estimated on the basis of mutual relations of prices of real estates subjects to the right of perpetual usufruct and the prices of real estates subjects to proprietary right obtained on deals carried out on different, comparable real estate markets.

## **4.7. DOCUMENTATION OF VALUATION. APPRAISAL REPORT**

The basic form of documentation of valuation is an appraisal report, drawn up by surveyor, including characteristics of the procedures and basis of valuation, as well as its results. Such a report is an author's **opinion** of surveyor on the real estate value, prepared exclusively in writing. It shows, among others, legal basis and circumstances of taken actions, relating to appraisal of the real estate value, basis and justification of choice of the approach, methods and techniques of appraisal, as well as of others methodological solutions. Furthermore, the report includes performance of calculation course, as well as final result of valuation and its justification.

In the appraisal report, the way of determination of the real estate value is indicated, including: the determination of object, range and purpose of valuation, formal base of real estate valuation, as well as sources of information on the real estate, determination of dates significant for estimation of the real estate value, including date of its inspection. Furthermore, the appraisal report contains description of the condition of real estate and indication of its intended use, as well as real estate market analysis and characteristics regarding assumed purpose and way of valuation. The appraisal report include also special clauses that indicate particular circumstances regarding the real estate valuation.

To appraisal reports are attached significant documents used for its preparation, including transcript and sketch of local plan, and in the case of lack of such a plan, decision on the location of the structure, map with real estate register, extract from Land and Mortgage Register set up for the real estate. In the case of lack of such an extract, the certificate of a proper court shall be attached, confirming that the real estate does not have Land and Mortgage Register, etc.

The confirmation of relevance of the appraisal report by surveyor who prepared it, occurs through the clause attached to appraisal report, in which the surveyor declares report's relevance.

Regardless of the appraisal report, the surveyor can prepare studies, reports and expertises regarding:

- real estate market and consultancy on the real estate;
- effectiveness of investment in the real estate as well as its development

- financial effects of establishment or change in the local plan;
- designation of subject to separate real estates of premises
- mortgage lending value of the real estate
- appraisal of the real estate value, to meet needs of individual investor
- valuation of real estates classified as investments, in accordance with requirements of regulations on accountancy;
- valuation of real estates as fixed assets of the units, in accordance with requirements of regulations on accountancy.

## **4.8. VALUATION REPORT**

As it is contrary to the appraisal report, which refers only to the real estate valuation day, the valuation report also refers to valuation of investments and assessment of their effectiveness, companies and their real estates valuation, intangible assets, machines and equipment as well as other elements of a real estate (assets).

The content of valuation reports is determined by International Valuation Standards published by International Valuation Standards Committee -IVSC, as well as guidelines and standards of such organizations specializing in real estates and business valuations as: Appraisal Foundation, American Society of Appraisers - ASA and Institute of Business Appraisers - IBA. The Royal Institution of Chartered Surveyors - RICS and The European Group of Valuers Associations – TEGoVA. E.g. Standard No. 7 TEGoVA 2000 refers to the issues of value forecast. It is some kind of novum regarding ways of real estate value estimation - divergence from inflexible rule that market value or other shall be determined exclusively for a specific day. The standard regulates, among others, such issues as estimation of forecast real estate value, which requires:

- market trends analysis, as far as overall income, expenditures, index of non used premises, capitalization rate and discount rate in the valuation date are concerned
- economic trends analysis, which results in over viewing evolutions of demographic structures and socio- economic evolutions, employment indexes and future competition

- study of economic cycles as well as micro- and macroeconomic indexes.

The conclusions based on the analysis and **report** shall appeal to specified time frameworks, which the analysis refers to, with the purpose of the clear indication of market conditions and points of reference, for which the surveyor conducted valuation. They shall avoid speculative elements that influence on the increase in value change risk.

## **4.9. VALUE VERSUS PRICE OF REAL ESTATE**

Although the real estate value is basis and starting point for the determination of its transactional price, it does not mean that the transaction will be made at a price equal to value. The actual price can significantly differ, in plus or in minus, from the real estate value. It depends on different kinds of factors that characterize real estate market, including above all the degree of real estate market saturation (supply) and amount of demand, expressed by the number of prospective buyers.

**The property value is not any absolute.** The actual price, at which purchase and sale transaction of real estate will be made, is usually known neither to seller, nor to the buyer before conclusion of the transaction. In the course of negotiations which precede conclusion of the transaction, each party represents own valuation of the same real estate. Usually the valuations differ significantly because, as a rule, points of view and calculations of seller and a buyer are different. The calculations are subjective, however the market makes them objective. The final appraisal of real estate price takes place only in the moment concluding the purchase/ sale transaction.

The price (transactional) results from negotiations between the parties, that is from clashing of subjective valuations with objective factors of valuation. That is why one cannot identify the value of the real estate with its price. In this sense real estate valuation should be treated as **value estimation**. It is particularly significant as in *Law on real estate management* a number of aberrations from real estate value appraised by surveyor has been set forth.

While concluding transactions in non bid course (it refers to some kinds of real estates e.g. housing , historic or used for the public purposes), the authority, on behalf of the Treasury, municipality as well as public or communal body, in accordance with policy of property management, can provide the buyers with price discounts. In each case however, the real estates price shall remain in a specified relation to real estate value, as it is indispensable condition to control rationalization of public and communal real estates management.

## **4.10. NON-MARKET FACTORS INFLUENCING REAL ESTATE PRICE**

The estimation of open market value of real estate is based under assumption that contracting parties of purchase/sale transaction being independent from each other and not acting in compulsory situation. However, in practice there are situations in which such conditions are not met. In this case one has to do with situations different than assumed.

One of them is example of forced sale that is when bank sales mortgage charged real estate e, if the borrower is not able to pay off the credit.

This case is one of the most frequent; however, it is also possible to sale real estate by other lender with collateral, who does not have other possibility of getting the money back.

The other case is so called sale resulting from necessity. Analogically as forced purchase it means that normal market conditions are not met and there are time limitations or others for finalization of transaction, what mostly marginalizes or even excludes indispensable for rationalization of transaction prepared procedures (e.g. marketing procedures) and negotiating procedures, which leads to price deformation.

In such situations one of the contracting parties' loses, characteristically for market transaction, market sovereignty, whereas the other, stronger and privileged party takes advantage of position to impose price terms.

Such a loss of sovereignty can take place also in the situation of strong inequality between demand for properties and their supply.

The consequences of surplus of the demand in relation to the supply can be exemplified by the situation on the real estate market in Warsaw in the year 2006 and partly in the year 2007. The buyers of apartments decided to purchase, at a high price, proverbial "pig in a poke", that is, apartments that had not been built yet. What is more - even the preparation procedures, indispensable for realization of the investment (building licenses), had not been concluded.

Similar asymmetry of market position of the contracting parties may result from aggressive sale, supported with aggressive advertisement, what violates basic definition of market transaction.

# **CHAPTER 5**

## **OPERATING MANAGEMENT (T. BRACH)**

### **Abstract**

Chapter 5 describes main elements of operational real estate management, which include ways of drawing rents, the control of the building and premises, recovery proceedings and eviction, as well as supervision of the building.

## **5.1. PROCEDURE OF TAKING OVER MANAGEMENT OF REAL ESTATE**

The real estate owner, while transferring management of the real estate, shall have the possibility to estimate the value of the real estate, before and upon management termination. The property manager shall have clearly specified range of rights, assigned to him by the owner. The initial situation shall be assessed objectively and written down in the real estate management agreement to guarantee right real estate management.

The procedure of taking over the management of the real estate consists in the act of signing the real estate management agreement. However, it requires that some basic elements of taking over the management of the real estate are specified, that is:

1. drawing up an inventory sheet.
2. list of the owner's purpose.
3. estimation of the real estate value, conducted by surveyor.
4. manager's knowledge of the market.

5. approval of the action plan with consideration to manager's work schedule.
6. real estate management agreement formally drawn up.

Ad.1. The inventory sheet is a technical action, however, it enables direct familiarization with the real estate, assessment of its technical condition and is a basis for the action plan and work schedule.

Ad.2. Unequivocally specified and reduced to writing owner's purpose is a basis for the budget estimation and possibility of carrying out e.g. marketing action. The purpose, specified by the owner, directs all actions of the manager, as well as selection of methods for its achievement. The purpose can be profit maximization, which can lead to rent of the whole building, e.g. office building, or to its sale. The purpose can be either long-term or short-term, however, to be achieved, the manager adapts their way of acting.

Ad.3. The appraisal report - the value of the real estate before the take over shall be appraised by surveyor. The next appraisal shall be made upon termination of the management agreement. Then it will be known whether the management was exercised properly and whether the manager, by means of their actions, contributed to increase in the value of real estate or structure. One shall remember that the appraisal before and upon the management should be conducted with the same method.

Ad.4. The knowledge of the real estate market. Analysis made by the manager, especially SWAT analysis that is strengths and weaknesses, opportunities and threats, relating to real estate, prove manager's knowledge of the market. Even the least real estate is placed within a given territory. The territory, known as local real estate market, is subject to different factors, that in- or directly influence a given real estate; on its attractiveness and, therefore, on its value. The knowledge of the market also enables the manager to create other possibilities of real estate development and to meet the owner's expectations e.g. by investments, modernizations, etc.

Ad.5. The action plan and the management agreement are two documents very coherent with each other. The action plan, divided into technical work schedule, inspections and conservations, as well as a plan of marketing action, should be attached to the real estate management agreement.

It is a very significant element while taking over the management of the real estate, as the activity carried out in accordance with a plan that is with the schedules will generate expenditure that must be taken into consideration in the



cash flow. Properly drawn up contract protects both the real estate owner and its manager. Such contract shall provide for: Time- that is how long the management will endure. Owner's purpose to be achieved during the validity of the contract. Proper delegations for the manager – the possibility and limits of decision making. Work schedule as well as remuneration for performed work.

There are several forms of the manager's remuneration. The first one is lump sum remuneration in which the contracting parties agree to constant remuneration. The second form is commission, dependent on the income. The third and most popular one is mixed remuneration. It consists of the basic wages – lump sum plus the mobile part – commission, dependent on the result. The insurance policy of manager shall be attached to every management agreement. Recently there has been a custom to attach also two other documents; the ethical code of real estate managers and working standards.

## **5.2. ORDER REGULATIONS IN USE OF REAL ESTATE**

The organizational regulations are a basic document that regulates organizational order in the building. It is part and parcel of the tenancy agreement. Both documents determine reciprocal rights and duties of the tenant and landlord. They determine safety rules, accessibility rules and reciprocal relations between the tenants.

Organizational regulations can be divided into following sections:

- Rules of operation of the building and its protection.
- Duties of the manager and the user
- Rules of keys' storage and hand - over
- Rules of garage use.
- Rules of hand-over of correspondence.

Each of these divisions contains necessary information regarding each issue, so that the users of the structure could move within in a free and safe way.

The regulation also takes into account the image of the building and ways of advertising of particular tenants. Above all, however, it indicates the manager and their function to be executed within a given real estate.

The legibility of functions and their accessibility by the building users influence significantly on the management efficiency. The basic functions determined in the regulation are: technical function, administrative function, function of security and information, function of maintenance of cleanness, which cover basic divisions of the organizational regulations.

The basic rules of operation of the building and its protection contain division into accessibility zones:

1. with general access, including: hall, restaurant, passageways and
2. zone for tenants only - office space and garage.

The present rule differentiates accessibility of flow of people, with limitation per hour. The only aim of the hourly limited accessibility is to protect real estate and order in the office space, as well as providing information on persons present in given places, which will be useful e.g. by fire evacuation.

The basic duties of the manager consist in ensuring efficient operation and proper use of the structure. Stress should be put on his/her responsibility for security of the structure and - as a result – for safety of people present in the structure and the property gathered there.

Moreover, the manager is responsible for the proper service of the reception office, as well as for ensuring order both inside and around the building.

The duties of the user contain, above all, complying with enforceable (accepted) regulations, proper use of the building equipment and appliances. The other duties embrace reporting on every faults and maintenance of order in the zone directly used by the tenant.

The rules of keys' storage and hand-over and the rules of hand-over of correspondence, set forth in the organizational regulations, significantly facilitate work of both user and tenant. What is more, they prevent third or unauthorized persons from entering into premises occupied only by the tenants. The leaving and receiving of correspondence has the same purpose.

The last section contains the rules of the garage use. The authorization of the garage use is a pass given to particular tenants, dependent upon subscriptions and number of places resulting from the tenancy agreement. Usually the tenant

appoints an employee, co-operator or guest to make use of the pass, although sometimes it may require joint decision making. A determined garage place is allocated to each pass. The administration of the building watches over so that the cars would park in determined places. Parking in different places may cause disorder and arguments between tenants or between tenant and the manager, so it is forbidden and may result in tenant's losing the pass.

Each section regulates specified reactions of users, tenants and managers of the buildings. However, only the whole of the regulations enables right relations between the parties.

## **ORGANIZATIONAL REGULATIONS**

**(example)**

Table of contents:

- 1) General provisions
- 2) The rules of operation of the building and its protection.
  - General rules
  - Real estate protection
  - Fire protection
- 3) The duties of the Manager
- 4) The duties of the User
- 5) The rules of keys' storage and hand-over
- 6) The rules of garage use
- 7) The rules of hand-over of correspondence

### **General provisions**

1. The present regulations is enforceable for all employees of Users (Tenants) having their registered offices in the building at. .... Street, Warsaw. It constitutes an integral part of the tenancy agreement signed with each User.
2. Having its registered office on the ..... floor in the room no..... (hereinafter called "Manager") exercises the management of the building and control over execution of the provisions resulting from the regulations.

3. Within the terrain of the building Manager exercises his/her through the following services:
- technical,
  - administrative,
  - of protection and information,
  - of maintenance of cleanness.

### **The rules of operation of the building and its protection**

#### General rules

- In the building, allowed for users and customers, there are following zones:
  - zone of general access (main hall, restaurant, escape routes),
  - office space ( from 0 to +9 floor),
  - garage ( from -1 to -2,5 floor),
- It is forbidden to smoke in the building.
- To protect property and order in the office space, there are two valid periods of differing flow of people.
  - Flow related to work, between 7.00 a.m. and 20.00 p.m. during all working days,
  - limited flow, between 20.00 p.m. and 7.00 a.m. during all working days and 24 hours a day on holidays
- While entering the building in the working time, employees of the Users shall present access cards (drawn up by the Manager on the basis of list of names of company workers prepared by the Users).
- The clients of the User can enter office space after receiving, in the reception office, telephone entry permission from the User.
- So that the employees and clients can be in the building beyond the working time (that is in the time of limited flow) it is required that User's Management informs the Manager or security and information service about this fact earlier and in writing ( it does not refer to the staff employed beyond the working time).

### **The duties of the Manager**

The duty of the Manager is to ensure efficient operations and use of the structure and, in particular:

- To ensure efficient operation of the technical appliances and amenities like fire protection system, as well as efficient placement of fire protection equipment and its periodic inspections.

- To set and sign evacuation routes and to prepare building evacuation plan.
- To ensure all day reception desk service and building protection
- To maintain general access rooms and space around the building in a clean and order condition.
- To draw up for all the employees of ..... on the basis of lists made by the Users) :
  - access cards,
  - garage entrance passes (for garage users in accordance with tenancy agreement)
  - receipts allowing to receive keys.
- To make the building available for work for Users and their clients during the working time, that is during all working days from 7 till 20 7.00 – 20.00 and on holidays for authorized Users (in accordance with the paragraph .II, subparagraph 1.4, 1.6, 1.7).
- To make the rooms available for cleaning services.

### **The duties of the User**

1. The duty of the User is to obey order regulations provided for in the regulations, proper use of technical appliances, own property protection and, in particular:
  - To hand over lists of names of employees to the Manager, with the aim of drawing up access cards, as well as to hand over lists of persons authorized to receive keys and use garage.
  - To restore access cards of the dismissed employees to the Manager ;
  - To equip all the employees with company identity cards including company's name, name, surname and employee's photography;
  - To use all the appliances in the building..... in accordance with their designated use;
  - To maintain order and cleanness in occupied premises;
  - To inform the Manager immediately on breakdowns and defects, which could threaten security or cause material loss. The reports shall be submitted to the Technical Service (telephone number.....) or to the reception desk (telephone number ...).
2. The duties of the User upon work termination:
  - To turn off the light in rooms and corridors and to switch off electric energy receivers, unless they require constant power supply.
  - To check closings of the water consumption points.

- To lock the occupied rooms with key.
3. It is forbidden for the Users:
- To carry out, without Manager's permission, any repairs relating to air conditioning, with the exception for the regulation of temperature in the building and technical installations
  - To regulate without permission sanitary and air-conditioning appliances, with the exception for the regulation of temperature in the office space.
  - To unbolt and dismantle electric devices (sockets, switches, mounting), as well as to use additional electric heaters;
  - To block slotted window- stool openings, ventilators and cover ventilation exhaust openings
  - To open windows when air-conditioning is switched on.
  - To block evacuation routes, corridors, halls and staircases with objects;
  - To enter into technical premises

### **The rules of keys' storage and hand-over**

The exclusive duties of the Manager include administration of keys for rooms in the building, installing additional locks and making new keys (with the exception for banks, which may assemble additional security devices, in arrangement with the Manager).

The User receives a set of keys to his rooms from the Manager and is responsible for them until leaving premises, by keeping them properly protected in the secretary's office of the User's company.

In the case of losing keys, the User shall inform the Manager and security and information services about the fact immediately and in writing, The Manager, upon User's order, shall make new keys or change key inserts.

It is possible to assemble additional locks, at the expense of the User, upon condition of written arrangement with the Manager regarding the security method for access to keys, in the case of breakdown or fire (it refers to a bank). The User is obliged to submit to the Manager or the head of security and information service written list of persons authorized to receive and return keys in the reception desk.

The Manager shall draw up, on the basis of received lists, receipts authorizing receiving keys from the secretary's office of the User's company (the receipt

will be kept in the reception desk on receiving keys and given back on their returning).

### **The rules of garage use**

1. A pass drawn up by the Manager, on the basis of garage tenancy agreement, authorizes use of appointed garage place. The duties of the garage user are to:
  - show the pass on entering and exiting the parking
  - observe traffic signs, indicated route directions, and switch on passing lights while driving
  - park the car forward facing the wall
  - guard damaged car (broken window, locks, doors, etc.) before leaving it in garage place
  - maintain cleanness in the appointed garage place, protect the car against oil and petrol leakage
  - comply with garage use recommendations.
2. In the garage it is forbidden to:
  - store engine fuels and lubricants, as well as other inflammable and vehicle refuelling materials.
  - repair car and wash its body and engine
  - keep the engine working while parking
  - park the car in a reverse way

## **5.3. WAYS OF DRAWING RENTS**

The rent is a commitment, resulting from the arrangement concerning payment for the used space of the real estate, between the parties, where one party is a landlord and the other one is a tenant. The tenant pays the rent resulting from the tenancy agreement. All the elements of the rent, terms of payment, ways of warranty of the contract provisions shall be laid down in the tenancy agreement.

The elements of the rent are: basic rent, operating costs, additional elements resulting from the contract, such as costs of parking or advertising.

Concerning the influence of time on the rent, the following types of rent can be distinguished:

- constant rent
- variable rent

The constant rent in the period laid down in the contract is fixed, while variable rent requires a method of its alteration. That is why one can distinguish:

- rolling rent
- indexed rent
- percentage rent

Constant rent (fixed in a given period of time) refers mainly to the basic rent, which, often referred to in contracts as net rent, does not include operating costs incurred by the owner. If they are included in the basic rent, it is often referred to as a gross rent. In practice there is a term "mixed rent", which means that only a part of operating costs is included in the net rent rate (basic rent rate).

The variable rent is deemed to mean basic rent rate with additional scalar, mainly referring to observed and assumed inflation.

In the case of the rolling rent, it changes in the same rate e.g. 2% per quarter.

The indexed rent is deemed to mean rent calculated with the use of indexes, e.g. inflation index, provided by the Central Statistical Office, however, monthly indexing is practically out of use. The most popular indexation is per quarter, half a year and even per annum. It results from economic stabilization and, connected with it, price stabilization.

The percentage rent is a rent resulting from summation of the basic rent composed of basic threshold and a percentage of turnover performed by the tenant in the hired commercial premises. This type of rent is the most frequent in shopping centres or restaurants. It guarantees the owner to receive rent rate which would meet their minimal economic satisfaction and let them make use of additional surplus generated by the tenant, in the case of the tenant generating high turnover, resulting e.g. from a favourable location of the real estate.

Example:

Basic rent	120 000,-
Rent rate	4%
Annual turnover	3 500 000,-



Basic threshold  $120\,000 : 0,04 = 3\,000\,000$

Annual rent equals:

Annual turnover – basic threshold x rate % o rent + basic rent

$(3\,500\,000,00 - 3\,000\,000,00) \times 0,04 + 120\,000,- = 140\,000,-$

There are two methods of calculating the amount of the basic rent. The first one is the method of income capitalization. It consists of arithmetic rent rate evaluation with reference to one square meter of commercial premises, taking into account construction costs, assumed capitalization rate, operating costs.

