The Approach based on the Income in the Context of the Real Estate Ownership

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The evolution of the real estate market in Romania approaches the past, present and future of the real estate market in the actual economic financial crisis reported to the other EU member states. The real estate market regards the operations, transactions through which ownership or use rights of buildings and lands are given. It has been observed that in 2014 the activity of the real estate market was visibly more intense than the one in the previous year, after the revival of the activity that has already been observed in 2014. We consider that this evolution is influenced both by the European context and the facilities banks provide regarding the crediting and the "First house" program", 2015 being considered the best year for the real estate market after the crisis.

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1. Introduction

The real estate market is considered to be the meeting place of the real estate demand and offer, through the transactions that happen and through the ones that did not materialize, thus giving the chance to analyze the market evolution. From the perspective of the freedom degree, we can claim that the real estate market is a free market, featured by the elaboration of the selling-buying documents. In the past, we could not even talk about a real estate market, given the fact that there was no competition, real estate agencies, selling-buying services being provided only through actuaries.

Thus, we can say that before 1989 we had a controlled, imposed market that did not offer the opportunity of acting freedom. An example is the use of standard prices for real estate goods, issued for the elaboration of the buying selling documentation, which were established by the state without the possibility of being influenced by the seller in a favorable manner for him. Real estate goods could not be sold at a higher price than the one established by law and calculated depending on the age of the building and the area it was located in. Following the basic concepts which are featured by needs, desires and demand, products, value, cost and satisfaction, exchanges and relations, markets, we can display them into the real estate field as follows in the next graphic:

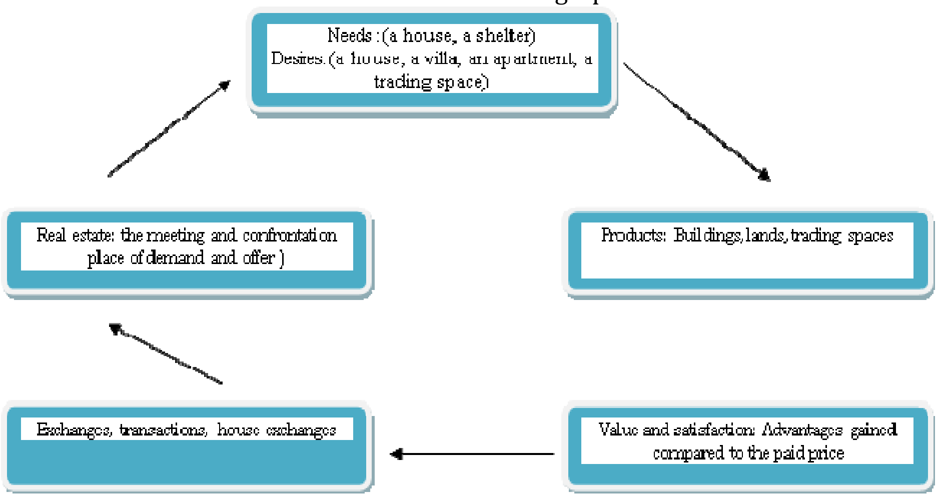

Figure no: 1 Basic concepts

2. Conceptual aspects regarding the income based approach

The income based approach gives information on the value by converting the future income flows (gross or net profit, gross or net rent, royalty, net annuity, net cash-flow, net operating income etc) in the value of the active (market or investment value).

The opinion to which we subscribe is that building built without authorization is extended in time, thus, we are in the presence of a continued contravention, and so in this case the limitation of prespription period runs from the day the contravention activity has ended.[135] The income based approach represents one of the classic methods of evaluation and namely three of them, which an evaluator can use in the evaluation process. It includes mathematic methods, techniques and procedures, used by the evaluator in order to analyze the capacity of real estate goods to generate benefits, which usually come from incomes and the re-selling value. The income based approach is based on the principle according to which if a real estate is bought, the investor does not have to pay for it more than the revenues that he will get while possessing it plus the re-selling value of the property.

3. The interdependence of the method with the evaluation principles

Within the income based approach, the principle of anticipation is basic, according to which, the value originates in the anticipated future revenues that are to be generated by the owned property. All income capitalization methods, all the associated techniques and procedures consider the future anticipated revenues. The principle of demand and offer is very useful to predicting future benefits and estimating the profitableness rates through income, as the income flows and the profitableness rates are determined by the market. If the demand for a certain type of space grows and overpasses the existing offer, owners can grow the price of the rent. As a result, the values of real estate goods grow until the demand and offer reach a balance again. On the other side, if the demand for a space decreases, the rents will also decrease and inoccupation rates will grow.