Example:

real estate with usable floor space of	10 000m <sup>2</sup>
costs of building's construction (investment cost)	1 500 000 PLN
annual operating costs	125 000 PLN
vacancy (on the average)	6 %
capitalization rate	10 %

- Annual repayment of investment costs  $1.500\,000\text{ PLN} \times 0,10 = 150.000\text{ PLN}$
- Annual total costs  $150\,000 + 125\,000 = 275\,000,00$
- Income indispensable for costs covering, making allowance for vacancy
- $275\,000\text{zł} \times 0,94 = 258\,500,00$
- basic rent rate  $258\,500 : 10\,000\text{ meters} = \mathbf{25,85\text{ PLN/1m}^2}$

The second method is a market method which consists of price determined by the relation of the demand to the supply on the local market. However, also in the case of this method, the basis of the calculation carried out by the owner consists of reasoning presented in the example above. Market situation can, however, ensure greater income or lead to changes in the calculation, e.g. by the change in the capitalization rate

This attitude explains why operating costs usually convey a separate part of the rent. If, in the case of basic rate, the owner achieves satisfactory income, operating costs are to be covered by the tenants. To notice distinct results, rates are often divided. Receiving repayment for the operating costs may be carried out in advance and then accounted in an annual cycle. The repayment may be also carried out in lump sum and accounted precisely in the determined intervals of time.

Apart from basic rent and operating costs, there are other additional elements of the rent, such as payments resulting from parking use, or payments for placed advertisements.

While fixing the rent payments, one shall lay down terms of payment and consequences resulting from their disregarding. The rule is that rent charges are paid by the tenant in advance, which means in the beginning of the tenancy period. It may occur that the rent is paid upon the termination of the tenancy period or in the mixed way, where basic rent is paid in the beginning and operating costs upon termination of the tenancy period.

The last question to be discussed, as far as rent drawing is concerned, is the way of warranty of payment - deposit. The amount of deposit usually depends on length of the tenancy agreement notice. The situations in which deposit will serve as payment shall be precisely laid down.

## **5.4. CONTROL OF BUILDING AND PREMISES**

The basic document regulating the duty of building control and storage of technical documentation is Building Law and Decree of the Minister of Infrastructure of 3 July, 2003 on the building structure record book<sup>17</sup> Quoted below articles no. 61 and 62 refer in particular to control types and their frequency .

According to the Article no. 61 “The owner or building manager shall use the building in accordance with its designated use and environmental protection requirements, as well as keep it in a proper technical and aesthetic condition.” In other words, the article assigns the responsibility for the technical condition of the building to its owner or contracted manager. It means that, in case of renting a part of the premises, the owner or the manager shall be responsible for the premises so they may control its technical condition and the way of its use by the tenants.

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<sup>17</sup>Journal of Laws, no. 120, position 1134

Whereas according to the article no. 62, "Building structures, during use, shall be subject to:

- 1) **periodic control, at least once a year**, based on checking the technical efficiency state of:
  - a) building elements, edifices and amenities prompt to detrimental impacts of the atmosphere, and devastating actions of factors appearing during use of the structure.
  - b) installations of environmental protection
  - c) gas installations and chimney wiring (smoke, emission and ventilation),
- 2) **periodic control, at least once per 5 years**, that is based on checking the technical efficiency state and usability of the whole of building structures, building aesthetics and its surroundings; the control shall include checking of the electrical system and lightning arrester system regarding connection efficiency, fittings, protection and protective from electric shocks, resistance of the wiring isolation and earthing of the installations and apparatus.

Carried out by the owner or building manager".

The above mentioned duty does not refer to building owners and managers of the individual family housing, farmstead and summer cottages.

The controls, referred to in the article no. 1, shall be carried out by the proper authorities. (For instance – the control of the technical state of electrical system, lightning conductor system, gas installations, shall be carried out by the persons with qualifications required for exercising control or , in the case of services of repairs, conservation of the proper energetic or gas devices, specified in particular regulations.

All the technical events, including controls referred to, which have occurred since the construction of the building, shall be registered in the structure record book. The purpose of the record book is to register all the technical events occurred during the life cycle of the structure that is since its construction till its demolition. Some managers call it "medical record book of the building". The terms of future controls and reviews result from the record book. The record book contains recordings made by officers and experts, authorized to exercise control.

The controls of the buildings and premises, which the owner or manager are obliged to, shall be reflected in their further activity that is they shall be properly transferred to:

- tenancy agreement
- management agreement

In every tenancy agreement the owner or manager on behalf of the owner, while commission of the part or of the whole of the building, reserves the right of exercising controls, assigned them directly in the Building Law. They must have the possibility of statement, whether given premises are used properly and in accordance with the contract.

The manager, while assuming the management of the real estate, assumes an obligation of the proper use of the entrusted real estate, in accordance with valid regulations. The controls' extension and their frequency shall be set forth in the contract. In this way duties of the owner are delegated to the manager, within the range relating to the managed area or premises.

## **5.5. RECOVERY PROCEEDINGS AND EVICTON**

Eviction and recovery proceedings result from disregarding of the contract drawn up between the landlord and the tenant. The eviction is the last stage of the long and strenuous process.

While signing tenancy agreement, tenant usually pays security deposit. The aim of the security deposit is either to secure prospective demands of the landlord, resulting from damaging the elements of rented premises, or to cover unpaid rent (seldom). Sometimes the amount of security deposit is calculated by taking into account both types of losses mentioned above.

If the tenant does not comply with the terms laid down in the contract, nor covers costs of the damages, nor pays the rent, disturbs other tenants or neighbours or their activity differs from the one laid down in the contract, then,

first of all, they shall be called (by means of a written notice) to obey the terms of the signed contract.

If the tenant does not comply with the appeal, the landlord can satisfy their demands from the security deposit. Then the landlord shall proceed with the legal action against the tenant.

When the lawful judgment is favourable for the landlord, the case is handed over to the bailiff that, executing the judgment, proceeds to debt recovery, and, if it is not sufficient, to the eventual variant – eviction.

In the practice, these processes are very long, always with negative impact on the landlord. It is the landlord that loses, as they cannot rent the premises. In the case of insolvency of the debtor (tenant) the situation is even worse, as assignee in bankruptcy satisfies the liabilities of the landlord in the fifth or sixth turn. The bankrupt's estate is assigned in the first turn to satisfy claims of the employees, the Treasury, Social Security Service and Tax Office.

## **5.6. SUPERVISION OF BUILDING**

The supervision of the building is one of the basic functions not only of the owner or manager, but also of all the services operating within the given building. The supervision scale differs in relation with the type of the building. In little buildings it is limited to installing interphones (videophones) and is based on the mutual acquaintance of all inhabitants. In more complicated buildings, such as hotels, office buildings or magazines, the control is exercised by technical services, through technical supervision, particularly through cameras and different types of sensors (e.g. fire sensors). The services, using special computer systems, keep on supervising all the technical devices working in the building. The safety of all the persons present in the building depends on efficient operation of the techniques as well as on the services. The electronic devices, being elements of the systems, control lifts, flow rate of air in the building and temperature or fire system.

The security exercises control over the building physically and technically. They supervise it physically by restricting its accessibility, registering all the

persons coming in and out. The system of industrial cameras is a TV register of the events, which may be used as documentation in the case of disputes solving. Controls, resulting from the Building Law and signed contracts, are another form of building supervision. The controls make the manager act properly, which contributes to the security. Another form of exercising control over all users of the building is to comply with provisions of the tenancy agreement and organizational regulations.

The insurance is worth mentioning, as it is a way of protecting the owner from unexpected events and situations. It is an insurance company that, by stipulating conditions, makes the owner manage the building properly.

## **CHAPTER 6**

### **GENERAL CHARACTERISTIC OF TREATMENTS CONSERVING TECHNICAL AND OPERATING EFFICIENCY OF REAL ESTATES (G. KUBIK)**

#### **Abstract**

Chapter 6 presents types and characteristic of the routine processes, actions and conservation treatments relating to the usual property use, also documentation and procedures of the use, planning and realization of current repairs and overhauls. Modernizations, reconstructions, rebuilding issues are also described by the author.

#### **6.1. TYPES AND CHARACTERISTIC OF ROUTINE PROCESSES, ACTIONS AND CONSERVATION TREATMENTS RELATING TO USUAL USE; DOCUMENTATION AND PROCEDURES OF USE**

One of the elements of proper real estate management is to maintain it in the non-deteriorated condition, in accordance with its designated use. The

maintenance of the building or the edifice in the proper condition consists, above all, in keeping technical efficiency of particular elements, providing them, as well as adjusting to the way of use of a given real estate.

According to British Standards Institute, Glossary of Management Terms of Technology (HMSO, London 1984) real estate maintenance is defined as “consolidation of all the technical actions or related administrative actions with the aim to maintaining the object or renewing its condition so as it can perform required functions.”<sup>18</sup>

The conducted works shall not only ensure further building use but also enable the use in a different, desirable way. The proper realization of this process calls for the proper preparations. First of all, one must indicate and separate elements requiring “intervention”, that is actions improving technical efficiency of a given real estate. Having specified what and in which way was damaged, one shall determine the costs incurred while damage is being repairs, so as to be able to get down to repairs, after optimization of the financial expenditures.

One shall remember that civil structure is a complicated construction, in which various functions are executed. The separation and repair of one element must make allowance for its situating within the whole system of operation of the real estate. These elements cause that technical maintenance of the real estate, amounts of work and costs in the following periods are different for particular structures.

The requirement of keeping the real estate in non-deteriorated condition, ensuring, at the same time, the possibility of execution of its functions, that is, in accordance with its designated use, as well as adjusting it to requirements of the environmental protection, is met on conducting of the building conservations, as well as current repairs and renovations. One of the elements constituting these actions is the technical service of all the amenities, systems and devices installed in the real estate.

The regulations of the Building Law impose on the real estate owners and managers many specified duties, relating to periodic inspections and controls of specified parts of the building.

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<sup>18</sup> Śliwiński A., Śliwiński B.: Facility management, C.H.Beck Publishers, Warsaw, 2006.



According to the article no. 62 of *the Building Law*, civil structure, in the course of use shall be object to periodic control, the time of duration of which shall depend on the role of a particular element within the building.

The elements of the structure and amenities, being in danger of detrimental atmospheric effects and devastating actions of factors occurring in the course of use, shall be subjects to annual control. The amenities and devices that influence on the environmental protection (e.g. all types of filters), shall also be subject to annual control (gas systems and chimney conductors of all kinds (ventilation, smoke, emission)).

The other parts of the building, such as elevations or electrical and lightning conductor systems, are subject to periodic control that shall be carried out every 5 years. The technical efficiency, safety of use and protection from electric shocks or conductor resistance shall be tested in the course of such controls. It is recommended that periodic controls be conducted during Spring time by persons with building authorizations, whereas the control of technical condition of electrical, lightning conductor or gas systems be carried out by persons with qualifications required for control over use of these devices. The article 62 of the Building Law specifies formal requirements in relation to the inspectors.

The reports shall be made as a result of the conducted controls. While getting down to the following control the inspector conducting periodic control shall, before its beginning, become familiar with reports resulting from previous controls and check whether the post-control settlements have been implemented.

The information content of the reports, resulting from periodic controls, is stipulated in the decree of the Minister of Home Affairs and Administration of 19 August, 1999, on technical conditions of the use of housing buildings. The report shall include:

- specification of technical condition of building elements;
- extent of consumption or damage of building elements;
- range of recommended repair work;
- order of repair to be carried out ;
- methods and means of use of elements of the building (in particular of those in danger of detrimental actions resulting from atmospheric effects);
- list of repair works recommended to be carried out in previous reports, yet t hat has not been implemented.

If necessary, graphic documentation can be attached to the report.

In the course of the control, technical condition of the following elements shall be subject to particular attention:

- external surfaces of external dams – surface;
- external walls including pillars, attics, cornices, balustrades and balconies;
- elements and devices attached to walls and roofs of the building;
- dehydration of the building (gutters and down pipes) as well as flashings (roof works);
- roofing's;
- central heating system and hot water system;
- fire protection of the building;
- sewerage system with elements carrying sewage off the building;
- transition of terminal systems through the building walls.

In the course of control special attention shall be paid to the condition of technical efficiency and operating value of the examined elements of the building. The control shall also refer to overall aesthetics of the structure and its surroundings.

The real estate owner or manager are obliged to store all the documents relating to the civil structure (projects, technical documentation regarding construction work), as well as all the reports during the period of existence of the structure. The owner or the manager is obliged to make the documents available to authorities any time, so that they can carry out control of civil structures.

The requirement is stipulated in the Building Law, according to the article 64 thereof,“ the property owner or managers are obliged to run for every building... (...) civil structure's record book, which is a document, destined for appointments relating to examinations carried out and controls over technical condition, repairs and rebuilding in the course of the use of the civil structure Exempted from this duty are the owners and managers of:

- detached houses;
- summer cottages;
- industrial buildings relating to agriculture.

All other documents relating to use and use of the building shall be attached to the record book of the civil structure. These are, above all, all types of service and exploitation manuals of the devices installed in the real estate It is a good

custom to attach "house regulations" as a document regulating the use of the real estate by its inhabitants.

## **6.2. PLANNING AND REALIZATION OF CURRENT REPAIRS, EXTENT, PROCEDURES, IMPLEMENTATION**

The current management of the real estate, known as operating management, is, besides financial management (taxes, rents, rent policy) and space management, technique management, as well as conservation management and technical maintenance of space.

Operating management is based on annual material plan, which takes into consideration required repair work, as well as expenditures securing execution of these actions. Usually the document completing such material plan is a schedule of task execution, which is in-time setting of actions.

The planning of actions can be made in form of economic and financial plans. Such plans are prepared by the property manager and accepted (approved) by the owner. The plans indicate repair requirements, conservation works, financial scale, material extent, time of duration, etc. The conservation works are based on maintenance of all elements of the building in current technical efficiency. After a while such works are not sufficient to prevent from consumption and it is required to carry out an overhaul.

The basic aim of building repairs is to maintain security of the real estate and ensure stable use of the building, in accordance with its destination.

The repairs in building engineering are divided, with regard to the extent of carried out works, into:

- Current repairs;
- Emergency repairs;
- Overhauls.

The current repairs consist in carrying out conservation and preventive works of the building and their necessity results from both periodic controls and current monitoring of the technical condition of the building. The repairs carried out while current repairs include above all elimination of the prospective damages of elements of the building and devices installed in the structure.

The property manager shall be up-to-date with inspections over substance entrusted to them, to the information on these inspections data from periodic controls are enclosed and, on the basis on that, a plan of repair works shall be prepared. The most important works to be carried out are relating to:

- securing safety of the users of premises and third parties;
- fire protection of the building;
- complying with requirements of the environmental protection;
- Preventive actions.

As all the actions undertaken by the property manager shall take into consideration the safety of the persons making use of the property, special attention shall be paid to the current use and control all of the amenities which the real estate is equipped with.

The ventilation system and necessary devices enable air exchange in the premises. There are two types of ventilation system: gravitational and mechanical. In both cases current repairs consist of ensuring tightness of ventilation lines, and in the case of mechanical system, providing technical efficiency of ventilators. .

The combustion ducts and flues ensure disposal of combustion gases and smoke. In this case, tightness is examined as well, however, repairs of the building can be carried out only by persons with suitable authorizations, that is, in accordance with the Building Law, by persons with foreman qualifications in chimney craft or with suitable building qualifications.

The hot water system ensures supply of water with given temperature to the dredging points. The tightness of the system is examined and, in the case of system being equipped with water meters, they also shall be subject to periodic control. The water supply system shall be subject to similar requirements.

The sewerage system enables sewage disposal. While exploiting sewerage system, special attention shall be paid to protecting the system from introducing sewage that can damage the system, as far as damages are concerned, they may be both mechanical and chemical. The quality of sewage

being drained is specified in detailed regulations. The tightness of the system is subject to control.

The gas system is one of the most important parts of the security of use of the building. Due to huge threat that can arise with the damage or failure of the system, controls of the system and devices relating to the gas system shall be conducted in accordance with recommendations stipulated in the regulations. Besides the requirement of periodic controls, in the case of system reconstruction, repair or excluding from use for more than 6 months, major test of tightness shall be carried out before the system is put into use again. Such a test shall be carried out in a strictly specified way, stipulated in the Decree of the Minister of Home Affairs and Administration dating for 16 August 1999 on technical conditions of the use of the buildings, where it stands that "(...) major test of tightness shall be carried out separately for part of the system with gas meters and for the remaining system omitting gas meters" and "on the system without corrosion protection, after its cleanness, blanking off endings, opening taps and gas disconnecting. The requirements for devices with the use of which the major test shall be carried out, have also been stipulated. Manometers used for carrying out of the major test shall comply with requirements of the class 0,6 and have legalization certificate. They must be appropriately scaled and indicate specified quantities on conducting the test (paragraph 44, subparagraphs 4-7 of the referred to Decree).

The systems, which are also subject to control and conservation actions, are electric systems and devices, as well as lightning conductor systems.

As far as electric systems are concerned, special attention shall be paid to security of their use, ensuring technical efficiency, appropriate operation of connections, fittings, protection from electric shocks and eventually earthing and resistance of the insulation of lines.

## **Overhauls**

An overhaul is an action consisting in exchange and repair of all used, destroyed or damaged elements of building and devices. They are carried out with the aim of restoring of the primary value to the structure.

The scientific research made it possible to specify and estimate life period for particular components of the building<sup>19</sup>, so some of them amount for:

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<sup>19</sup> Adamiec T. and Mirski J. Z.: The maintenance of the building resources. WSiP, Warsaw, 1999

walls of prefabricated stratified or Ferro concrete units	circa 100 years
Klein's ceilings	100 – 130 years
Ferro concrete staircases	120 – 150 years
oak stave floor	50 – 80 years
facade plaster works, simple, cement- calcareous	30 – 40 years
roofs of wooden construction	50 – 75 years
roofs of steel construction	100 – 150 years
roofing of black pate	20 – 30 years
roofing paper	10 – 20 years
roofing-tile	20 – 60 years
water supply, water sewerage and gas pipes	25 – 50 years
central heating pipes	20 – 45 years
electrical system pipes	30 – 40 years

with the course of time, each gets used up, what results in decrease in the use value and value of the structure

**Table 6.1. Phases of technical condition for particular elements of the building.**

Elements of building	Element consumption process			
	Satisfactory condition	Unsatisfactory condition	Bad condition	Totally bad condition
Gas systems	0 - 10	11 - 15	16 - 20	≥ 21
Electric systems	0 - 10	11 - 15	16 - 20	≥ 21
Water supply systems, water sewerage systems, central heating systems	0 - 10	11 - 20	21 - 30	≥ 31
Structural component	0 - 20	21 - 35	36 - 50	≥ 51
Finishing components	0 - 25	26 - 40	41 - 60	≥ 61

Source: Own preparation on the basis of Adamiec T., Mirski J.Z.: The maintenance of the building resources. WSiP, Warsaw, 1999.

While carrying out conservation works, current repairs and overhauls specified costs are generated. The structure of costs of building repairs changes in the course of time of its use. In this way, while constructing the civil structure, building works amount to 60% of costs incurred, while costs of installing and

finishing works- 40%. After 60 years of use of the structure this proportion gets reversed and costs incurred during installing and finishing repairs are significantly higher.

The time required for carrying out repair depends mainly on materials used. In this case, the ruling principle is that the better quality of the material used for construction of the particular building element, the lower and more efficient the costs incurred in conservation are, although the initial costs are higher.

While discussing the issue of overhauls, one cannot omit issues regarding maintenance of basic structural components, like steel and Ferro concrete components. In the constructions one can indicate so called "weak points", as follows:

- connections junctions;
- connectors;
- bearings;
- articulations;
- dilatation devices.

As a result of the effect of atmosphere, vibrations and other influences, they can be subject to corrosion, fractures or slackening of connections what may threaten security of the use of the building.

### **6.3. MODERNIZATIONS, RECONSTRUCTIONS, REBUILDING, GENERAL CHARACTERISTICS, DECISION MAKING CRITERIA**

During the use of the building occurs its moral consumption and of its elements, that is intangible value of the structure decreases because of the increase of the users' requirements. As well as different possibilities of implementation of the technical solutions that enable meeting of the increasing demands of people, by means of the latest technical solutions.

The works relating to modernization, improvement or keeping the structures up-to-date are modernizing actions. They include also rising of the aesthetic considerations, enriching architecture of the building that, designed according to the obligatory patterns after some time, may not comply with the latest trends or tastes. Such treatments often raise prestige of the building users or owners.

An example that illustrates the necessity of carrying out modernization is the condition of housing resources in Poland. Many flats still lack of water supply systems or sewerage systems. To raise the standard of these flats one shall equip them with technical systems and devices such as: water pipelines, bathrooms, toilets, central heating, etc .Such works are often related to the necessity of rebuilding of the flat operating system (e.g. the necessity to arrange space for bathroom or a toilet).

**Table 6.2.**

Flats in Poland with no amenities (% of all flats)

Amenities	In towns	In the country
Water supply system	1,5	11,8
Toilets	5,7	26,5
Bathrooms	8,0	24,1
Gas system	26,0	82,4
Central heating	15,9	36,5

Source: The housing conditions of the population, data provided by Central Statistical Office of Poland, based on the balance of the state of housing resources for 31.12.2005.

Modernization (rebuilding) may be related to the change in a way of use of premises, structure or real estate. According to the article no. 71 of the Building Law “the change in the way of the use of the building or its part is particularly deemed to mean:

- modification of premises or room with housing destination or destination for public usage, that used to have different destination or were constructed with a different purpose, including the destination of the habitats for non housing purposes;
- undertaking or abandoning, in the building or its part, activity that changes conditions of: fire protection, flood security, work security,



work, health, hygienic and sanitary, environmental protection, growth or load system.”

All kinds of changes in the way of use of the civil structure or its part, shall be subject to the statement submitted to authorities. That is why the following documents shall be attached to the statement:

- description and drawing defining the location of the building in relation to the borders of the real estate with other civil structure situated on the same or neighbour real estate;
- designation of the building in which the way of designated use shall be altered;
- technical description of the building type and character of the structure, including its construction, technical and functional data, size and load distribution, and, if necessary, technical data;
- statement of possession of right to dispose of real estate for building purposes;
- statement issued by commune head, mayor, president of the town on conformity of the way of use of the structure with settlements of in force local development plan or, in case of lack of such a plan, final decision on the conditions of terrain development and site planning;
- in case of alteration of designated use that leads to lowering conditions of fire protection, flood security, work security, work, health, hygienic and sanitary, environmental protection, size or load system - technical expertise carried out by persons with building qualifications in the appropriate specialization.

The statement shall be submitted before change in the way of use. The change in the way of use can occur if within 30 days' time upon statement's delivery, the authorities do not appeal against it in the form of a decision, and not later than in 2 years' time upon delivery of the statement (Article no.74, act 4 of Building Law).

Carrying out of the construction work in buildings recorded in Register of Historical Monuments requires additional permission, issued by the Voivodship Conservator of Monuments.

# **CHAPTER 7**

## **ORGANIZATION OF PROPERTY MANAGEMENT (M. CICHARSKA)**

### **Abstract**

Chapter 7 relates to issues concerning marketing, human resources, technical resources, operations and financial management in the real estate management company.

## **7.1. MANAGING A REAL ESTATE COMPANY**

Management of most of companies means planning and organizing work of employees as well as control/ audit of their performance.

Real estate management is an activity performed often not only by a single manager but a specialized company, which should be organized and monitored itself.

Real estate management requires accessibility to market resources. Most significant are financial resources, human capital, and technology. Resources determine position and company's strategy and certainly we can and should talk about marketing, personnel, processes, technical resources, financial and even knowledge management.

Following chapters are focused on issues connected with organization of property Management Company.

## **7.2. MARKETING MANAGEMENT**

Product and services sales have significant meaning for a success of companies operating on markets worldwide. Property managers sell management services. Their performance and success is based on fulfilment of client needs and expectations in terms of real estate management.

Most of managers tend to target their clients. Targeting enables them to focus on group of potential services receivers, type of properties, as well as strategy.

Following the classification of property into residential, commercial, industrial, agricultural and special purpose real estate (churches, schools etc), managers often specialise in one or two types of them. Usually only major agencies specialise in management of all property's types.

Property market can also be divided into private and public sector, where real estate ownership type is used for classification. In Poland for example, most of state owned properties have to be managed by licensed managers chosen on the basis of public procurement law.

Segment choice is only a first step in marketing management. Next one is qualification of customer's needs, as well as preparation of marketing mix in form of marketing plan.

Marketing mix consists of 4 Ps- **product, price, place and promotion**.

In property management product means simply services offered and provided. Manager may perform his duties (administration, marketing and physical management activities) on daily/ weekly basis, depending on mutual agreement with property owner.

Next "P" is a **Price**. In case of property management it is amount of money paid by owner to manager (salary). It is also a price of utilities and media that are

covered by the owner or occupier as a result of contracts and agreements between property manager and electricity, water etc. providers.

**Place**, basically a location where a product or service can be purchased. It does not necessarily mean a physical market place; it may indicate a virtual store (like internet shopping). Choice of distribution channel belongs to product/ service provider and is based on subject and object structure.

Subject oriented chain of distribution is defined by potential and current client (client oriented approach). Distribution chain focused on objects is described by procedures and activities performed in order to gain new clients and meet needs of current ones.

Services may be provided by the property managers personally or may be outsourced.

Last but not least is **Promotion**, which stands for communications that in our case property manager may use on the market. Some distinguish 4 forms of possible promotion activities such as advertising, public relations, word of mouth and point of sale.

Decisions concerning choice of marketing mix strategy are basic for any marketing oriented management style. They should be based on data, market and business cycles analyses.

Every market, also real estate market, is under influence of changing factors/ trends which cause so called business/ economic cycles.

Cycles refer to the fluctuations of economic activities of market participants in the long term. Cycle can be described by 4 major shifts: recovery, prosperity, stagnation and recession.

Property managers behave differently during 4 cycle stages. For instance during prosperity stage market players are more willing to invest. In that case managers should be prepared to put additional services offer as well as encourage property owners to invest in overhauls, facilities and so on. Recession or even already stagnation stage is a signal for manager to think about costs cutting solutions and maintaining property income on possibly high level.

Also price, place and promotion aspects of property management should be adjust to the current economic cycle stage.

Loyalty programs are also powerful tool in hand of property managers (especially commercial and industrial). Well established relations between

client and service provider play important role during a recession stage and can encourage client to continue cooperation.

## **7.3. HUMAN RESOURCES MANAGEMENT**

Management is an art of meeting objectives by organizing work of others. Therefore without any doubt human resources management plays important role in company's strategic plan. An HR activity consists of two layers: company aims/strategy oriented and employees' needs and development.

Human resources activities include recruitment, motivation and employee assessment. Recruitment process in the property management company depends on kind of services which firm is providing and price/ salary strategy. Activities profile determines who is needed and how many licensed managers will be employed. It is legally required that each property management company among all employees has to hire licensed managers.

Recruitment process in the management company is similar to processes in other companies. Most common are hiring recruitment/ headhunting company to do the process or use company's HR department. First solution is mostly while recruiting upper level management. But many operations of property management companies do not require involvement of upper level managers and (small) firms can actually run their business without them.

However international corporations offering management, consulting and other services on the real estate market hire specialists not only from property field but also financial directors, IT specialists and so on.

When company decides to recruit on their own usually HR specialists use so called word of mouth, newspapers ads or internet. Real estate industry attracts many potential employees, no wonder that separate job portals are created on the internet in order to address demand and supply side of labor market.

After recruitment process is completed next challenges occur. Human resources management is responsible for employees' motivation on the way to achieve company's goals. Depending on companies profile and size it can involve face to face sessions, group workshops, and salary level increase. It also involves so called corporate culture, which includes bonuses, personal development path, and team building events and so on.

Motivation systems require employee and progress control. While property management companies offer services, clients' satisfaction is probably the best factor indicating managers' performance. Clients can share their opinion in questionnaire, interviews etc.

Another way of progress control is possible within the company. Turnover, contract aims audit are just examples. Every firm has tools at their disposal to make sure if employees are performing their job on the possibly high level.

Other important area is personal development path. It is believed that job satisfaction is a key to better performance of each worker. Development and needs fulfillment is closely linked with employee motivation and loyalty programs.

Example of HR activity in this field are internal and external trainings, workshops, also "on the job" trainings while new activities are learned during performing duties and work shadowing- observing other performing their job.

Trainings in form of seminars or workshops are usually treated as a quick way to share condensed information and knowledge with the audience. Their role is also to motivate listeners to start new projects, share ideas with others and so on.

On the other hand trainings alone are only ways of communicating issues, passing theories. Without will and practical steps will not bring any change. Implementation and enforcement of new methods after trainings by supervisors seems to be an imperative.

Other form of is **coaching**, directing and training of workers. It may include motivational speaking, supervised practice. Usually coach is a person who is an expert in field explored by the worker. Coach offers advice and support to the younger team player and most often is not employee's supervisor but a person with job seniority.

Also personal career path and promotion possibilities play important role in the motivation programs for workers, who wants to be in charge of their development within a company.

## **7.4. TECHNICAL RESOURCES MANAGEMENT**

Concept of management does not only concern workers, teams, but also resources.

On of the resources in the property management are technical resources, which are technical devices used by managers and building users during day by day operations.

Important in technical resources management is ownership of these resources. They may belong to the owner of the building, owner of company which is renting a space or may be provided by the managing firm, also rented, leased. It depends on strategy, costs, importance and kind of resource and many other factors.

For instance clearing of snow from building façade which usually requires heavy duty equipment. Equipment may belong to the building's owner, building's occupier, property management company, also rented. Other option is to outsource entire "clearing of service". Every single solution (except last one) requires from property manager to hire a person to actually do the "clearing off job".

If property management company decides to own technical resources used in building operations, needs to be ready to manage them also. Usually this means hiring additional specialized manager (or even couple of managers) to take care of the stock.

## **7.5. COMPANY'S OPERATIONS MANAGEMENT**

Management does not only concerns human and material resources, but also processes that take place and knowledge as well. In every company operations like information and documents circulation, skills development programs, strategies to win new clients, should be well established, practiced and managed.

Important factor in day to day management is a proper definition and documentation of company's operations (also called know how). Procedures are important, especially in case of large companies where many workers carry out similar duties. Gathered and shared knowledge saves time and money. New employees do not waste time to create procedures which are already well established among other co-workers; also knowledge is secured and will not disappear when a worker is changing job.

Documentation of procedures used within a company alone is not enough and does not guarantee a success. Implementation of structures, constant monitoring and up dating are very important factors.

Work of property managers on daily basis consists of number of recurrent activities like rent calculation and collection, building operations management, and so on.

Important is to create frames for all activities and to improve their effectiveness on one hand, on the other to assure constant flow of gathered knowledge among employees.

## **7.6. FINANCIAL MANAGEMENT**

All in all company's finances includes processes connected with gathering, managing and spending of financial resources. They may be in form of initial capital, income, also loans, and credits and so on. Outflow of financial resources



is caused by expenditures on day to day operations, salaries for employees, loan commitments etc.

Financial management consists of several areas like book-keeping, managerial accounting, financial analysis, internal audit. In most cases financial management rules and requirements are similar in each sector, as well as in property management. For example financial reporting or taxation and accounting.

Nevertheless companies (and property management also) often approve and use their own procedures, especially when internal issues are concerned, like documents flow, expenditures acceptance, audit and control of amounts due. This area, even though being a part of financial management in general, is very specific and individual for each firm. Often no other but financial manager is a person responsible for efficacy and liquidity by providing and interpreting financial data, forecasting, or even formulating long-term business plans.

Crucial factor in property management is budgeting issue. Preparing a property management plan manager also prepares a budget, which indicates level of expenditures on services required and planned to be bought.

Manager also needs to make a forecast about possible profit and include it in budget calculations.

Managing property's budget and level of commitment in budget execution is a key to success in financial management. First step, like in any other management process, is aim determination. Financial aim may be presented in absolute or non absolute value.

Profit in absolute value terms may be counted as a profit earned by the real estate management company from all property management activities or from each property separately. This measure, although very clear and simple to understand, is not used very often, while not useful when effectiveness needs to be determined.

Financial managers often use non absolute value concept instead. In real estate management important is to predict and measure a possible transaction price per square meter.

Profit generated and presented in form of per square meter price helps to specify

if company actually gains or loses while engaging in new deals and manages more space.

Usually economy of scale rule applies also to property management, and when firm decides to administrate more space fixed costs are divided between income from already managed properties and new ones (net profit per square meter increases).

Property management companies sell services, in this business people are the key to success. Often while expanding operations and hiring more staff firm counts on increase of net profit per employee. More employees can carry out number of additional project which usually increases profitability.

After financial goals for the company are set, next step should be creation and implementation of internal audit procedures. Financial reporting, book-keeping should not only meet principles of accounting but also be source of clear and reliable information for decisions makers- managers.

Financial accounting standards are result of law and tax requirements, which should be met by every company, also property management ones. Managerial accounting supports decisions makers while setting future goals. Useful in this process is description of "profit centres". For property management company **profit centre** will be a building, buildings complex which brings profit (profit and loss statement).

Profit centre analysis helps managers to define which building (property) brings highest / lowest income. It may be a basis for future corrections in managed properties portfolio, such as costs cutting, investment, and tenants overturn or manager replacement.

From the management point of view audit of results seems to have a significant meaning. Monitoring of actual situation and counteracting against deviations in a real time are forms of audition and correction use not only by property, but all managers.

If for example profit from a specific property is dropping or is simply lower than predicted, while security costs are higher property manager should be able to catch a difference and take necessary steps to prevent further losses.

It may be change of security system, search for addition source of money etc. Solutions depend on managers abilities to adjust project to new situation.

On the other hand even audit and monitoring processes will not cover all risk areas within the property management. Uncertainty is always a part of every business activity. One can and should prepare to face it, but in some cases it is simply impossible to predict and overcome adversities.

Every business activity is exposed to **risk**. Depending on the business nature, the type of risk will vary: operational risk, financial risk, investment risk, credit risk, liquidity risk, tax risk, legal risk, occupational risk, interest rate risk etc. For property manager first two have a significant meaning.

Operational risk is affiliated with loss resulting from inadequate of simply defective **internal processes, people, systems, or external events**.

In property management this could be lost of tenants, withdraw of major client, economic slump on the property market, drop of prices per square meter, etc.

Second significant on the real estate market is financial risk, which is associated with use of any type of financing and source of risk lies in loans/ credits costs. If costs of external financing are higher than company's income, risk that firm will not have adequate cash flow to fulfil all financial commitments occurs.

## **7.7. OFFICE**

Personnel recruitment is a part of property management office organising. Skills required from recruited staff and workplace solutions may vary depending on type of properties managed by the company.

In case of residential properties important part of business will be service provided to a single occupier, who is an end user. Individual clients usually require face to face contacts while addressing questions concerning use of premises or rent collection. Therefore physical presence of residential property manager is required.

Most often manager acts as a building administrator and performs job on premises on daily basis (or as agreed).

It is always important to appoint a person within a property management firm responsible for contact with tenants, especially when rent payments and terms are concerned.

In case of offices managing significant amount of residential properties usually an accountant is a person responsible for monthly billings and sending information by mail, e-mail, and fax to tenants. Then building administrator holds responsibility for distributing information about changed rates.

Smaller property management agencies usually combine role of accountant and administrator, and this person is fully responsible for building operations as well as contact with tenants and rent collection.

Rent settlement may take place in administrators office, which is located on premises or it may be in the head office of management.

A first option is more convenient to tenants. Second one for property management. In firms taking care of more than one building second solutions is more common. Integrated system of rents collection, income and expenditures helps managers to control operations and is a significant source of information for each of them. On the other hand integrated accountancy system requires separate/ additional space, which in case of small firms generates costs difficult to cover due to low profitability in comparison to large companies.

Commercial and industrial properties tenants have a bit different expectations. Building administration and rent collections is only a part of manager's duties, also protection of owner's investment and maximization of owner's return is a part of manager's job. Therefore in commercial and industrial sectors property management is performed by large companies, hiring number of licensed specialists.

In case of commercial properties, especially business properties, including office space, shopping centres, hotels, external and internal design and building layout has a high priority (often prestige indicator). For industrial properties manager (warehouses, factories) accessibility (infrastructure), stock security is main issues.

Nowadays many commercial and industrial building operate 24/7. Role of property manager is to provide a service when needed, in the real time, which often requires his personal assistance even after so called office hours.

To sum up, property management office organization is based on client's expectations and needs, also on management (managers) abilities to perform duties on the profit & loss basis.

# **CHAPTER 8**

## **COSTS MANAGEMENT AND EFFECTIVENESS OF THE REAL ESTATE (U. SŁOWIK)**

### **Abstract**

In the Chapter 8 basic information about cost formation and accounting issues crucial for each company were presented along with basis of effectiveness calculations. One of the most common cost control method- budgeting is described in this chapter.

### **8.1. THE BASIS OF COST FORMATION AND ACCOUNTING, BUDGETING**

The real estate management, besides legal, technical and organizational issues, consists, also or even above all, in management of finances relating to the real estate.

Within a framework of the financial economy, it is necessary to carry out range of economic and financial analysis of the real estate situation, which should precede planning and determination of strategy for a given real estate. From the investment point of view, a real estate should be treated in relation to possible profits that can generate. Analysis should be preceded with the assessment of its technical condition, as well as designation of sources of prospective repairs, assessment of its standard and market position, with the aim to determine its

potential and prospective income. Comparative analysis of the real estate enable to asses correctness of the costs levels, effectiveness of real estate use, as well as give possibility to determine directions of its development. They will also be necessary to determine required financial expenditures and to assess the possibilities of their financing.

The basic categories, within a framework of which the issues relating to the management of real estate finances are concentrated, refer to incomes and costs. However, one shall pay attention to the fact, that classification that is commonly used, e.g. in budgets, is not identified with classification of the accounting act.

The next consideration is the fact, that there is more than just one system of the classification of real estate costs and incomes. The choice of categories depends on many factors, among others, on: type of real estate, way of its use, age of building, management method. To talk about practical application of real estate finances management, that is, about budgeting, every manager shall adjust the categories of revenues and costs to real estate under his/her management, so that the analysis meets his /her purposes and expectations.

It is important, however, to underline, applied in reporting and financial analysis, approach to particular categories. First of all, it is quite common to use in an interchangeable way categories of incomes and revenues, as well as of costs and expenditures, within the meaning of reporting in accordance with the accountancy act. Regardless of application of complete or simplified accountancy, these categories are not identical. While talking about manager's reporting, we take into account documents used for communication with the owner, current control of his/her activities, as well as financial management of the real estate, unnecessarily in the accounting sense! That is why, while taking into account finances of real estate from the manager's point of view, we are closer to cash than accrual basis. Certainly, be closer to cash basis does not mean, however, its complete and literal application by the manager in the course of practical activity. One cannot forget that the real estate manager is not an accountant and his activity, relating to real estate, exceeds accounting field.

On one hand, actual incomes from real estate are important to the manager (received rents, cash advances or other categories of revenues) , on the other hand, however, the manager, in his projects of budgets prepared with consideration to potential of real estate, introduces, rare in other spheres, categories of possible and effective incomes. It is also worth mentioning that not all categories of revenues or costs present in commercial law partnerships, "constituted over the real estate", shall be present in budgets and vice versa.

The manager's reporting is deemed to use for current control of financial management (being one of his competencies), therefore he often refers to the accrual (e.g. so as to be able to react to arrears, irregularities) The manager cooperates with the accounting department that makes use of his information and provides him with return information. Certainly, such situation occurs especially in so called commercial real estates. In the case of communities (these are not subject of consideration in this and following chapter), the problem does not occur (simplified accountancy, accountancy in a limited range, form of business).

However, general approach that should be used during preparation and reading of reports and projects of budgets, is a method that can be described as “money received”.

Above referred to, budget of the real estate is a particular document in the real estate management. Its function is both to plan and control financial management of the real estate (being subject to manager's competencies). It is element of manager's reporting towards the owner, serves to control his/her work, as well as to control effectiveness of real estate operations. The range and types of budgets will be different for different real estates, however, basic principles and problems related are the same, regardless of types, forms of ownership and sizes of the real estates. The owner is interested in obtaining information on the condition of the real estate (both financial and technical), hire level, amount of rent, problems with rent arrears, operating costs and overall situation of the real estate.

**Table 8.1.**

The real estate budget - basic functions budget

The real estate budget – basic functions budgets		
Control function	Information function	Forecast function
<ul style="list-style-type: none"> <li>• self control of manager and his/her team,</li> <li>• of the manager’s work by the owner</li> <li>• of plans and assumption</li> <li>• of changes and their result</li> <li>• of prompt reaction to problem arising</li> </ul>	<ul style="list-style-type: none"> <li>• on current financial situation,</li> <li>• on the effectiveness of the actions undertaken</li> <li>• on problems</li> <li>• on plans accuracy</li> </ul>	<ul style="list-style-type: none"> <li>• analysis – conclusion accuracy of the decision made,</li> <li>• determination of the financial needs</li> <li>• problem elimination.</li> </ul>

Source: own preparation



By means of a budget, one can forecast what actions will occur in a particular time. During budget preparation one shall take into account:<sup>20</sup>

- complete open market value of space for rent, calculated on the basis of the level of market rents,
- forecast of losses resulted from vacancies and delays in payments of rents ;
- general seasonality in the hire of space, that influences on the level of income ;
- forecast of income from sources different than hire of space (parking places, vending machines, etc.) .
- forecast of costs, repair expenditures;
- condition of surrounding in which the real estate operates and will operate (above all situation in a given segment of real estate market, its stability, potential of growth, threatens or opportunities, macroeconomic conditions e.g. inflation changes, percentage rates, etc.)

The fundamental condition of budget preparation consists in determination of all revenues and expenditures relating to the real estate.

The real estate manager, on the basis of management agreement signed with the owner, shall submit to the owner, in fixed dates, appropriate financial reports on obtained results. The real estate owner shall compare planned and realized profits and expenditures, as well as respective amounts of deviation. The owner of the real estate specifies, how often and in which form real estate manager shall submit him/her financial reports. Usually, besides determined, standard, numerical part (expressed in appropriate tables), he/she will expect the description of condition and financial analysis of the real estate under management.

So that right financial management can be conducted, the real estate manager shall prepare the following types of budgets:

- operating(annual),
- cash flow,
- capital,
- long term,
- pro forma.

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<sup>20</sup> Downs J. C. Jr: Principles of Real Estate Management. IREM, Chicago, 1980.

Annual **operating budget** is the basic type of a budget. Such a budget is prepared for period of 12 months, usually for a calendar year. The budget shall include all incomes and expenditures relating to a given real estate year-to-year or month-to-month. In tabular layout of the budget one shall forecast quantities different from planned and actual, as well as deviations between actual and planned quantities. In the operating budget one can also take into account month-to-month costs and profits, as well as sums assigned to square meter of premises per month.

The construction of the operating budget consists of few „levels“:

- **possible gross income**, includes all possible incomes from the real estate, determined under assumption of the complete hire of space (what occurs rarely in practice)
- **effective gross income** is possible income less losses resulting from uninhabited flats and rent arrears, as well as possible decrease in rent because of periodical reductions or exemptions. The situation on the real estate market influences on level of effective income (especially in the case of particular types of real estates) as well as situation of the real estate (e.g. proper, for a given type of real estate, standard of a building)
- **net operating income** that results from gross income less totality of operating expenditures. Overhauls, modernizations and loan costs do not influence on its level. NOI is a base of the calculation of many indexes relating to investment expenditure's effectiveness.

**Cash flow budget** - exactly determines how much money we will get from a real estate and how much money will we need to cover all expenses in particular months. The budget is prepared after operating budget and on its basis. The difference between cash flow and operating budget is based on the consideration of non-operational expenditures, that is, loan costs (capital instalments and interests), as well as investment expenditures (expenditures for overhauls, modernizations, etc.), that is, information provided by capital budget.

Another type of budget is **capital (repair) budget**. It is prepared in the case of necessity of conducting repair, modernization or installing additional equipment in a structure. In the capital budget one shall determine annual quantities of overhauls expenditure and reserves for that purpose (repair fees of owners, loans, subsidies, grants, etc.).The reserves shall be accumulated with consideration to the number of years that will pass till moment of conclusion of

a given repair type, as well as the income resulting from interests of deposits till moment in which appears necessity of their use. The repair budget enables to determine e.g. amount of advance money for repair fund for the following years or financial needs – amount of loan. The base of such budget is precise determination what parts of a real estate shall require serious repairs or exchange, when it may happen and what repair or modernization works shall be conducted, as well as how much it will cost (catalogues providing prices of building and installation works can be useful for costs' estimation).

The opinion of surveyor is, in many cases, necessary for these settlements. After determination of extent of repair and modernization works, as well as their respective costs, the real estate manager shall determine the way of their financing. On the basis of operational and cash flow budget he shall assess whether works can be financed from current financial surplus. If the resources appear to be insufficient, repair and modernization investments can be financed from owner's resources, bank loans or earlier accumulated advance money from the repair fund. While making use of loan, one shall carefully analyse the profitability of such a method of financing - that is its costs (interests, commissions) and additional profits to be obtained from investment, moreover, it is necessary to determine possibility of paying off the loan and its service from operating income.

The real estate manager can also prepare **long-term budget**. It is prepared usually, when the owner considers possibility of sale of the structure. It is usually prepared for a period not longer than 5 years.

The budget pro forma is a special type of a budget, prepared for planned investments in the real estate or in the case of new buildings.

## **8.2. THE BASIS OF EFFECTIVENESS CALCULATION**

Information included in budgets, is a source for economic and financial analysis of a real estate, as well as for calculation of effectiveness of investment in a real estate. The information included in repair budget enables to check whether it

was justified to provide additional finance or capital, through repairs, modernizations, extensions, etc.

The investment needs assessment are determined on the basis of technical condition assessment - real estate consumption, changes in demand on real estate market determined by particular types of surface, or analysis of the real estate situation. It also takes into account the financial possibilities of the investor (owner), with possible designation of necessities to finance development or repair activities through loans. These issues have already been discussed in the part relating to capital budget of the real estate. In management it is important to determine profitability of undertaken investment work. This process is conducted with the use of information included in the budgets, as well as through application of available tools in the form of methods of effectiveness' calculation (in the further part of study).

The complementary information indispensable for effectiveness calculation (not included in the budgets), are, among others:

- price at which real estate was purchased;
- relation of land price to building price (depreciation affects only the value of building);
- forecast economic life of a building;
- the method of building's depreciation;
- conditions of financing and total costs of the loan;
- forecast of the period of real estate ownership;
- estimation of increase in the value in relation to time of its sale;
- terms of sale;

The calculation of effectiveness provides answer to a question whether expenditures planned for changes in the real estate will bring in expected result in the form of increase in value, increase in income or decrease in costs.

# CHAPTER 9

## EFFECTIVENESS OF EXPLOITATION AND COMMERCIAL BUILDINGS MAINTENANCE (U. SŁOWIK)

### Abstract

Chapter 9 presents methods of calculating operations' effectiveness, along with costs and income analysis.

### 9.1. COSTS ANALYSIS

Real estate investment and management process effectiveness relies on well prepared planed and audited costs management. Often companies tend to use a policy of costs minimization as a major strategy to achieve a goal. Often it brings effect only in a short term. In a long term it leads to depreciation and drop in property's attractiveness, and results in growth in investment expenditures in the future. Effective costs management does not anything in common with exaggerated expenditures cutting, but needs to be rational.

Basic costs classification divides them into:

- capital costs
- operational costs

Capital costs are investment expenditures and loan/credit costs, which include:

- major overhauls- under taken to improve technical standard and safety of property. Usually complex and long term process, requiring changes in building design (construction), insulation replacement etc.
- modernization- aim of which is to increase property's standard by applying new technology and solutions.
- reconstruction of the real estate/ refurbishment of premises- goal of which is a change of property's profile.  
Includes changes in the building layout and construction solutions.
- Extension of real estate- increase of space.

Necessity of real estate renovations is based on property's technical condition, first of all on physical and functional usage level specified prior to budget preparation.

**Operational costs** are strictly connected with current activities and positioned in the operational budget. These costs may be divided into:

- **Fixed costs**, which occur over a period of time, regardless of manager's duties performance and occupancy level.  
Fixed costs include property taxes, property insurance, other taxes and local fees.
- **Variable costs**, dependent on occupancy rate, manager's activities (although there are some cases when manager has only limited influence, like in case of electricity bills because electricity unit price is fixed by media provider).

Operational variable costs can be classified as:

- Media costs (energy, electricity, gas, hot and cold water, rubbish and sewage disposal).
- Costs of repairs and renovations, maintenance (for example lift maintenance and repairs, landscaping).
- Property cleaning
- Services (building security, book- keeping, cleaning if this service is outsourced).
- Salary and administrative costs (salaries of staff hired to take care of day to day operations, also administrative costs of document write out etc.).
- Property manager salary.

Costs analysis is a process which should be conducted using different approaches. First of them is presented below. Manager analyses planned and incurred costs in order to find a cause of possible deviations.

Category	Year / Quarter / Month		
	Plan	Execution	Deviation*
Media – energy, gas...			
Outsourced services • Supplier 1 • Supplier 2			
Repairs & conservation			
Salary			
Taxes & insurance			
Management costs			
.....			
	*Cause of deviation – reaction		

Source: Own elaboration

Presented table is equivalent of operational budget (costs part). Analysis on monthly basis allows manager to act almost immediately when deviation occurs when possible (cut on excessive electricity use, supplier change etc).

Next step should be focused not only on costs but also on service (also media) provided. It simplifies preparation for periods when service (media) costs will be higher than an average, like during winter time. Also helpful is use of scale and indicators like electricity costs per square meter, number of tenants and so on. In case of real estate it is also possible to use benchmarking- similar properties or changes in media usage rates during different periods of year.

## 9.2. INCOME ANALYSIS

Second important category in financial management is income. In case of real estate basic source of income is rent.

Category	Year / Quarter / Month		
	Plan	Execution	Deviation*
Income from rent • Tenant 1 • Tenant 2			
Income from exploit fees			
Income from banners and billboards placed on and in the building			
Income from ad hoc renting			
Income from additional services			
Other			
	*Cause of deviation – reaction		

Source: Own elaboration

As presented above property can generate income from other sources than rent. If categories shall occur depends on property's character (type) and manager's invention. For example income from ad hoc initiatives could be generated while renting a property (usually rooms) for conferences, birthday parties, and photo shoots etc.

Other category is income from exploit fees, amount of which is specified in the tenancy agreement.

Depending on rent calculation specified in the agreement it may cover fees for perpetual usufruct, property tax, conservation and renovations costs, landscaping costs, costs of common area maintenance. On basis of mutual agreement between tenant and owner (represented by property manager) following classification of rent may be presented<sup>21</sup>:

1. **Gross lease:** rent paid by the tenant is a fixed amount of money for the whole tenancy period. Tenant pays fixed amount of rent, owner/property manager is responsible for payments such as property tax,

<sup>21</sup> Wofford L. E., Claurette T. M.: Real Estate, 3<sup>rd</sup> ed. John Wiley&Sons, Inc, New York 1992, s. 518.



insurance, media, building maintenance. Gross rent is used in case of short term renting. Such a form causes that owner is exposed to inflation risk and media prices increase, while from fixed amount of rent has to cover all expenses (even when they suddenly increase).

2. **Net lease:** tenant pays fixed rent and additionally participates in agreed operational costs and pays property tax. It is worth to stress out that there are now universal rules concerning value of net rent. Every single agreement is unique. Rent may be paid in form off:
  - Single net lease- tenant is responsible for paying operational costs of rented space.
  - Double net lease- tenant is responsible for paying operational costs of rented space and participates in operational costs of common space.
  - Triple net lease-tenant agrees to cover all property taxes, insurance costs, as well as maintenance on the property plus normal fees such as rent.

Protection against costs increase (such as property taxes, insurance) is an important issue for owners and tenants as well. Various solutions are possible. It may be agreed that owner along with tenant will hold responsibility for covering costs of tax increase depending on size of occupied space. Also maintenance costs may be calculated on basis of size of rented

3. **Percentage lease:** rental is based on a percentage of the monthly or annual gross sales (seldom profit) made on the premises by tenant. Amount of rent depends on property type, tenant's occupation. Nominal rent amount is required in order to cover basic costs of property's operations and investor's financial commitments. Percentage lease is usually used while retail trade is concerned and is described as<sup>22</sup>:
  - percentage of the monthly gross sales without a nominal rent guaranteed
  - percentage of the monthly gross sales with guaranteed nominal rent
  - percentage of the monthly gross sales with guaranteed nominal (minimal) and maximal rent.
  - Profit percentage

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<sup>22</sup> Beaton W. R., Bond J R. Ferguson J. T.: Real Estate. op. cit, s. 109.

4. **Gross lease with graduation:** rent amount is fixed for a period of time, then it can increase or decrease by an agreed percentage or amount.

Income analysis should be based on similar areas as costs analysis, like: execution plan, deviations causes, economic indicators, relations between factors.

### 9.3. EFFECTIVENESS OF OPERATIONS

Methods for the financial appraisal of long-term projects can be divided into:

- Standard methods, also called traditional or statistical- rate of return.
- Appraisal methods (chapter 10).
- Methods used in order to discount future cash flow to its present value NPV and IRR.

Rate of return- is a method indicating period of time needed to gain expected return from the investment (annual or annualized rate of return on a past or current investment, or even estimated return on a planned investment).

Most commonly used are NPV and IRR methods.

**Net present value (NPV)** is defined as a difference between present value of cash inflows and the present value of cash outflows.

$$NPV = \sum_{t=1}^n \frac{C_t}{(1+r)^t} - C_0$$

Where:

$t$ - the time of the cash flow

$n$ - the total time of the project

$r$ - the discount rate

$C_t$  – the net cash flow (amount of cash) at time  $t$

$C_0$  – the capital outlay at the beginning of the investment time ( $t= 0$ )

The proposed investment is worthwhile when  $NPV \geq 0$  (net present value is positive), it adds value to the company. In case of many investments it is useful

to compute NPVs for all of them and rank them in order of desirability and chose most profitable ones (with the highest NPV level).

**The internal rate of return (IRR)** is a discount rate that results in  $NPV = 0$ , also the rate of return that equates the present value of the expected future cash flows to the initially invested capital.

Project may be accepted if the internal rate of return is equals or higher than the discount rate (return rate required by the investor),  $IRR \geq r$

If  $IRR > r$ , then also  $NPV > 0$ , project brings higher profit then expected

If  $IRR < r$ , then also  $NPV < 0$ , project is unprofitable

If  $IRR = r$ , then also  $NPV = 0$ , project reaches required level of profitability.

Reliable costs & income, and investments analysis based on above presented methods are absolutely a must in property manager's work, especially while planning future operations.

# **CHAPTER 10**

## **PHILOSOPHY AND METHODOLOGY OF DRAWING UP A PLAN (L. KOWALCZYK)**

### **Abstract**

Chapter 10 concerns methodology of real estate management plan creation. The role of the plan for each property manager as a main management tool is stressed out. The notion and functions of the real estate business plan are covered by the author with the emphasis on individual character of each plan based on different needs and aims of the owner/ manager and specific characterises of each property.

### **10.1. NOTION OF REAL ESTATE BUSINESS PLAN**

The real estate management consists in making decisions and performing actions leading both to keeping the real estate in a non - deteriorated condition, in accordance with its destination, and to making justified investments in this real estate. Therefore the management consists not only in the administration (performing actions related to current operation and keeping the real estate in a proper condition),but also in independent strategic decision making or preparing thereof and suggesting to the real estate owner The strategic decisions made by the manager or presented to the owner shall concern the choice of strategy for the real estate management, change of the real estate function, tenant rationalization, investments in the real estate (extension, outbuilding, rebuilding) as well as increase in the value thereof.

The instrument aiming at facilitating work of the manager is a real estate business plan. Perhaps it should also indicate decisions to be made and actions to be taken so as to meet the requirements and expectations of the real estate users as well as to increase the value of the real estate. In the course of drawing up a plan, the real estate manager finds out range of new possibilities hidden in the real estate, which concern its running and possibility of the real estate to create positive cash flow. Furthermore, the real estate manager gets familiar with conditions which the best possible way of real estate running depends on. The balance between costs and expenditures and potential effects, and the final choice of the strategy for the real estate management is a philosophy and sense of drawing up business plan for this undertaking that is the real estate business plan. The real estate business plan is as independent as the real estate itself. The applied methodology is, however, the same for all of them. The drawing up a real estate business plan requires getting much information on the real estate and its environment, as well as familiarization with the purposes of the owner, carrying out market and competition analysis, finding out individual characteristics of the real estate, being of its advantage, which one wants to make use of, and its faults, the influence of which should be minimized.

The real estate business plan is a set of documents that describe:

- the real estate,
- economic environment of the real estate,
- the purposes of the real estate owner ,
- the strategy for operating a real estate in a specified time,
- receipts and expenditures related to the real estate.

The real estate business plan shall include basic data thereof, which concern: location, owner and manager, currently performed function, technical condition (in the case of building and structures), real estate users.

Every real estate is situated in a determined economic environment, composed of other (competitive and similar) real estates, current and prospective users, companies supplying utilities (hot and cold water, central heating, electric energy), companies conducting repairs and conservations, companies dealing with garbage disposal. In the same time, economic environment is consisted of banks facilitating credits, government bodies, scientific and research institutions, institutions stipulating: rules of law, regulations on environmental protection, **land development plans**, etc.

The purposes of the real estate owners are different. The owners of commercial real estates aim at maximizing the profits generated from owned real estate or to increase their value in accordance with their strategic purposes. The strategy for real property management is to assist the achievement of their long-term purposes. On the other hand, the owners of the housing real estates, being part of housing co-operative, are much more interested in decrease in operating costs, and therefore, in potential decrease in rent and improvement in housing standards. Also the owners of the housing real estate are interested in increase in the property value (or, at least, in keeping it on the same level). So as these purposes can be achieved, the manager should choose a determined strategy, that is a way of operating the property in the future, leading to the achievement of the owner's (owners') interests. This strategy can mean conducting repairs and conservations or making investments (reconstruction, extension) to raise its standards, change its destination, increase real estate value or keep the value on the same level. It can also mean postponing of these actions, if the owner's purpose is, e.g. sale of the real estate.

The realization of a chosen strategy is usually connected with specified financial expenditures which shall be forecasted in advance and accurately planned. The expenditures should foster and usually mean additional receipts from the real estate and their number can be esteemed. The comparison between expenditures and receipts enables valuation of effectiveness of the planned investments and the choice of the most favourable solutions.

The real estate business plan is a tactical plan prepared usually for the period of 3 to 5 years. Therefore it shall present both receipts and expenditures for a given period.

## **10.2. FUNCTIONS OF REAL ESTATE BUSINESS PLAN**

The real estate business plan performs various functions:

- Provides information on the real estate and its economic environment,

- Shows legal, technical or financial condition. It enables to become familiar with the market and competition, as well as to assess competitive position of the examined real estate.
- Introduces to strengths and weaknesses of the real estate, as well as threats and opportunities coming from its environment. The strengths of the real estate are the characteristics that distinguish a real estate in a positive manner from the other e.g. high standard, ecological technology (in the case of building). The weaknesses of the property are characteristics that distinguish it in a negative manner or make it difficult to use it in accordance with its destination, e.g. lack of access roads, parking places, unfavourable neighbourhood, and inappropriate users. The opportunities are various chances that can arise from each of the element of the real estate environment, e.g. economic policy of the government assisting development of housing real estates, preferential credits, housing real estates' assistance programmers. The threatens are various limitations of the real estate management e.g. proceeding recapitalization of the buildings, regulated rents that do not cover operating costs and costs of repairs conducted in communal real estates, increase in operating costs, etc.
- Facilitates making both current and strategic decisions relating to the real estate under management. Enables choice of the strategy for the real estate and shows the way of its realization.
- Enables effective real estate management
- Conditions the achievement of purposes of the real estate owner
- Provides information on the real estate for the future users, sponsors and other units interested therein
- Helps to obtain external financial resources and cooperation partners.
- Should present to the manager step by step how to act to achieve the purposes of the real estate owner.

The functions which should be performed by a well prepared business plan make it the main instrument enabling and facilitating work of the real estate manager. That is why it should be drawn up for every real estate requiring professional management with the aim of:

- Getting detailed knowledge on the condition of the real estate and its environment.
- Showing potential strategic variants of operating the real estate ,
- Choice of the determined operation (management) plan in the future on the basis of assessment of the proposed strategically variants from the interest perspective of the real estate owner.

- Drawing up working plan for the real estate owner
- Assessment of the manager and way of managing the real estate
- Getting financial resources for investment in the real estate



# CHAPTER 11

## ANALYSIS PROCEEDING DRAWING UP REAL ESTATE BUSINESS PLAN (L. KOWALCZYK)

### **Abstract**

Chapter 11 includes presentation of research and analysis commonly used in the process of information gathering which are crucial for business plan creation (market and completion analysis).

Drawing up the real estate business plan requires various information, both on the real estate like on its economic environment. To get the information it is necessary to carry out many researches and analytical works. The basic researches include:

- Analysis of the data concerning the real estate,
- Analysis of the microenvironment (the closest environment) of the real estate , especially market and competition analysis,
- Analysis of the macro environment.

**The real estate analysis** should include research of the legal aspects, technical condition, building technology, and degree of consumption, insurance, users, space usage, required repairs and conservations, economic and financial situation. The sources of data that enable carrying out such analysis can be: construction logbook, situational plan of the real estate, protocol of real estate examination and control, construction documentation, protocol of commissioning of building, permission for the building exploitation, documents regarding repairs, conservation and modernization of the building, protocols of failure and catastrophes, real estate material and financial plan, repair and conservation plan, real-estate register, real estate valuation report, etc.

**The market analysis is a set of researches embracing assessment of the market to which the real estate belongs and forecast for the future.** It is worth mentioning that real estate market analysis, due to their diversity, should be carried out for particular market segments, which can be distinguished in connection with the functional types of the real estates (housing segment, office segment, magazine segment, industrial segment, agricultural segment, specialized segment).

Due to the real estate immobility in time and space, real estate market analysis should also take into account its territorial division and in particular:

- Local real estate market (market of flats, little commercial and service structures within the range up to 20 km),
- Super local or regional real estate market (market of hotels, lodging-houses, hospitals, larger industrial, commercial and service structures),
- Domestic real estate market (office structures for central administration, large industrial, sport structures and infrastructure),
- International real estate market (airports, ports).

When real estate market segment and its range are distinguished and defined, one shall examine<sup>23</sup>:

- 1) Demand on real estates, as well as its changes and trends,
- 2) Main customers (buyers, lessees, tenants),
- 3) The customers' expectations towards real estate
- 4) Real estate supply
- 5) The real estate prices and rents

While research of the local real estate market, which is sensitive to various changes, one shall take into consideration:

- Population (number of population, its age and family structure),
- Employment (number of the employed, salary level, income stability),
- Quantity, age and quality structure of existing real estates, their technical conditions,
- Number of available housing and usable premises
- Land availability and prices,
- Degree of the development of the building materials local market

Market analysis shall present to the property manager opportunities thereof and threats for the real estates under his management. The opportunities may

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<sup>23</sup> Kowalczyk L.: How to draw up real estate business plan. Real estates, Market, Law. 2000, no.4.

include: big number of prospective clients, little number of the competitors, control over particular market segment, growing demand. On the other hand, threats are: little number of customers, decreasing demand, growing supply, competition.

One shall remember that real estate market is compound, imperfect, with small flexibility of demand and supply. The specification of the real estate market, and, in particular, its imperfection, small transparency, lack of information, intensifies difficulty in researches and analysis.

The institutions dealing with registering of the transactions (notary public's offices, Tax offices, agencies) do not usually make available the information on them. The transactions are often conducted beyond these institutions. Furthermore, notary's acts contain too little information on the real estate characteristic.

The data on rent rates for the hire of premises are not registered. Even the data on the local market, which can be collected, are heterogeneous. They come from markets that are non - uniform geographically, in quality and price.

The prices quoted in the newspaper announcements are often overrated and are subject to negotiations later on. On the other hand, prices stipulated in the notaries acts, are usually underrated with the aim of lowering administrative and notaries fee, therefore information on them happen to be distorted.

After conducting the analysis of the chosen real estate market segment, a person drawing up the real estate business plan shall prepare the forecast of the market development, taking into account, on one hand, the results of the conducted researches and, on the other hand, determined conditions resulting from macro environment (this problem shall be discussed more broadly in the further part of this report).

While conducting **the competition analysis** one shall monitor competitive real estates, managers thereof, as well as prospective competitors that can appear in the future.

One shall underline **that competitive real estate is a property performing the same function and characterized by the same or at least similar standard of services offered, and which are localized on the same market.** It may happen that it is difficult to indicate competitive real estates for a given one. In this case one shall examine **similar real estates that perform the same**

**functions, have similar standard and are localized in the same segment of the market.**

**The potential competitions of the real estate are real estates under construction (which perform the same functions).**

Competition analysis shall enable providing answer to the following questions:

- How many competitors are there?
- Which services do they provide?
- What are their customers like?
- What are their strengths and weaknesses?
- Why are they successful?
- What are their plans for the future?
- At what prices do they hire, sell, lease?
- Who manages the competitive real estates?
- What are the qualifications of the persons managing the competitive real estates?
- What are the salaries of the manager of the competitive real estate?

The competition analysis is to show the opportunities and threats for the real estate under management coming from the closest environment. The opportunity is a small number of competitive real estates as well as of good, highly qualified managers thereof. The threatens are big number of competitive properties as well as competitive managers that can attract good customers and obtain big revenues. The results of competition analysis shall be the assessment of the position of the real estate within the market and the formulation of the proper strategy for management thereof for the following years.

The conducting of the competitor's analysis requires gathering much information on them. They can be obtained form many sources: specialist press, announcements placed in daily press, statistical reports, clients, managers of the competitive real estates, local land development plan, program of governmental tasks in the municipality, as well as proper information, and so on.

One shall underline that it is low probable that data required for the competition analysis can be gathered at once, even with significant work expenditure. Usually information comes gradually and it takes more time to get satisfactory picture of the competitor's situation.

The monitoring of the macro-environment of the real estate shall include researches of:

- economic conditions,
- social conditions,
- natural and environmental conditions,
- factors relating to the administration and development.

Due to the fact that the real estate market is highly dependent on the processes occurring in the economy, the real estate analysis should be completed with the analysis of such aspects of the macroeconomic situation of the country which influence on the real estate market

Due to connections between the real estate market and economic situation, the following information may be useful for analysis:

- Gross Domestic Product (GDP) and dynamics of its changes
- investment expenditures and their changes,
- inflation rate and its changes
- individual consumption and changes
- unemployment rate
- interest rate of the credits facilitated for the investment purposes
- tendency to save
- availability of the credit system to purchase and development of the real estates
- tax allowances.

**Social conditions analysis** should provide information on the number of population inhabiting a given territory, its structure, density, as well as number and types of particular households, employment profile, education level, income.

Research of natural and environmental conditions shall show:

- location of the real estate in relation to natural locations, leisure devices
- surface features
- microclimate
- transport system
- placement of the structures of public utility
- availability of technical devices,
- sources of pollutions and their extent.

While Analysing factors related to the administration and development, one shall obtain information on:

- taxes and local fees ,
- quality of the services offered (medical service, fire brigade, police)
- land development plan ,
- existing municipal, energetic and gas systems (their quantity, quality, age, degree of consumption)

While conducting monitoring of the macro environment, one shall take into account changes in the controlling environment of the real estate sector. Under this scope the government forecasts range of changes especially for the housing sector. The changes shall result in the housing sector functioning more easily on the market and in competition growing, which is combined with the decrease in prices. One considers legal solutions enabling better exploitation of land destined for housing, as well as widening of the financing sources for the housing, from resources obtained by pension funds, insurance companies, investment funds.

The monitoring of the macro environment facilitates the assessment of opportunities and threats to the real estate management.

Carrying out of the analysis that were mentioned earlier is a labour-consuming task. This requires making use of much information, the sources of which can be:

- economic forecasts of the government ,
- reports and publications of Central Statistical Office, concerning real estate resources ,
- data of the institutions which register transactions (notary public's offices, Tax Offices, agencies),
- publications placed in such periodicals as „Warsaw real estate market”, „Real estates, market, law”, “Surveyor”, “The world of real estates”, “Home and Market”, “Domus”, “Housing Community”, etc.
- daily press,
- monitoring of the local real estate market ,
- local land development plan,
- programme of governmental tasks in the municipality
- land cadastre.

# CHAPTER 12

## PROCEDURE OF BUSINESS PLAN CREATION (L. KOWALCZYK)

### **Abstract**

Chapter 12 describes procedures of business plan creation and choice of the optimal option/ solutions for a specific real estate.

Starting point for real estate management plan preparation are aims of the property owner (owners). To reach the target, it is essential to optimise management strategy formulated in the management plan. Essential for the choice of the adequate strategy is real estate itself, especially functions, location, property laws, users, technical condition, as well as owner's financial standing. Also so called environment (economy, demand and supply of properties, prices, competition) plays important role. Information about owner's targets as well as about property itself is basic for the plan formulation, in order to produce optimal (strategic) solutions.

Proposed strategic options should be examined in terms of its plausibility. Economic effectiveness of proposed options as well as possible threats should be tested and is essential for the project to be successful.

After optimal solutions is being chosen and approved by the property owner plan needs to be putted into practice. Also procedures including property management options are required, as well as financial resources required in order to full fill the business plan guidelines. As well time table, which clearly presents what is intended to be done to reach the target in the specific time-

frame, is required. Time- table should include deadlines for each stage of the project, which leads to the main aim.

Management plan accepted by the property owner (owners) may be executed by the property manager.

Well prepared property management plan should act as a guidepost for the property manager. Which means that it should include hints for the manager, simply step by step suggestions what to do to full fill owner's expectations.

Procedure of property management plan formulation is being presented below-character 12.1



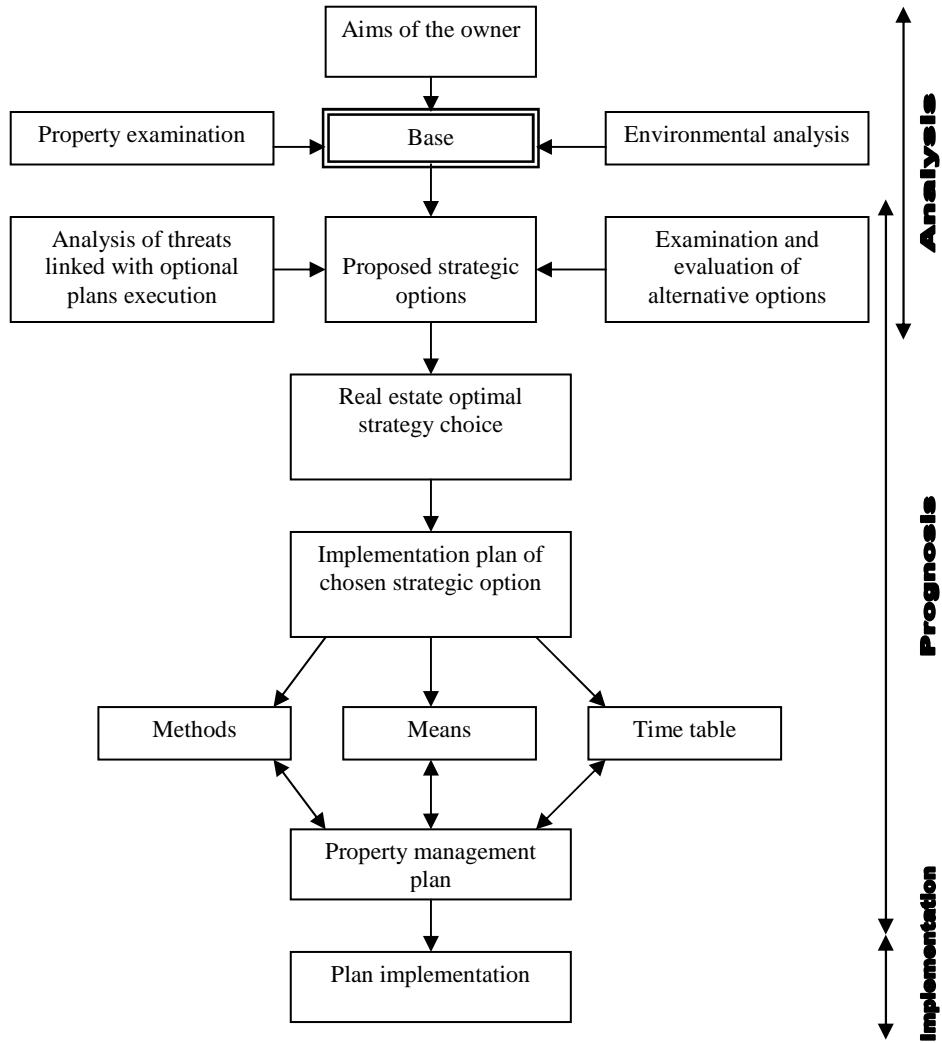


Fig. 12.1. Procedure of property management plan preparation (own elaboration)

Character 12.1 presents that process of management plan formulation is dominated by various types of analysis, such as owner's aims and expectations, property examination, as well as market as well as competition, macro trends, also management options and potential threats.

This type of analysis provides information, which is used during plan formulation process. Prognosis used to create a management plan describes alternative options (solutions), as well as costs and possible economic effects.

Financial forecasts are usually made for a 3-year or longer period of time. Economic analysis and evaluation of possible management options is made on the basis of financial forecast. Usually financially optimal plan is chosen and presented to the property owner. Plan approved by the owner is implemented.

Presented above analysis and prognosis influence and complement one another. It is worth to stress out that analysis and prognosis should be conducted in the systematic manner, because every single management plan requires updating and needs to be adjusted to current property owner's needs, technical condition of real estate, as well as rapidly changing economic factors.

# **CHAPTER 13**

## **CONTENTS OF REAL ESTATE BUSINESS PLAN (L. KOWALCZYK)**

### **Abstract**

Chapter 13 presents detailed information about the real estate business plan content, which includes components of the plan, financial and strategic analysis, choice of the optimal variant, plan of realization of the chosen option etc. Author emphasized importance of financial and strategic analysis and significance of conclusions draw up.

### **13.1. THE COMPONENTS OF THE PLAN**

One shall underline that, currently, there are no regulations, which would obligatorily determine contents of the real estate business plan. The National Qualification Board, on the basis of the real estate management theory, as well as on the foreign experience, have required that candidates, applying for a real estate manager license, present business plan with the determined structure and contents, which will be discussed in the next part of the present study. One shall expect that, in spite of the change in the Real Estate Management Law in September 2007 and leaving the issue of license exams for the entities organizing post - graduate studies and to the universities organizing studies leading to Bachelor's and Master's Degree, relating to the real estate management, the idea of the business plan, its preparation, its philosophy, procedures and expectations relating to such a plan will not be altered.

One shall underline that each real estate requires drawing up, adequate only for it, business plan that would take into consideration the purposes of the owner (owners), functions, locations, market conditions, **financial situation** and overall economic environment. Due to the fact that there are different real estates, the business plans drawn up for them are different too. It results from the fact that the “philosophy” of drawing up the management plan for non-commercial real estates (housing, of public use, of special purpose) is completely different from the “philosophy” of drawing up business plans for commercial real estates, oriented for maximization of the owner's profits. Furthermore, business plans for different real estates vary, as such vary in type, location, standard, purposes of the owners and possible ways of purpose achievement. The differences are emphasized in the contents of particular parts of the business plan. They are clearly evident, visible in the course of formulating particular variants of the real estate dealings, financial analysis, ways to assess effectiveness of the suggested strategic variants and sources of financing.

The typical layout of the real estate management plan shall be as follows:

- introduction,
- basic data on the real estate
- description of the real estate market,
- financial analysis,
- strategic analysis,
- assessment of the variants of the real estate dealings,
- plan of realization of the chosen variant,
- summary and final conclusions,
- annexes.

The real estate business plan shall be drawn up in writing. It should contain such a quantity of sufficient information on the real estate, its surroundings, way of management, the manager and the chosen strategic variant, so that the expectations of the target recipient can be met. This document should be “self-sufficient” and defend itself in the case of the absence of its author during its looking over, exam and assessment. Auxiliary data, that, if needed, can be used to explain doubtful problems, may be enclosed as annexes or kept by the manager and supplied to the interested parties.

A well drawn up business plan is some kind of a showpiece certifying professional qualifications of the manager. It should be written with the assistance of typewriter or computer, supplemented with drawings,

photographs, maps and charts. The contents of the plan should be presented with the division into clearly marked and numbered chapters, in accordance with the table of contents.

The title page should contain: address and function of the real estate, data on the building lot, data on the owner, personal data on the manager (author of the study) and the date of drawing up the plan. It may also contain photography of the real estate. The real estate business plan should also contain list of the titles of particular chapters with their respective page numbers (table of contents).

Subsequently, the contents of the real estate management plan should be presented, in accordance with the layout presented above. The introduction should determine, above all, the purposes of the study and expectations of the real estate owner (owners). It can, however, indicate the strengths and weaknesses of the real estate, its opportunities and threats coming from the environment, as well as the real estate dealings that will be discussed in the further part of the study.

## **13.2. BASIC DATA ON REAL ESTATE**

The purpose of this part of a plan is to familiarize interested parties with the real estate, its technical condition, owners, users and history since its construction until the present moment. Therefore, this part of the study shall contain:

- **real estate identification** (type of the real estate, its function, address, area),
- **geodetic designation of the real estate.** One shall provide information on the precincts, number and area of the lot on which the real real estate is situated, neighbourhood and other location data. In the case when the real real estate consists of a few, geodetically separated lots, such data should be provided for each of them. On the other hand, when the real estate is a part of a greater land real estate, one should point out this fact in the description, as well as specify what part it is.
- **Legal position of the real estate.** In this point information should be provided on the present owner of the real estate. In the case of joint ownership, this information should also be provided (the shares of co-

owners may also be given). In the case of the housing community, it is recommended to provide information on the co-owners of the premises and their respective shares in the joint ownership of the real estate. If the land is subject to the perpetual usufruct, the time and conditions thereof shall be provided. In the case of non-regulated legal position information on the possessor of the real estate (or its part) should be provided. It is also recommended that history, relating to so far concluded acts of purchase and sale, be presented, if these acts refer to the described real estate. One shall also provide all the data significant for the determination of the legal position in the future, including data on the heirs, inheritance proceedings, claims regarding return of the real estate.

- **Technical condition of the real estate.** Provide the year of the construction (rebuilding, development, reconstruction, repairs) of the buildings and structures. One shall also describe the structure, basic material required for construction of particular buildings and constructions, as well as their parts (construction elements, basements, foundations, partition walls, stairs, ceilings, window and door woodwork, sanitary and electric installations, roofing, chimney conductors). The description of the premises and other components of the real estate should also be provided.
- **The way of use of the real estate.** Inform what requirements the real estate meets at present. If there are various ways of the use of the real estate. They should all be provided for, all together with the determination of extent of their use and used parts of real estate (e.g. ground floor – usable premises, other floors – living premises). In the case of the forecast change in the way of use of the real estate or its part, this information should also be given, as well as effects related and the time of its occurrence. If in the past there were changes in the way of use of the real estate, information on that should also be provided. It is also recommended to inform on what has been stipulated in the land development plan of the municipality and when the plan was drawn up. If a municipality does not have such a document, it also should be written down.
- **List of equipment** of the lot where the real estate is situated, such as: appliances of the landscape architecture (all together with quantity of objects and their description), fencing, roads, access roads, parking places (all together with types, parameters, length, diameters), equipment for children playground (all together with types, quantities and materials of which they were made), lighting and others (all together with indispensable description)

- **The documents relating to the real estate** It should be specified whether they are technical documents of the building, whether they are up-to-date, what parts they consist of, what supplements and actualization they require (if they are not complete), where they are stored and who is responsible for their storage. One shall also describe the existing documents relating to the real estate, of which the manager is aware (e.g. maps, plans, reports on land and buildings records), notaries acts, designs for buildings or others. . If the Land and Mortgage Register has been set up for the real estate, it is recommended to give its number, as well as court where it can be found. If the real estate has different Land and Mortgage Registers (besides register for the whole real estate, the real estate has Land and Mortgage Registers for particular premises or co-operative ownership rights to the premises), they should be provided for. If there is no Land and Mortgage Register, it should also be written down.
- **The investments and repairs** indispensable for keeping the real estate in non-deteriorated condition, with division into types of works and their respective costs. It is recommended that information be given on the previously conducted repairs and conservation works, as well as technical inspections (time of their conducting, costs, who conducted them, assessment of their quality). If it is necessary to conduct overhaul in the next few years, its extent and costs should be provided for. One can also provide information on the possible investments which would increase the value of the real estate, as well as their costs.
- **The users of the real estate.** In this point of the plan one shall specify who and in what way makes use of the real estate, as well as of its particular parts – whether the owners makes use of it, or whether it is subject to lease or hire. If there are, other than owners, users of the real estate, the information on them should be given, as well as it should be written down since when, on what basis and of which part of the real estate they make use. One shall also provide information on all unused premises, as well as written down since when they are unused, what reasons are for that and what the possibility of making use of them is. If new users are required for unused premises, the information on it should be provided for. It is also recommended to carry out characteristics of the persons making use of the real estate, and in particular:
  - of the way they behave, as well as correctness or incorrectness of their use of the real estate,
  - whether they perform duties relating to rent, investments and other fees

If among the users of the real estate, are such that use it incorrectly, devastate it or have arrears, this fact should be pointed out in their characteristics. Then it should also be provided for what the possibilities are to evict the current users and find new ones.

- **Information on the manager.** One shall provide their personal and identification data, name and form of business, address, since when and on what basis the current manager administrates the real estate, as well as who and on what basis managed the real estate in the past. It is also important to describe:
  - the extent of rights and responsibilities of the manager
  - the purposes and priorities of the real estate owner. In this point it should be written about the way the owner presented the expectations towards the real estate, way of its use, users, amount of profits obtained from the real estate. It is also important to provide information whether and how the owner formulated intentions concerning change in the real estate intended use as well as intentions and possibilities of investments in the real estate.
  - Potential intention and will of the owner to sell the real estate. In this case, it should be written: when, to whom, on what terms and at what price the real estate may be sold.

### **13.3. DESCRIPTION OF REAL ESTATE MARKET**

This part of the real estate business plan shall include information on a local market, competitive real estates, prospective users, sale prices, hire, lease, as well as on the managers that operate within the market. The real estate, competitive in relation to the given, is anyone comparable. The literature on this matter, distinguishes 9 basic attributes of comparability<sup>24</sup>:

- type of rights to real estate,
- form of financing,
- transaction terms,

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<sup>24</sup> Hopper A., et al.: The real estates and companies valuation, volume I Real estates estimation, Twigger SA, Warsaw, 1996, s. 86-67.



- market conditions,
- location,
- physical characteristics, economic characteristics
- use
- movable real estate belonging to the real estate.

If it is difficult to obtain information on competitive real estates, one can assume that similar real estates are competitive ones. Therefore, in this part of the drawn up document one shall present:

- **Information on the place and local real estate market** (local, number of inhabitants, basic geographical data, economic characteristics, territorial extent of the real estate market)
- **Information on competitive real estates** (their number, differences between themselves, as well as between them and the real estate under management, standard way of use, value, current rent rate and potential profits). If new real estates appear in the local market, due to investments, they also should be taken into consideration and their location, size and expected time of completion should be included.
- **Assessment of the described real estate** (in relation to others, taking into consideration technical condition, standard, way of use, incomes, operating costs per square meter of premises, possibility to sale and expected price amount.)
- **Information on prospective buyers.** One shall write down what are the possibilities of keeping present and gaining better users (tenants, lessees). One shall also provide how the change of users will influence on the future income from the real estate. If there is no possibility of gaining new users this fact shall be clearly marked and reasons thereof provided.
- **Data on the market of real estate managers** (how many of them operate, how do they manage competitive real estates, what is the extent of their services, what is their remuneration, what are the operating costs of the real estates under their management).

## 13.4. FINANCIAL ANALYSIS

Financial analysis should describe the real estate as a financial unit, that is, unit connected with incomes and costs, revenues and expenditures. It is recommended that it contain information on:

- incomes generated by a real estate and costs incurred in real estate keeping, as well as increase in incomes or reduction in costs, possible to achieve.
- Operating budget, presenting the way revenues and expenditures of operating are shaped.

**The operating budget** should take into account all the revenues generated by the real estate in a given year (sometimes divided into quarters or months resulting from the use of the real estate<sup>25</sup>). One shall also take into account the revenues independent from used premises e.g. obtained from making the walls or roof available for advertisements, making the extension terrain of the building available for parking place, etc.

This budget should also take into account all the operating expenses incurred in the operation of the real estate. These expenses are incurred for:

- utilities,
- maintenance of cleanness ,
- keeping the real estate in a good technical condition
- real estate insurance ,
- marketing,
- taxes,
- administration.

The operating budget shows results of the real estate management in the course of generating cash and making use thereof. If revenues are higher then expenditures, then the surplus of cash resources can be used for investment. In the case of lack of cash resources or their insufficient amount, the manager should come up with an idea how to obtain them from the external sources. In this case, one should prepare in addition:

- capital budget and

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<sup>25</sup>In community real estates there will be advance money for keeping real estate, in cooperatives there will be fees for the use of premises paid by its members, in commercial real estate there will be rents resulting from hire

- cash flow budget, from the overall activity including revenues and expenditures coming not only from the operating activities but also from investment and financial activities.

**The capital budget** presents, on one hand, own resources of the real estate owner, which can be spent for investments as well as resources obtained externally for investment financing (credits, loans, repair fund) and, on the other hand, expenditures incurred in investments in the real estate.

The connection of capital and operating budget and adding financial activity (crediting, repayment of the credit instalments and interests) is equal to drawing up **cash flow budget projecting the overall operating activity**, which presents the whole of revenues and expenditures relating to operation of a real estate.

If a real estate has been operating for a long time, then the budgets are presented for the past 2 (3) years so as to prepare, on the basis of data included in them (after taking into account changes occurring in the real estate environment), forecast budgets for the following years.

- Potential sources of financing . In this point of the plan one shall suggest to the real estate owner, after previous analysis and assessment of the potential sources of financing, the optimum for a given real estate. One shall take into account both own sources (profit, amortization, sale of redundant real estate, shares) and external sources of financing (credits, loans, bonds, leasing, factoring, franchising, project finance, venture capital. However, one shall remember that every way of financing has specified advantages and disadvantages. The financing from own sources gives the owner the right to all the profits and to make all the decisions, yet, in the same time it restricts investments possibilities, moreover, in the case of shares issue it means bearing additional costs and being subject to the control of the shareholders. On the other hand, external financing enables increase in the investment profitability (financial leverage), provides tax advantages (the cost of credit is the cost of getting profits) and theoretically unlimited possibilities of project financing, but in the same time it is connected with the necessity of bearing, usually high costs (interests, commissions, etc.) and the necessity to secure credits, moreover, it can result in the financial risk (**leveraged loan**).
- Current market value of the real estate (in the case of heterogeneous real estate one shall provide value of the particular parts of the real estate)
- Possible changes in the real estate value (factors that can influence the change in the real estate value, both dependent on and independent

from actions undertaken by the owners, managers or users of the real estates).

One shall add that this part of the business plan should present incomes and costs, as well as revenues and expenditures for the last year and the forecast of these positions for at least three following years. It is recommended that not only the budget for the last year be presented in this way but its realization as well.

The financial information on the real estate concerning previous years shall serve as a starting point for formulation of the economic forecasts (after taking into account changes occurring in the real estate market and its economic environment).

## 13.5. STRATEGIC ANALYSIS

The carried out analysis of the real estate, monitoring of its economic environment, analysis of its financial situation as well as purposes and expectations of the real estate owner, make the real estate manager aware of strengths and weaknesses of the real estates as well as its opportunities and threats coming from the environment. These information make it possible to choose specified strategy for real estate management.

One shall underline that in the market economy only real estates managers who choose the proper strategy are successful. To choose the proper strategy one shall previously determine possible variants of the future real estates dealing. During determination of these variants one shall remember that the question consists, mainly, in differing ways of the real estates dealings instead of little differences that can be contained in the same way of real estate use. The following examples of variants can be mentioned:

- **keeping the real estate in constant condition (that is conservative variant)** ). The extent of actions indispensable for keeping the real estate in non-deteriorated condition should be presented, as well as its costs and approximate incomes (for the next few years), the extent of indispensable construction works and repairs, its approximate costs, time of execution, and assessment of profitability. .

- **demolition of a real estate** ( reduction of the real estate value), possible land redevelopment, which is usually out of question in the case of new buildings.
- **increase in real estate value through investment**, that is e.g. through extension, reconstruction (**development variant**) . One shall write down in what the variant consists, provide the extent of actions to be taken with the aim to increase the real estate value, its operating costs and incomes (for the next few years), extent of indispensable construction, repair, investment and modernization works, approximate costs, time of execution and assessment of the profitability.

This part of the plan should also contain:

- short characteristics of variants possible to realize
- variants rejected (as well as reasons for rejection)
- recommendations for a variant that, in the opinion of the plan maker, is optimal and should be chosen for realization ( along with justification).

While characterizing possible variants of real estate dealings, one shall remember that almost all of them (development variants in particular) require determined investment expenditures. Investment in the real estate is capital expenditure, incurred with the aim of current profits, obtained from rents or dividends, as well as income, obtained upon the sale of the real estate, as a result of the increase in the real estate value. The investment is effective if the income is obtained, that is, when there is surplus of the sources generated in relations to sources invested. In addition, in the case of nonprofits investments, effective solutions are those resulting in e.g. limitations of current operating costs, improvement of the used premises, etc.

Therefore, while describing the variants of the real estates dealings one shall calculate their costs, necessary investment expenditures and expected results. One shall present forecast operating budgets, cash flow budgets, capital budgets and then conduct assessment of the investment effectiveness for each of the suggested variants of the real estate dealings.

The assessment of the investment can be conducted, as it is known, with the use of dynamic indexes (that take into consideration money changes in time) or in statistical depiction with the use of statistical indexes (calculated for a given time point).

In the case of multi annual investments, requiring huge expenditures, when the changes in money value in time occur, dynamic methods of assessment of the effectiveness shall be applied. Such assessment of the investment effectiveness

means comparisons between financial results obtained in the end of the forecast period (previous cash flows should be capitalized, through reducing the values to the last year), while making of investment decision in the present day is deemed to mean comparability of the money that will be used in the investment also in the present day, that is discounting.

Among the dynamic indexes that are used with the aim of assessment of investment effectiveness, are (precisely described in the basic bibliography):

- NPV – Net Present Value,
- Internal Return Rate (IRR)

In the case of investments which do not require huge expenditures or single undertakings (at present) simple statistical indexes are sufficient to assess their effectiveness.

Among the most popular, we can distinguish:

- return period of the incurred investment expenditures
- return rate<sup>26</sup>.

The assessment of effectiveness of investment, carried out for described variants of the real estates dealings enables choosing the optimal variant. Such variant should be recommended to the real estate owner (owners) together with the description of the way of its realization.

## **13.6. PLAN OF REALIZATION OF A CHOSEN VARIANT**

This part of the plan shall present what the real estate management will look like for a given strategic variant. It is recommended that this part contain following data.

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<sup>26</sup> Indexes used for the assessment of the investment effectiveness were described precisely in: Bryx M., et al. Introduction to the Real Estate Management. Warsaw, 2004.

**Expected real estate revenues and expenditures for a period of one or few years.** One shall present receipts and expenditures relating to the real estate for the following calendar year, with the division into particular sections.

**Forecast financial result for the managed real estate** (receipts, costs, profits, losses) for the next and following years.

**Planned repairs and investments**, to be conducted in the next and few following years (estimated costs, terms, profitability) and schedule of their realization.

**Other action plans** relating to realization of the chosen strategic variant,

**Threats to the realization of the chosen variant for the real estate management.** One shall provide, possible to predict, threats to realization of the real estate business plan in the next year and few following years, as well as ways of counteractions for the threats. It is recommended to provide approximate matter and financial effects of threats and lack of realization of a chosen strategic variant

One shall underline that in the course of the real estate management process appear many risk, which can occur during implementation of a chosen strategic variant, and even be threat to its realization. Therefore **manager should at first become aware of (recognize) risk related to realization of a chosen strategic variant and then take all the actions to minimize it.** It is extremely important to recognize risk constituting threat to a chosen strategic variant. One shall pay special attention to:

- 1) overall economic situation,
- 2) customers (demands, competencies, way of decision making),
- 3) contracting parties (designers, contractors of construction works, suppliers of building materials and utilities)
- 4) location of the real estate (neighbourhood, territorial development, park places, accesses, order of demolition, type of land, etc)
- 5) situation on the real estate market
- 6) competition
- 7) source for investments financing (debt volume, interests, possibility of loan service, lack of cash inflow).

As the risk is recognized, one shall proceed to its estimation and then forecast actions aiming to its minimization. These actions, known as risk treatments, are important part of risk management<sup>27</sup>.

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<sup>27</sup> In the literature the following stages of the risk management are described: identification, assessment, risk treatments and review, source: Jedynak P. and Szydło S.: Risk management, Ossolineum, Wrocław, 1997, page 11.

There are various ways of risk treatments. The most popular are:

- 1) risk avoidance
- 2) risk prevention
- 3) risk retention.

Risk avoidance occurs when the real estate owner (or manager on behalf thereof) does not take any actions because they consider this risk too big.

Risk prevention methods may include actions aiming at prevention of the random event or making their occurrence impossible. They might consists in:

- proper choice of the real estate location
- proper choice of contractors of constructions and assembly works executed within
- the real estate
- proper choice of the real estate users
- fixing the proper contractual clauses
- safeguard of the cash inflow.

The basic methods of the risk retention are self insurance and insurance. Self insurance consists, above all, in gathering own resources, aimed to cover potential losses. Other risk retention method is insurance. In this case, through paying insurance premium, the responsibility for potential losses resulted from random events is transferred to the insurer.

Beyond mentioned methods of risk management, one can consider also:

- risk transfer to entities different than the owner (it occurs in the case of factoring) ,
- risk division (in the case of finding a partner)
- risk compensation (taking such actions which, beyond losses, generate profit that can cover losses incurred,
- repressive methods (consisting in reduction of the extent and meaning of losses previously occurred).



## **13.7. PLAN SUMMARY AND FINAL CONCLUSIONS**

In the summary one shall write down whether and how the real estate manager or way of real estate management influence real estate condition, choice of the variant of the real estate dealings, as well as costs and expenditures related to the real estate.

The summary should also include assessment of the quality of the service and manager's remuneration in relation to competitive companies. It is also recommended that effects of the manager's work be assessed, taking into consideration changes in the real estate value. In this part of the plan one can in addition underline risk related to the chosen strategic way of real estate management. It is good to show defects and failures of the report (inform what was omitted, show information shortage and difficulties in getting to the source materials)

To sum up, in this part of the report one shall present, in a syntactical form, significant information on the presented real estate business plan.

## **13.8. ANNEXES**

A coherent way of the presentation of the real estate business plan does make allowance for many calculations, detailed information and documents (being on the basis of the report), which could make it little eligible. Therefore they are enclosed to the real estate business plan as annexes.

The documents enclosed to report as annexes are the following:

- notarial act ,
- extract from the Land and Mortgage Register
- land register statement,
- building register statement

- copies of the agreements and basic technical documentation
- cost estimation
- appraisal report
- results of the analysis of the chosen real estate market segment
- results of the competition analysis
- maps,
- drawings
- plans,
- photography of the real estate.

# **CHAPTER 14**

## **EXEMPLARY MIXED- USE PROPERTY MANAGEMENT PLAN (U. SŁOWIK)**

### **Abstract**

In the Chapter 14 mixed- use property management plan is described. Plan has a form of step by step instruction, which reflects property management plans prepared by property managers. Reader has an access and can monitor all issues and dilemmas connected with property management presented in this case study. Among others it includes aims of the management plan and owners expectations, basic information about the property and strategic options evaluation.

### **14.1. INTRODUCTION- AIMS OF THE MANAGEMENT PLAN AND OWNERS EXPECTATIONS**

Property management plan is a tool created for the owners, who tend to maximize potential profits. Attractive location of the real estate, as well as good technical condition allows owner to expect that demand for the space in his property will be significant.

Possible options of property conservation, general overhauls and modernisation:

- Conservation- renovation plan, which aim is to keep property in the not deteriorated shape, as well as rents and building worth on the possibly high level.
- Conservation and renovation is conducted from the owner's own expenses and rent income.

**Option I**

- Overhaul- modernisation plan to raise attractiveness and standard of property, which leads to growth of income and property value. Plan will be conducted from owner's expenses and rents income.

**Option II**

- Plan as presented above plus a loft conversion into a high standard apartment.
- Works will be carried out from the owner's expenses and rents.

**Option III**

## **14.2. BASIC INFORMATION ABOUT THE PROPERTY**

### **Law status**

Real estate from our example is a developed plot of land number 126, area of 743 sq m, apartment building localized at the address 38 Karmelicka Street, Kraków. Property has a land and mortgage book number 4148 Piasek Kraków, City Centre area. According to land and mortgage register property owners are:

- **Owner I** of 1/12,
- **Owner II** of 1/12,
- **Owner III** of 1/12,
- **Owner IV** of 1/3,
- **Owner V** of 1/36,
- **Owner VI** of 1/18,
- **Owner VI** of 1/3 (owner of apartment number 5)

According to C LWH 423 card and part III and IV land and mortgage book nr 4148 Kraków Piasek City Centre there are no liabilities (such as mortgage) on the property.

It is important to stress out that only one apartment in the whole building (apartment number 7) has a separate land and mortgage book 138860, District Court Kraków Podgórze Land and Mortgage books department.

It is indicated in part II of land and mortgage book nr 138860 that Owner VI is the only person who has rights to the apartment number 7 and that the apartment is free from any liabilities, including mortgage.

There is information in part III of land and mortgage book nr 4148 Kraków Piasek City Centre that all owners manage the building together.

Owners specified responsibilities and rights to occupy and use commercial space and apartments.

### **General location**

Real estate is located in the Krakow city centre, in an Old Town district, Karmelicka Street. It is historical part of the city, with many monumental buildings. Property offers easy and fast access to the theatres, cinemas, exhibitions, galleries and museums.

Street was recently modernized which has an influence of its commercial attractiveness. Vehicular traffic is restricted in this area, which definitely creates a positive environment for pedestrians.

Dunajewska, Karmelicka and Podwale Street junction is a place where buses and trams depart in almost every possible direction. It is very important and valuable feature of property, especially in case of running a business.

Real estate is being used according to spatial development plan for Krakow, which was approved by the resolution nr VII/58/94 on 16<sup>th</sup> November 1994 by the City Council.

This part of town is regarded as housing and services district, with high buildings and it is surrounded by the similar districts. Near by a green city area is located. Spatial development plan does not include any functional changes in this area.

### **Location details**

Building was developer at the beginning of XX century. Unfortunately it is not possible to specify a year, while whole documentations is missing, and people able to answer the question already passed away. Property is not protected by the monuments conservator. Building is located among other buildings, most of them are mixed- use developments.

The building is heading Karmelicka Street and it is located between similar buildings. On the back of the building there is a backyard and a small garden. Entrance to the backyard from the street is impossible while entrance gate was transformed into commercial local during the 20s of the last century. Also entrance form the back is not possible also, while there is another property located close to it. It means that parking a car is difficult.

The building is shaped into a letter L, with 4 floors and an attic, which is currently not used, also there is a cellar. Up front, on the ground floor three small commercial locals situated. On the back there is an apartment. On the 1,2<sup>nd</sup> and 3<sup>rd</sup> floor there are apartments only. The building has two staircases, front staircase (nr 1) and back stairway used before by the servants, currently not used by anyone (nr 2).

### **Technical condition of the building**

Property was built from bricks, rocks and bricks foundation. General technical condition of the building is good. Detailed inspection showed:

- **Foundation-** rock and bricks. Protection against dampness- good condition.
- **Cellar walls**– made from pieces of stone and bricks.  
Inside and outside walls are 45 cm thick. Inside walls are partly covered (from 60cm to full height of the wall) with concrete which is 10 cm thick.  
Cellar height differs- from 1, 80 to 2,05meter. Part of walls are plastered, floor is made from the concrete. Walls are in the good condition. No damages and signs of dampness were affirmed.
- **Ceiling in the cellar** – it is a Klein, beams every 1,10m. Ceiling in a good shape. No signs of overloading were spotted.
- **Ceiling of the 1st, 2nd and 3 rd floor-** regular wooden ceiling.

- **Outside walls-** made from bricks, thickness 45cm. Condition of outside walls- good. Outside plaster layer requires renovation and painting.
- **Inside construction walls-** made from bricks, thickness 45cm. Walls vertical and in the good condition. Plastering- concrete and limestone- good condition.
- Inside partition walls- bricks and concrete- limestone mortar, thickens- 12cm. Vertical walls. Plastering- concrete and limestone, good condition.
- Roof construction and roofing- the building is covered with double slope roof, 30° gradient. Small repairs and chimneys modernization is required.
- Staircase- concrete stairs covered with wood in a medium condition requires modernisation. Necessary staircase painting and plaster replacement.
- **Building installations:**
  - Wiring- replaced in 1997, copper wires, automatic fuses, yearly inspections, good condition.
  - **Gas** – replaced in 1998. Building has an access to the city gas network, main safety valve situated outside the building (according to regulations). Condition- good.
  - Water supply system- access to the city water network, main valve and water meter- in the cellar, valves are also located by every apartment- medium condition of the whole installation.
  - **Sewage system** – sewage from each apartment goes thru cast iron pipes to the main catch pit. Medium condition of the whole sewage installation.
  - Central heating- replaced in 2000. Copper pipes, gas heating, heaters with valves in each apartment. Condition- good.

The property has also access to the telephone installations- Polish Telephony Plc. and lightning conductors on the roof in the very good shape. Currently there is no cable and internet network access.

### **Technical issues**

**Usage grad is being calculated on the basis of the following formula:**

$$S_z = A_i \times S_{z_i} / 100$$

Where:

$A_i$  – share of each element in the building total development cost in %

$Sz_i$  – % of each element usage level

**Table 14.1.**

Average grade of the buildings wear and ear level

Name of the element	$A_i$ [%]	$Sz_i$ [%]	$A_i \times Sz_i / 100$ [%]
Foundations	19	15	2,85
Walls and partition walls	14	15	2,1
Ceilings	8	40	3,2
Stairs	4	30	1,2
Roof	10	25	2,5
Floors	9	15	1,35
Inside plaster and painting	4	45	1,8
Elevation, outside works	6	40	2,4
Widmows and floors	8	60	4,8
Sewage system	3	60	1,8
Water supply system	2	5	0,1
Central heating	5	2	0,1
Gas installation	3	4	0,12
Wiring	5	5	0,25
Sum	100		<b>24,57</b>

The building's usage level is described as a 25%. Although the property was developer over 100 years ago it is still in the good technical condition, thanks to systematic preservation and overhaul works.

### Real estate characteristics

The building is used for housing needs- 4 apartments and services- 3 premises.

Data:

Plot	743 sq m
Development	264 sq m
Backyard	479 sq m
Total capacity	4125 cubic m
Total space	864,6 sq m



Housing (4 apartments)	391,2 sq m
Services (3 premises)	64,1 sq m
Ceilings and stairways	295,7 sq m
Attic	113,6 sq m
Number of floors	4
Number of staircases	2

Specification of apartments and commercial space, Figure 14.2.

**Table 14.2.**

Apartments and service premises space in square

Story/ floor	Floor space in sq m	Number of fleet or shop	Space of the fleet or shop
Ground floor	114	1	23,1
		2	22,2
		3	18,8
		4	49,9
I floor	138,5	5	108,5
II floor	148,1	6	108,1
III floor	154,7	7	134,7
Attic	113,6		
Ceiling	76,6		
Staircase	119,1		

The building has the following installations: electric, gas, telephone, water-sewage and central heating. Building's construction:

- Foundations- stone and bricks, limestone
- Construction system of the supporting walls– crosswise
- Construction walls of over ground floor- bricks and cement-limestone mortar
- Cellar walls- stone and bricks
- Outside walls- bricks with cement- limestone mortar, 45 cm thick.
- Partition walls – bricks
- Ceiling over the cellar- light Klein plate
- Ceilings over ground floors- wooden with cement- limestone plaster.
- Roof – zinc metal sheets
- Stairs- concrete, wooden lining

- Outside plastering- - cement and limestone
- Windows and doors- woodwork

### **Technical Documentation**

Original technical documentation of the building is missing since the II World War. Documents are being recreated step by step after each modernization.

Available documents:

- Copies from the land and mortgage book.
- Plan of central heating installation
- Plan of gas installation
- Plan of electricity wiring
- Building usage acceptance documents
- Property technical book
- Floor plans
- Documents regarding legal situation of the apartment number 7
- Protocols of technical inspections

All documents holds the Owner number VI.

### **Development and use of property**

Land is developed with 4- floor building, with a cellar and an attic. There is no parking space and possibility to drive and park in the backyard. Total area of a building is 864, 6 sq m., whereas 391, 2 sq m is an apartment space, 64, 1 sq m is a commercial space. Detailed space specification is presented below, character nr 21.3

**Table 14.3.**

Detailed about the space

Floor	Apt. Or commercial space number	Space in sq m	Function	Description
Ground floor	1	23,1	Service and commercial area	Customer service point – mobile phones
	2	22,2	Service and commercial area	Cosmetic shop

	3	18,8	Service and commercial area	Clothing shop
	4	49,9	Residential area	Rented apartment
I floor	5	108,5	Residential area	Owner occupied apartment
II floor	6	108,1	Residential area	Rented apartment
III floor	7	124,7	Residential area	Owner occupied apartment

Currently all apartments and commercial space are occupied. Commercial space renting brings profits. Rent and payment for the media provided are paid on the regular basis, small delays are not causing any threat to the buildings operations and profit level for the owners.

### Details of required modernisation

In order to keep the property in the not deteriorated technical condition modernizations 2006-2010 are required:

- Stairway number I painting
- Elevation renovation
- Renovation of the stairway floor
- Replacement of gutters
- Renovation of the chimneys

To increase property's value following renovations are required:

- Front door replacement
- Elevation renovation and painting
- Windows replacement
- Loft conversion
- Renovation and modernization of apartments, which will increase the standard of living.

### Property management policy

According to chapter III of land and mortgage register book number 4148, Kraków Piasek, City Centre district, property is managed by the owners. Practically Owner VI has the biggest contribution to the property management. But his performance is mostly limited to the operational functions. Investments

decisions and decisions about choosing general contractor are made by all co-owners of the property.

### **Summary and Conclusions**

- Analyzed property is located in Kraków, in the city centre, Old City district.
- It is a residential and commercial space building
- Total area of a building is 864,6 sq m, apartments- 391,2 sq m, commercial space 64,1 sq m
- General technical condition of the real estate is good, but renovation and modernisation of some of the elements is highly recommended.
- All commercial space is rented on the basis of market process, as well as two apartments, remaining two apartments are owner- occupied.
- Excellent location of the property is a main advantage.
- No parking space and no possibility to drive and park in the backyard, as well as restrictions related to the location in the Zone B are inconveniences.

## **14.3. REAL ESTATE MARKET ANALYSIS**

### **Description of the market**

Analyzed property is located in Kraków, which is a capital of Małopolska and the biggest city in the region. It is an administrative centre, as well as economic, cultural and science in the South Poland. It is also a historical city, listed by UNESCO in 1978- World Heritage.

Kraków has an advantageous location in terms of transportation. To international roads- E77 North- South and E40 West-East are crossing each other in Krakow. There is a motorway from Kraków, which will be in the future a part of international motorway Brussels- Kiev. Transportation net is completed by national roads leading to various directions.

Weak point is a lack complex system of ring roads, and huge part of transit goes thru the city. Works in that field are performed and ideally transit thru the city

will be eliminated. Kraków has an air connection with the biggest European airports, as well as with the rest of the world. Also railways net lead from the city to other locations in Poland as well as in other countries. Kraków area is approximately 326, 8 sq km, 740 thousand citizens. About 60% of Kraków population are people in the production age. Unemployment rate is relatively low, purchase power is comparatively high. There is a positive business atmosphere in Kraków. Special Economic Zone is located here. Financial market is well established. There are 32 banks within the city range, 4 of them have their headquarters here, also 8 brokerage houses and about 200 consulting agencies are located in Kraków.

It is important to stress out that Old City district is especially attractive for business activities. One of reason for that is a prestigious location, other number of tourists and residents, who often visit theatres, cinemas, restaurants and pubs in this area.

Therefore real estate prices in Kraków are relatively high. Properties in this city are concerned as a fruitful form of investment.

Spatial range of tenement house by the Karmelicka 38 Street is being appointed by taking into consideration the following factors:

- Type of property: mixed- use in the Old City area
- Developed- between XIX and XX century
- Transpiration
- Accessibility to the commercial area, schools, hospitals etc.
- Ownership structure- private buildings and communities.

### **Clients- needs, preferences, inclinations**

Described real estate is a mixed-use property. There are a number of similar properties in the close neighbourhood.

Potential apartment occupiers are considering following factors:

- Attractive location, which means location close to the city centre, but on the side street- lower noise level.
- Nearness of green sites
- Full range of services located relatively near
- Easy and convenient access to the Health-care institutions, research and cultural institutions, as well as recreation and sport facilities.
- Transport accessibility- by car and public transpiration.
- Garage access or parking space availability.

- Good technical condition and interior decor of the apartment.

Analysed property offers wide range of renting solutions from services, trade to office. Commercial space occupiers will be mostly interested in:

- Prestigious location
- Quite significant pedestrians traffic- potential customers passing by each day (the city centre, easy access thru the public transportation).
- Easy access thru car and parking place closeness
- Possibility to adjust and arrange the rented space to fulfil occupiers' needs by: additional phone lines activation and internet access, etc.
- Good technical condition and interior decor of the rented space.

Also all occupiers consider rent level and operating costs as highly important. It is important to mention that property requires further investments in order to maintain completeness on the market.

### **Competition**

Group of potentially competitive properties, in terms of functions, location and characteristics is relatively high. Like private owned prosperities, developed between XIX and XX century, in a good technical condition, located in the neighbourhood- streets of similar attractiveness (Podwale, Zwierzyńska, Straszewskiego etc.).

In the close distance from the Karmelicka property there are buildings, which have similar features. Buildings exteriors are similar, but after elevation modernization property will differ from the other ones.

In each property ground floor level is designated for commercial space- such as shops (clothing, cosmetics, home electronics, book stores, restaurants, etc), starting from 20 to over 100 sq m space.

### **Analysis of similar properties**

Analysed mixed- use properties have similar characteristics to Karmelicka street property and are localised in the limits of local real estate market.

## Residential properties

Aim of the analysis is to find out whether real estate market characteristics contribute to income increase, before as well as after modernization and redecoration- which obviously leads to a standard increase.

**Table 14.4.**

Rent paid for a similar standard apartment

Feature	Property considered	Similar apartments			
		1	2	3	4
Overall location	Old Town	Old Town	Old Town	Old Town	Old Town
Specific location	Karmelicka Street	Podwale Street	Zwierzyniecka Street	Piłsudskiego Street	Dunajewskiego Street
Use	Apartment	Apartment	Apartment	Apartment	Apartment
Space in sq m	108,1	129,3	150,46	132	116,5
Date of market examination	III 2006	III 2006	III 2006	III 2006	III 2006
Legal status	Lease	Lease	Lease	Lease	Lease
Fitting	Full	Full	Full	Full	Full
Technical condition	Good	Average	Good	Average	Average
Road access	Good	Average	Good	Good	Average
Rent / sq m	18,9 PLN	19,4 PLN	22,0 PLN	24,2 PLN	17,2 PLN
Average market rent		20,70 PLN			

Above presented tables, in comparison with competitive properties, indicate that current rent levels are not high.

In relation with planned redecoration and modernization and loft conversion analysis, of rents level of similar apartments, was conducted.

**Table 14.5.**

Rent level, good standard apartments (Option II, apartments)

Characteristics	Property considered	Similar apartments			
		1	2	3	4
Overall location	Old Town	Old Town	Old Town	Old Town	Old Town
Specific location	Karmelicka Street	Podwale Street	Zwierzyniecka Street	Piłsudskiego Street	Dunajewskiego Street
Use	Apartment	Apartment	Apartment	Apartment	Apartment
Space in sq m	100	85	76	82	71
Date of market examination	III 2006	III 2006	III 2006	III 2006	III 2006
Legal status	Lease	Lease	Lease	Lease	Lease
Fitting	Full	Full	Full	Full	Full
Technical condition	Very good	Very good	Very good	Very good	Very good
Road access	Good	Average	Good	Good	Average
Access to the public transportation	Very good	Very good	Very good	Very good	Very good
Rent / sq m	?	29,4 zł	31,6 zł	32,9 zł	28,2 zł
Average market rent		30,5 zł			

**Commercial use properties**

City centre is a place where many commercial use properties are located, offices as well as shops and restaurants. It is extremely prestigious location with the intense pedestrians' traffic, which is an advantage for any type of commercial activities.

High and medium standard properties are located here. Survey concerning rent level of similar commercial space was conducted. Good standard properties prices will be presented first (Variant I), then high standard (Variant II)

**Table 14.6.**

Rent prices for commercial space, good/ average standard (Option I)

Characteristics	Similar apartments			
General location	Karmelicka Street	Podwale Street	Zwierzyniecka Street	Piłsudskiego Street



Specific location	Examined property	Property 1	Property 2	Property 3
Floor	Ground floor	Ground floor	Ground floor	Ground floor
Legal status	Rented	Rented	Rented	Rented
Fitting	Full	Full	Full	Full
Technical condition	Good	Good	Good	Good
Access / parking	Good	Good	Good	Good
Space specification	Commercial space	Commercial space	Commercial space	Commercial space
Space [m <sup>2</sup> ]	18,8	23,6	20,1	18,5
Last examination	III 2006	III 2006	III 2006	III 2006
Rent rate	61,20 zł	65,70 zł	57,20 zł	59,50 zł
Average rent rate/ per month		<b>60,80 zł</b>		

**Table 14.7.**

Rent rates for commercial space, high standard (Option II)

Characteristics	Similar apartments			
General location	Karmelicka Street	Podwale Street	Zwierzyniecka Street	Piłsudskiego Street
Specific location	Examined property	Property 1	Property 2	Property 3
Floor	Ground floor	Ground floor	Ground floor	Ground floor
Legal status	Rented	Rented	Rented	Rented
Fitting	Full	Full	Full	Full
Technical condition	Very Good	Very Good	Very Good	Very Good
Access / parking	Good	Good	Good	Good
Space specification	Commercial space	Commercial space	Commercial space	Commercial space
Space [m <sup>2</sup> ]	18,8	25,6	29,4	21,8
Last examination	III 2006	III 2006	III 2006	III 2006
Rent rate	?	97,65 zł	85,10 zł	91,70 zł
Average rent rate/ per month		<b>91,48 zł</b>		

In case of commercial space renting it is likely to receive (without media charges) about 91,5 PLN for a square meter in this area. It is necessary to emphasize that small space premises were taken into consideration. Rate per square meter is usually higher in case of small premises than a large space.

### **Summary and conclusions**

- Researched property is localised in the central district of Kraków, which is considered as attractive for commercial space and apartment's occupiers.
- There are many similar and competitive properties in the close distance to researched real estate.
- Analysis of similar residential properties shows that Karmelicka street property has a certain advantage over the competition, which is a good technical condition and favourable relation of property's attractiveness to the rent.
- Car accessibility as well as parking on the premises is limited, which has a negative influence on business and housing. Although there is an attended parking car park (150 parking places) in the close distance from the property.
- Standard increase will enable raise of rent level.

## **14.4. CURRENT FINANCIAL ANALYSIS**

### **Income and costs**

Real estate gains an income form the following sources:

- Commercial space renting, 64,1 square meter,
- Second floor apartment renting, 108,1 square meter and ground floor apartment, 49,9 square meter.

Additionally property owners pay an advance to cover costs of the common space management and renovation fund, which is 3,27 PLN per square meter. Occupiers are responsible for individual payments for media (water, electricity etc.) provided to each apartment.

**Table 14.8.**

Elements of the exploit costs and renovation found advance in 2005

Advance for renovation and exploitation in 2005	Rate sq m	Calculation base sq m	Monthly	Annual
Exploitation costs:				
Cleaning	0,60 zł	864,6	518,76 zł	6 225,12 zł
Renovation fund	1,00 zł	864,6	864,60 zł	10 375,20 zł
Cost of media/ common area	0,65 zł	195,7	127,21 zł	1 526,46 zł
Others	0,10 zł	864,6	86,46 zł	1 037,52 zł
Management costs	0,50 zł	864,6	432,30 zł	5 187,60 zł
Insurance	0,30 zł	864,6	259,38 zł	3 112,56 zł
Proport tax	0,12 zł	864,6	103,75 zł	1 245,02 zł
<b>Sum</b>	<b>3,27 zł</b>		<b>2 392,46 zł</b>	<b>28 709,48 zł</b>

**Table 14.9.**

Rent level in 2005-commercial space

Space sq m	Rate per sq m
<b>23,1</b>	65,00 zł
<b>22,2</b>	63,10 zł
<b>18,8</b>	61,20 zł
<b>Average rate per sq m</b>	<b>63,10 zł</b>

**Table 14.10.**

Income in 2005

Income	Space in sq m	Average rent per sq m	Monthly income	Yearly income
Rent income from the commercial space	64,1	63,10 PLN	4 044,71 PLN	48 536,52 PLN
Income from renting apartment on the second floor	108,1	18,90 PLN	2 043,09 PLN	24 517,08 PLN

Income from renting apartment on the ground floor	49,9	20,00 PLN	998,00 PLN	11 976,00 PLN
Sum				85 029,60 PLN

**Table 14.11.**

Costs in 2005

Common space costs in 2005	
Costs	Owner costs
Current exploitation costs	9 290,28 zł
Energy	844,21 zł
Cleaning	6 825,12 zł
Insurance	3 059,45 zł
Technical inspections	899,60 zł
Small repairs	3 067,45 zł
Intercom conservation	341,39 zł
Property tax	1 212,20 zł
Property manager salary	3 112,56 zł
Sum	<b>28 652,26 zł</b>

**Opportunities for income increase and costs decrease**

- 1) Property can generate higher income if:
- 2) the building will be modernized and renovated
- 3) there will be a loft conversion into an apartment, and then it will be rented or sold.
- 4) commercial space will be modernized and renovated, and then rented for a higher rate.
- 5) current repairs and conservation will be regularly carried out to maintain property's standard
  - a) there will be efficient costs management
  - b) In the future most probably significant expenditures on modernization and renovation will be required.

### **Potencial Finance sources**

So far all investments were conducted from owners' expenses, current renovation found or profit generated by the property. It is likely that these means will not be sufficient. In such a case mortgage seems to be a reasonable solution.

### **Property appraisal**

For the purpose of the analysis it is agreed that property's market value is equal to the sum of all apartments and commercial space worth.

Value of the commercial space and apartments was estimated by income approach, investment method, and capitalization technique.

Choice of the appraisal method results from the fact that property generates income. It is also important that very seldom ownership rights to this kind of property are sold/transferred on the market. Average income was calculated on the basis of rent rates already paid by the occupiers.

Also owner occupied apartments were appraised by the use of this, because potentially they can generate a profit. Capitalization rate was specified by the use of market method.

### **Commercial space value**

Value of the commercial space and the apartments was estimated by the income method, simple capitalization technique. Choice of this specific method results from the fact that commercial premises and one apartment generate an income, other apartments potentially can bring profit if rented, usually this kind of apartments are not sold on the market but rent.

To specify capitalization rate market date was used and also information about annual net income from the rented premises. Value of the usable area was calculated on the basis of current rents. Following formula was used:

$$W = \frac{D}{R_0}$$

Where:

$W$  – property value,

$D$  – net operating income / earning before interest and taxation,

$R_0$  – general capitalization rate.

Possible to generate income from each rented premise is considered as each owner profit. General capitalization rate relates to the profit rate expected by the investor. If we know sale price or value of similar properties and income generated by them, we are able to calculate capitalization rate by the formula  $R=D/W$ . To sum up capitalization rate should correspond to an average capitalization rate of similar properties, described by price/ value to income rate. Data considering income come from the occupiers and owners.

**Table 14.12.**

Data necessary to calculated average capitalization rate for the commercial space

Characteristics	Similar properties		
Value ( $W_i$ )	188 013,33 PLN	147 103,62 PLN	142 855,66 PLN
General location	Old Town	Old Town	Old Town
Detailed location	Podwale Street	Zwierzyniecka Street	Piłsudskiego Street
Use	Retail	Retail- services	Retail
Yearly income( $D_i$ )	16 921,20 PLN	12 503,81 PLN	11 857,02 PLN
Capitalization rate $R_i = (D_i; W_i) \times 100\%$	9,00%	8,50%	8,30%
Average capitalization rate	8,60%		

**Average market capitalization rate  $R_r$  calculated as:**

$$R_r = \frac{\sum_{i=1}^n R_i}{n}$$

where:

$R_i$  – capitalization rate of described as „i” property,

$n$  - number of compared properties,

$R_r$  – capitalization rate of the researched property.

$$R_r = \frac{9\% + 8,5\% + 9\% + 8\%}{4} = 8,63\%$$

Capitalization rate was set at 9%.

2005 annual net operational income from the commercial space renting is described by the following factors:

Commercial space:	64,1 square meter
Average monthly rent per square meter	63,10 PLN
Annual income:	48 536,52 PLN
Monthly income (rent):	4044,71 PLN
Annual income (rent):	
4044,71 PLN x 12 =	48 536,52 PLN
Monthly operating cost (commercial space):	408,32 PLN
Annual operating costs:	4 899,80 PLN
Annual net operating income:	
48 536,52 PLN – 4 899,80 PLN =	43 636,72 PLN

$$D_R = 43\,636,72 \text{ PLN}$$

There was no loss caused by difficulties with renting a space or rent payment arrears.

Income value of the commercial space in the current technical condition is 484 852, 40 PLN, estimated by the following formula:

$$W = \frac{D_r}{R_i} = \frac{43\,636,72 \text{ PLN}}{9\%} = 484\,852,40 \text{ PLN}$$

### Apartment's value

Capitalization rate was estimated on the basis of the following market data:

**Table 14.13.**

Apartments capitalization rate calculation

Characteristics	Similar properties			
Value ( $W_i$ ) [PLN]	419 949,44	534 263,32	422 738,04	331 033,71
General location		Old Town	Old Town	Old Town
Detailed location	Podwale Street	Zwierzyniecka Street	Piłsudskieg Street	Dunajewskiego Street
Use	Apartment	Apartment	Apartment	Apartment

Yearly income (D <sub>i</sub> ) [PLN]	25 616,92	33 925,72	33 649,95	20 424,78
Capitalization rate $R_i = (D_i/W_i) \times 100\%$	6,10%	6,35%	7,96%	6,17%
Average capitalization rate	6,65%			

For the calculation purposes capitalization rate was set as 7%.

In 2005 potential annual net operating income generated by the apartments was shaped by the following factors:

All apartments space: 491,2 square meters

Potential yearly income (formula presented in the table below):

89 382,84 PLN

Monthly exploitation costs: 1 979,37 PLN

Yearly exploitation costs: 23 752,46 PLN

Potential annual net operating income:

89 382, 84 PLN – 23 752, 46 PLN= 65 630,38 PLN

$$D_R = 65\,630,38\text{ PLN}$$

Income value of all apartments in the current technical condition amounts 937 576, 86 PLN and was calculated by the following formula:

$$W = \frac{D_r}{R_i} = \frac{65\,630,38\text{ PLN}}{7\%} = 937\,576,86\text{ PLN}$$

**Table 14.14.**

Potential income from apartments renting in 2005

Income	Space in sq m	Rent rate per sq m	Monthly income	Yearly income
Potential income from renting the ground floor apartment	49,9	20,00 PLN	998,00 PLN	11 976,00 PLN
Potential income from rating the apartment on the first floor	108,5	18,90 PLN	2 050,65 PLN	24 607,80 PLN
Income from renting apartment on the second floor	108,1	18,90 PLN	2 043,09 PLN	24 517,08 PLN



Potential income from renting apartment on the third floor	124,7	18,90 PLN	2 356,83 PLN	28 281,96 PLN
Sum of potential income				<b>89 382,84 PLN</b>

Income value of the whole property is equal with sum of the value of all commercial space and apartments

Income value of the commercial space:	484 852, 40 PLN
Income value of the apartments:	937 576, 86 PL
Income value of the entire property is:	1 422 429, 3 PLN
Market value of the entire property in the current technical condition was estimated as:	1 422 429 PLN

### Summary and conclusions

- Karmelica street property was developed in the beginning of XX century.
- Property generates income: two apartments and three commercial premises are rented.
- Real estate costs management is rational.
- There is a possibility of gaining higher income if:
  - Renovation and modernization will be conducted
  - Loft will be renovated and converted into an apartment.
- Renovation and modernization can be financed by the owners from their own expenses accounts, rents and mortgage.
- Real estate value in the current technical condition amounts **1 422 429 PLN**

## 14.5. STRATEGIC ANALYSIS

### Property strengths

- Prestigious location
- Close distance to the city centre
- Easy access to the public transport.

- Karmelicka street parking lot for about 180 cars.
- Walking distance to the park (Planty Krakowskie)
- Two staircases enable to divide bigger apartments to smaller ones with separate entrances.
- Attractive rent rates
- High demand for properties in this area
- High potential income
- Developed backyard
- Garden
- No conflicts of interests between current owners
- Planned renovation and modernization.
- Possibility to finance the investment from owners own expenses.

### **Opportunities**

- Economic growth of the city and region.
- Small number of new buildings in this area of the city
- Possibility to find new occupiers

### **Weaknesses**

- No parking space.
- Limited car accessibility.
- No car entrance to the backyard.
- Stairway requires renovation.
- No elevator.
- Significant number of competitive properties.
- Occupier who missed rent payment.
- Property renovation requires a significant amount of money.

### **Threats**

- Increased difficulties for car drivers- car access restrictions.
- Cadastre tax
- Decrease of demand for apartments in the old buildings.
- Rent rate decrease caused by many similar properties being offered on the market.
- Changes in law.
- Media prices change

- Potential conflict between the owners.

### Procedures description

For the analysis purposes three options are considered for the period 2006-2010:

- **Option I** (conservative approach) - aim of this approach is to maintain property in the current condition and maintain its market value.
- **Option II and Option III** – development variants, which aim is value and income growth.

### Option I

Basic assumptions:

- Renovation and modernization of the property, technical inspection according to Construction Law.
- Renovation of the outside elevation
- Staircases painting
- Staircases floor renovation
- Plumbing renovation
- Fences painting
- Part of gutters replacement
- Renovation will take place between 2006-2010
- Work will be financed from renovation found
- Yearly 6% rent increase is planned. Aim is to reach following rent level:

**Table 14.15.**

Forecasted rent rates (Option I)

	Space in sq m	Rent rate per sq m [PLN] in:					
		2005	2006	2007	2008	2009	2010
Apartment on the ground floor	49,9	20,00	21,20	22,47	23,82	25,25	26,76
Apartment on the second floor	108,1	18,90	20,03	21,24	22,51	23,86	25,29
Commercial space 1	23,1	65,00	68,90	73,03	77,42	82,06	86,98
Commercial space 2	22,2	63,10	66,89	70,90	75,15	79,66	84,44

<b>Commercial space 3</b>	18,8	61,20	64,87	68,76	72,89	77,26	81,90
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Operational costs will increase 6% yearly (property tax increase, higher costs of current repairs). Money advance to cover operational costs will increase 6% yearly, and according to owners agreement advance will be as follows:

	2006	2007	2008	2009	2010
<b>Advance for the renovation fund</b>	1,06 PLN	3,73 PLN	2,20 PLN	0,30 PLN	0,60 PLN

**Table 14.16.**

Renovation works schedule Option I

Details	Prognosis [PLN] in:				
	2006	2007	2008	2009	2010
Renovation fund	10 997,71	38 699,50	22 825,44	3 112,56	6 225,12
Renovation of plumbing installation		37 599,50			
Replacement of gutters	2 850,00				
Modernization of elevation			21 615,44		
Stairways painting	4 820,00				
Stairway floor renovation	1 660,12				
Chimneys renovation					4410,12
Replacement of internal doors				1660,56	
Fence painting	667,59				
Other unplanned expenses	1 000,00	1 100,00	1 210,00	1 452,00	1 815,00
<b>Sum</b>	<b>10 997,71</b>	<b>38 699,50</b>	<b>22 825,44</b>	<b>3 112,56</b>	<b>6 225,12</b>
Sum of renovation expenses in 2006-2010	81 860,33				

**Option II**

Assumptions:

- Renovation works planned in the Option I are essential, but schedule needs to be modified-
- Floor of both staircases requires renovation.
- To increase property attractiveness and competitiveness following renovation and modernization works are required:
  - Renovation of the front side elevation.
  - Windows replacement where required.
  - Door replacement (front and annex door)
  - Modernization of the commercial space (floor, walls), functional improvement- additional telephone lines, internet connection and so on.
  - Bathroom renovation in the rented apartment.

Works will be financed from owners own expenses and rents. Due to higher standard rents will be increased by:

Commercial space- 12,5%; 11%; 26%; 10%; 9% each year  
 Apartments- 15%;15%; 10%; 8%; 8% each year

**Table 14.17.**

Planned rent rates (Option II)

Space specification	Space in sq m	Rent rate per sq m [PLN] in:					
		2005	2006	2007	2008	2009	2010
<b>Rent increase</b>			15,00%	15,00 %	10,00 %	8,00%	8,00%
<b>Apartment on the ground floor</b>	49,9	20,00	23,00	26,45	29,10	31,42	33,94
<b>Apartment on the second floor</b>	108,1	18,90	21,74 zł	25,00	27,49	29,69	32,07
<b>Rent increase</b>			12,50%	11,00 %	26,00 %	10,00 %	9,00%
<b>Commercial space 1</b>	23,1	65,00	73,13	81,17	102,2	112,5	122,6
<b>Commercial space 2</b>	22,2	63,10	70,99	78,80	99,28	109,2	119,0
<b>Commercial space 3</b>	18,8	61,20	68,85	76,42	96,29	105,9	115,4

Operating cost will grow by 7,5% each year due to requirements to keep the property in the very good condition. Works will take place between 2006-2010, detailed schedule is presented below:

**Table 14.18.**

Schedule of renovation works [PLN] (Option II)

Work specification	2006	2007	2008	2009	2010
Renovation of plumbing installation		31 599,50			
Replacement of gutters	2 850,00				
Elevation modernization			36 542,56		
Staircases painting	5 320,00				
Chimneys modernization					4410,12
Doors and windows replacement				12 964,53	
Staircase floor renovation	7 896,00				
Fences painting	667,59				
Other expenses	1 000,00	1 100,00	1 210,00	1 452,00	1 815,00
Expenses in individual years	17 733,59	32 699,50	37 752,56	14 416,53	6 225,12
Renovation fund	10 997,71	38 699,50	22 825,44	3 112,56	6 225,12
Sum of expenses in 2006-2010	<b>108 827,30</b>				

**Option III**

- Renovation works planned in the Option I are essential, but schedule needs to be modified-
- Floor of both staircases requires renovation.
- Modernization and renovation works as scheduled in Option number II
- Loft into high standard apartment conversion. 90 square meter apartment will be rented
- Rents increase will be the same as presented in the Option II.

- Works will be financed by the owners from their own expenses, rents. Owners did not decide for mortgage while loans in PLN have high interest rate, foreign currency loans have a high currency risk.
- It is assumed that each year building operations cost will increase by 7,5%
- Advance paid by each owner to cover operations cost will increase by 7,5 %
- Adaptation works are planned to be completed in May 2007

**Table 14.19.**

Renovation works schedule [PLN] (Option III)

Work specification	2006	2007	2008	2009	2010
Loft modernization		96689,85			
Renovation of plumbing installation		31 599,50			
Gutters replacement	2 850,00				
Modernization of building elevation			36 542,56		
Staircases painting	5 320,00				
Chimneys modernization					4410,12
Replacement of doors and windows				12964,53	
Staircases floor renovation	7 896,00				
Fences painting	667,59				
Extra expenses	1 000,00	1 100,00	1 210,00	1 452,00	1 815,00
Overall cost in each year	17 733,59	129 389,35	37 752,56	14 416,53	6 225,12
Renovation fund	10 997,71	38 699,50	22 825,44	3 112,56	6 225,12
Sum of expenses in 2006-2010	205 517,15				

## 14.6. OPTIONS ASSESSMENT

### Results of Each option implementation

To evaluate results of each variant implementation and execution of each owner plan financial analysis of 2006-2010 period will be conducted. Financial analysis of all options includes costs and income, as well as renovation and modernization analysis and options evaluation based on the following criteria:

- Property value (WN) and its changes caused by each variant ( $\Delta$  WN)
- NPV – **net present value** which is a method for the financial appraisal of long-term projects.
- NPVR – indicator of net present value, which shows differences in profitability between each option. Project with the highest indicator should be chosen.
- IRR- **internal rate of return** is a metric used to decide whether to invest or not. It indicates the efficiency of an investment.

Evaluation of future income requires calculation of its current value. Discount rate was calculated by taking into consideration following issues:

- Quotation of basic interest rate, may 2006, source:NBP
- Low inflation rate is not essential in this case
- Diverse risk assessment formulas usually include approximate information and are illegible for real estate market investors.
- Property investments may be compared with other investments by using their return rate values.
- By taking into account above presented issues and specific characteristics of the real estate market it is assumed that:

*Discount rate = Safe investments rate + market risk premium*

$$Discount\ rate = \frac{3,9 + 4,2 + 4,71 + 11,4}{4} \cdot 1,16 = 7,018$$

where:

3,9 – profitability of 52- week bill,

4,2 – WIBOR,

4,71 – 5- year bonds,

11,4 – discount rate (an average from 20 banks),

1,16 – market risk premium.



For further calculations discount rate was set at 7%

## Financial analysis of option I

### Strategic analysis for Option I- prognosis.

**Table 14.20.**

Operation budget [PLN]

Budget position	2006	2007	2008	2009	2010
Income	119 182,03	126 332,95	133 912,93	141 947,71	150 464,57
Income for renovation fund	10 997,71	38 699,50	22 825,44	3 112,56	6 225,12
Overall income	130 179,74	165 032,45	156 738,37	145 060,27	156 689,69
Exploitation costs	23 458,71	24 866,23	26 358,21	27 939,70	29 616,08
Conservation and small repairs costs	3 613,37	3 830,17	4 059,98	4 303,58	4 561,80
Renovation costs	10 997,71	38 699,50	22 825,44	3 112,56	6 225,12
Property management costs	3 299,31	3 497,27	3 707,11	3 929,54	4 165,31
Sum of operational costs	41 369,11	70 893,18	56 950,74	39 285,38	44 568,31
Operational income	<b>88 810,64</b>	<b>94 139,28</b>	<b>99 787,63</b>	<b>105 774,89</b>	<b>112 121,38</b>

Apartments' value appraisal, end of 2006 (after modernization)

Apartments value in the current condition, may 2006	937 576,86 PLN
Coefficient of apartments value growth in 2006-2010	1,31
By the end of 2006 apartment value will grow by 2%	$1 \times 1,02 = 1,02$
By the end of 2007	$1,02 \times 1,06 = 1,08$
By the end of 2008	$1,08 \times 1,06 = 1,17$
By the end of 2009	$1,17 \times 1,06 = 1,24$
By the end of 2010	$1,24 \times 1,06 = 1,31$

Expected apartments' value by the end of 2010:

$937\,576,86 \times 1,31 = 1\,228\,225,7$  PLN

Evaluation of commercial space value after modernization and renovation, end of 2010.

Commercial space value, current standard, June 2006	484 852,40 PLN
Coefficient of commercial space value growth 2002 – 2006	1,31
By the end of 2006 apartment value will grow by 2%	1x1, 02 =1, and 02
By the end of 2007	02x1, 06=1,08
By the end of 2008	1, 08x1, 06=1, 17
By the end of 2009	1, 17x1, 06=1, 24
By the end of 2010	1, 24x1, 06=1, 31

Expected commercial space value by the end of 2010:

$$484\ 852,40 \times 1,31 = 636\ 844,43\ \text{PLN}$$

Anticipated overall property value (after modernization and renovation) by the end of 2010 in Option I will amount **1 865 070 PLN**.

**Table 14.21.**

Sale income after 2010

Transactional price	1 865 070 PLN
Sale price (4%)	74 602,8 PLN
Taxation base	1 790 467,20 PLN
Income tax	179 046 PLN
Profit from sale	1 611 421,2 PLN
Discount rate 7%	0,7130
Discounted profit from sale	1 148 943,3 PLN

**Table 14.22.**

Cash flow calculation – Option I [PLN]

Detailed list	2006	2007	2008	2009	2010
Net operational income	88 810,64	94 139,28	99 787,63	105 774,89	112 121,38
Pre – tax Cash flow	88 810,64	94 139,28	99 787,63	105 774,89	112 121,38
Commercial space depreciation (2,5%)	11 878,88	11 878,88	11 878,88	11 878,88	11 878,88

Taxation base (3-4)	76 931,76	82 260,40	87 908,75	93 896,01	100 242,50
Rate of income tax	19,00%	19,00%	19,00%	19,00%	19,00%
Income tax (5*6)	14 617,03	15 629,48	16 702,66	17 840,24	19 046,08
Operating flow (CF <sub>1</sub> ) (5+4)-7	74 193,60	78 509,80	83 084,97	87 934,65	93 075,31
Cash flow	74 193,60	78 509,80	83 084,97	87 934,65	93 075,31
Discount coefficient for 7%	0,9346	0,8734	0,8163	0,7629	0,7130
Discounted net income (9*10)	69341,3	68568,9	67822,3	67085,3	66362,7
Sum of discounted flows	69341,3	137910,2	205732,5	272817,8	339180,5
Discounted sale income					1 148 943,3
Investment value of capital (E)					1 488123,8
Initial expenditures (CF <sub>0</sub> )					1422429,3
Net Present Value NPV					65694,5
Net current value indicator NPVR					1,12
Internal rate of return (IRR)					8%

## Financial analysis of Option II

Discount rate  $r=7\%$

Strategic analysis of Option II– prognosis.

**Table 14.23.**

Operational budget Option II [PLN]

Detailed budget position	2006	2007	2008	2009	2010
Income	132 431,80	148 209,16	172 066,84	187 216,35	202 878,15
Income for the renovation fund	11 153,34	11 989,84	12 889,08	13 855,76	6 225,12
Sum	143 585,14	160 199,00	184 955,92	201 072,11	209 103,27
Operational costs	23 790,67	25 574,98	27 493,10	29 555,08	31 771,71
Maintenance and repairs costs	3 664,50	3 939,34	4 234,79	4 552,40	4 893,83

<b>Renovation costs</b>	11 153,34	11 989,84	12 889,08	13 855,76	6 225,12
<b>Property management costs</b>	3 346,00	3 596,95	3 866,72	4 156,73	4 468,48
<b>Sum of operating costs</b>	41 954,52	45 101,11	48 483,69	52 119,97	47 359,14
<b>Operating income</b>	101 630,63	115 097,90	136 472,23	148 952,15	161 744,13

### **Apartments' value appraisal, end of 2010 (after modernization and renovation)**

Apartments value in the current condition, June 2006	1 247 319,71 PLN
Coefficient of apartments value growth in 2006-2010	1,43
By the end of 2006 apartment value will grow by 2%	$1 \times 1,04 = 1,04$
By the end of 2007	$1,04 \times 1,09 = 1,13$
By the end of 2008	$1,13 \times 1,1 = 1,25$
By the end of 2009	$1,25 \times 1,08 = 1,35$
By the end of 2010	$1,35 \times 1,06 = 1,43$

Expected apartments' value by the end of 2010:  
 $937 576,86 \times 1,43 = 1340734,9$  PLN

### **Evaluation of commercial space value, after modernization and renovation, end of 2006.**

Commercial space value, current standard, June 2006	484 852,40 PLN
Coefficient of commercial space value growth 2006 – 2010	1,44
By the end of 2006 apartment value will grow by 2%	$1 \times 1,03 = 1,03$
By the end of 2007	$1,03 \times 1,08 = 1,11$
By the end of 2008	$1,11 \times 1,12 = 1,25$
By the end of 2009	$1,25 \times 1,08 = 1,35$
By the end of 2010	$1,35 \times 1,07 = 1,44$

Expected commercial space value by the end of 2010:  
 $484 852,40 \text{ zł} \times 1,44 = 698 065,36$  PLN

Anticipated overall property value (after modernization and renovation) by the end of 2006 in Option II will amount **2038800,3 PLN**.

**Table 14.24.**

Income from sale after prognosis period (Option II)

Transactional price	2 038800,3 PLN
Sale price (4%)	81552PLN
Taxation base	1957248,3 PLN
Income tax	195725 PLN
Profit from sale	1761523,3 PLN
Discount rate 7%	0,7130
Discounted profit from sale	1 255966,1 PLN

**Table 14.25.**

Cash flow calculation – Option II [PLN]

Detailed list	2006	2007	2008	2009	2010
Net operational income	101 630,63	115 097,90	136 472,23	148 952,15	161 744,13
Pre – tax Cash flow	101 630,63	115 097,90	136 472,23	148 952,15	161 744,13
Commercial space depreciation (2,5%)	12121,31	12121,31	12121,31	12121,31	12121,31
Taxation base (3-4)	89 509,32	102 976,59	124 350,92	136 830,84	149 622,82
Rate of income tax	19%	19%	19%	19%	19%
Income tax (5*6)	17 006,77	19 565,55	23 626,67	25 997,86	28 428,34
Operating flow (CF <sub>t</sub> ) (5+4)-7	84 623,86	95 532,35	112 845,56	122 954,29	133 315,79
Cash flow	84 623,86	95 532,35	112 845,56	122 954,29	133 315,79
Discount coefficient for 7%	0,9346	0,8734	0,8163	0,7629	0,7130
Discounted net income (9*10)	79089,46	83437,95	92115,83	93801,83	95054,16
Sum of discounted flows	79089,46	162527,41	254643,24	348445,07	443499,23
Discounted sale income					1255966,1
Investment value of capital (E)					1699465,3
Initial expenditures (CF <sub>0</sub> )					1422429,3
Sum of discounted renovations for 7%					21366,45

Net Present Value NPV					255669,55
Net current value indicator NPVR					2,97
Internal rate of return (IRR)					10,5%

### Financial analysis of Variant III.

### Strategic analysis of Option III – prognosis.

Table 14.26.

Operational budget Option III

Detailed budget position	2006	2007	2008	2009	2010
Income	132 431,80	165 470,96	209 124,68	227 223,60	246 069,60
Income for the renovation fund	11 153,34	12 613,88	14 230,76	15 298,07	16 445,42
Sum	143 585,14	178 084,84	223 355,44	242 521,66	262 515,02
Operational costs	23 790,67	26 903,37	30 271,12	32 541,46	34 982,07
Maintenance and repairs costs	3 664,50	3 939,34	4 234,79	4 552,40	4 893,83
Renovation costs	11 153,34	12 613,88	14 230,76	15 298,07	16 445,42
Property management costs	3 664,50	3 978,48	4 326,62	4 542,95	4 770,10
Sum of operating costs	42 273,01	47 435,07	53 063,29	56 934,87	61 091,42
Operating income	101 312,13	130 649,77	170 292,15	185 586,79	201 423,61

### Apartments' value appraisal, end of 2010 (after modernization and renovation)

Apartments value in the current condition, May 2006	937 576,86 PLN
Coefficient of apartments value growth in 2006-2010	1,43
By the end of 2006 apartment value will grow by 2%	$1 \times 1,04 = 1,04$
By the end of 2007	$1,04 \times 1,09 = 1,13$
By the end of 2008	$1,13 \times 1,1 = 1,25$
By the end of 2009	$1,25 \times 1,08 = 1,35$
By the end of 2010	$1,35 \times 1,06 = 1,43$

Value appraisal of loft converted into an apartment was conducted by the use of income method, capitalization technique:

On the basis of market data value of this kind of apartment in this specific neighbourhood was estimated in May 2006. Value was 346 500, 00 PLN. Then it was assumed that value will grow by 2% (like other apartment).

Prognosis of apartments' value by the end of 2010:

$$(937\,576,86 \text{ PLN} \times 1,43) + (346\,500 \text{ PLN} \times 1,43) = 1\,836\,229,9 \text{ PLN}$$

### Evaluation of commercial space value, after modernization and renovation, end of 2010.

Commercial space value, current standard, June 2006	484 852, 40PLN
Coefficient of commercial space value growth 2006 – 2010	1, 44
By the end of 2006 apartment value will grow by 2%	$1 \times 1,03 = 1,03$
By the end of 2007	$1,03 \times 1,08 = 1,11$
By the end of 2008	$1,11 \times 1,12 = 1,25$
By the end of 2009	$1,25 \times 1,08 = 1,35$
By the end of 2010	$1,35 \times 1,07 = 1,44$

Expected commercial space value by the end of 2010:

$$484\,852,40\text{zł} \times 1,44 = 698\,065,36 \text{ PLN}$$

Anticipated overall property value (after modernization and renovation) by the end of 2010 in Option III will amount **2 534295, 3 PLN.**

**Table 14.27.**

Income from sale after prognosis period (Option III)

Transactional price	2 534295,3 PLN
Sale price (4%)	101371,8PLN
Taxation base	2432923,5 PLN
Income tax	243292 PLN
Profit from sale	2189631,5PLN
Discount rate 7%	0,7130
Discounted profit from sale	1 561207,3 PLN

**Table 14.28.**

Cash flow calculation – Option III

Detailed list	2006	2007	2008	2009	2010
Net operational income	101 312,13	130 649,77	170 292,15	185 586,79	201 423,61
Pre – tax Cash flow	101 312,13	130 649,77	170 292,15	185 586,79	201 423,61
Commercial space depreciation (2,5%)	12121,31	12121,31	12121,31	12121,31	12121,31
Taxation base (3-4)	89 190,82	118 528,46	158 170,84	173 465,48	189 302,30
Rate of income tax	19%	19%	19%	19%	19%
Income tax (5*6)	16 946,26	22 520,41	30 052,46	32 958,44	35 967,44
Operating flow (CF <sub>t</sub> ) (5+4)-7	84 365,87	108 129,36	140 239,69	152 628,35	165 456,17
Cash flow	84 365,87	108 129,36	140 239,69	152 628,35	165 456,17 zł
Discount coefficient for 7%	0,9346	0,8734	0,8163	0,7629	0,7130
Discounted net income (9*10)	78848,34	94440,18	114477,66	116440,17	117970,25
Sum of discounted flows	78848,34	173288,52	287766,18	404206,35	522176,6
Discounted sale income					1 561207,3
Investment value of capital (E)					2083383,9
Initial expenditures (CF <sub>0</sub> )					1422429,3
Sum of discounted renovations for 7%					88167,3
Net Present Value NPV					572787,3
Net current value indicator NPVR					3,53
Internal rate of return (IRR)					14,5%



## 14.7. EVALUATION OF OPTION I, II AND III EFFECTIVENESS

### Comparative analysis of indicators

**Table 14.29.**

General information about Option I, II and III indicators

Indicator	Option I	Option II	Option III
Investment value of the capital	1488123,8	1699465,3	2083383,9
Property value in 2006 ( $CF_0$ )	1422429,3	1422429,3	1422429,3
Property value in 2010	1 865 070	2 038800,3	2 534295,3
Value increase $\Delta W$	31,35%	43,27%	78,79%
Net present value NPV	65694,5	255669,5	572787,3
NPVR	1,12	2,97	3,53
Internal return rate IRR	8%	10,5%	14,5%

Property value increase  $\Delta W$  was estimated as (discount rate not included):

$$\Delta W = \frac{W_{2010} - W_{2006}}{W_{2006}} \cdot 100\%$$

### Option III Effectiveness evaluation

Indicators analysis shows that Option III is optimal to achieve owners' goals.

- Property value increase is the highest- 78,79%
- Property value by the end of 2010 is the highest in Option III
- Capital investment value is also higher than in case of Option I and II
- High NPV rate allows to assume that investment will be profitable
- NPVR amounts 3,53
- Internal return rate is 14, 5%, which is two times higher than required by the investors' lowest return rate (7%)

In each option NPV is a positive number, which means that each option is profitable for the owners.

Option I is a rather conservative solution. Current property value stays at the same level; possibly lowest amount of money was invested.

Option II is more pro-development plan. More money invested gives a chance not only to keep the current property value but also to increase it. Option II will be a good solution if owners will not be able to invest money into loft conversion. But gathered information shows that owners are able to convert loft into an apartment (even without mortgage) and can pick Option III, which is the most profitable one.

It is highly recommended to implement Option number III.

## **14.8. CHOSEN OPTION IMPLEMENTATION WITH THREATS CONSIDERATION**

### **Recommendations**

- Recommended option is 3<sup>rd</sup> plan e.g. property modernization and loft into apartment conversion.
- According to data it is more profitable to modernize the building than to leave it in the current technical condition.
- Works will place according to the following schedule:
  - Renovation – 2006-2010
  - Modernization - 2006-2009
  - Loft into an apartment conversion - 2007
  - Works will be financed from rents and owners capital.

Potential threats for the Option III implementation and possible action agenda:

- Unexpected costs increase of modernization and renovation works.
  - Renovation works extension
  - Necessity to prepare new costs calculation or works schedule
  - Mortgage while owners capital is too small to cover all costs
1. Demand drop for mixed-use developments and apartments in the city centre
    - Rent decrease
    - Favourable payment conditions for the occupiers
    - Marketing action- apartments adds in the newspapers
    - Cooperation with real estate brokers

2. Increased supply- increased competition, while more building in the neighbourhoods are being renovated
  - Shorten renovation works if possible
  - Individual approach to each occupier- individual needs fulfilment
  - Favourable rents and conditions

To reach intended income level and property value increase it is required to:

- Conduct up to date repairs
- Control property finances
- Monitor local property market and react to changes
- Cooperate and communicate with occupiers on daily basis
- Annual property technical condition evaluation,

Summary and conclusions.

- Analyzed property is located in Kraków, in the Old Town district- prestigious and attractive part of the city. It is a tenement house from the beginning of XX century in an average good technical condition, with apartments and commercial space on the ground floor.
- During the period when analysis was conducted all commercial space and two apartments were rented, two apartments were owner-occupied, there was no delays in rent payments.
- 3 options for the property future were analyzed
- Option I – assumes no changes,
- Option II - assumes property modernization and renovation, which will lead to increase of standard.
- Option III – property modernization and renovation, as well as loft into an apartment conversion.
- Option III is recommended, while it is most profitable solution.
- To prepare a long term strategy more detailed analysis of property market is recommended,
- Property is not rented in 100%, owners occupy 2 apartments, commercial space is quiet small
- Property analysis is very general. Market position of each apartment was not investigated.
- It is important to stress out that value of each apartment sold separately may not be equal to the value of property sold as a whole.

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