In current practice of romanian courts and doctrine a constantly rising problem reffers to different types of offense such as continues, continuedontravention, instant offense, recidivism, and competition offenses against criminal law. There are also law ferenda proposals on the future realization in the text of a possible Contraventional mCode a special article regarding contraventional record.[136]

4. The applicability of the method and restrictions

When evaluating the real estate property, we generally use the approaches by comparing the sales, the income capitalization and costs. The evaluator will reconcile the values resulted from the use of two or more associated approaches/methods.

These approaches are based on the substitution principle, namely he establishes if there are more similar goods or services, and the ones with a lower price will attract the demand. When applying each method we need the income type/cash flow with the capitalization rate/actualization rate. When other income form is used, it will be necessary to argue reported to the decision not to use the net operating income. It is forbidden to use the market level of the rent, of the inoccupation rate, of the expenditures associated to the owner as well as the use of the level of the capitalization/actualization rate, without displaying in the report their estimation mode.

5. The market and investment value

The income approach is used to estimate the market value of the real estate properties. "The market value is the estimated sum for which an asset could be change at the evaluation date, between a buyer and a vendor, through a transaction that is assumed to happen between parts that have no relation, each acting independently, according to an adequate marketing procedure and in which the parts have consciously acted, carefully and without constraints. The market value is most probable price that can be reasonably attained on the market, at the date of evaluation, according to the definition of the market value.

This is the best attainable price in a reasonable manner, by the vendor and the best attainable price in a reasonable manner by the buyer. The best use can be to continuously use of the existing asset

[135] Mihăilescu Mădălina Elena, Câteva considerații pe marginea sancțiunii contravenționale a desființării lucrărilor și aducerii lucrărilor în faza inițială", "Curierul judiciar" nr. 3/ 2011, ISSN 1582-7526, Edit ALL Beck.
[136] Mihăilescu Mădălina Elena, Sanctiuni contraventionale, Aspecte de drept material în dreptul românesc și comparat, unic autor, Editura Hamangiu, București, România, 2013, ISBN 978-606-678-666-9;

or an alternative use. This can be determined by the use which a participant on the market would intend to give to an asset when he establishes the price he would offer. Determining the best use assumes that:

- The use is possible, through the point of view of what would be considered reasonable by the participants on the market,
- The use is legally allowed, considering any restrictions in the use of the asset, as an example, the specifications in the regional planning,
- The use is financially feasible, considering if an alternative use, which is legally allowed and physically possible, will generate a sufficient profit for a typical market participant, after all the conversion costs of that use had been considered, over the profit that is generated by the existing use.

The investment value of an asset for the user or for the possible owner, for a certain investment or for operating objectives. This is a type of value that is specific to the entity. Though the owner value of an asset can be equal to the amount of money that could be gained from its sale to other entity, this type of value reflect the benefits gained by an entity from the ownership of an asset and, as a result, it does not necessarily assume a hypothetical exchange.[137] The investment value reflects the situations and the financial objectives of the entity which is evaluated. It is frequently used to quantify the investment performance. The difference between the investment value of an asset and its market value represents the motivation for the buyers or the sellers to enter the market. The market value is objective, non-personal, apart from the investor, and the investment value is based on subjective criteria.

6. Leasing contracts

Through the location contract, the owner of a good transfers all the use and occupation rights of the property to the other side for a certain period of time in exchange for a price named rent. The leasing contracts can be negotiated to meet every situation, but most of them are included in one of the following categories: fix rent contracts – assuming a fix value of the rent for the whole period of the contract; contracts with periodical adjusting clauses of the rent – can be ranked as: depending on a certain specified criterion – progressive rent; this type of locational contracts is as positive when a tenant wants to develop a business in that space, paying lower money in the beginning and more money in time, reported to the attained results; depending on the periodical re-evaluation of the property; in this case, the re-evaluated value of the property influences the periodical adjustment of the rent; according to the idex; Contracts with percentage calculus of the rent – this type of contracts aim at the case when the rent, partially or as a whole, is calculated using a percentage on the turnover, the profit or other income forms of the tenant.

The rent is negotiated based on the gross rents when the operating expenditures of the good are supported by its owner, and based on the net rents, when all the expenditures associated to the property are supported by the tenant.

Is required a correlation between contraventional penalties and criminal penalties as there are many situations in practice when contraventional fines exceed thelevel of the criminal fines.[138]

7. Frequent contractual clauses

In the context of the actual real estate market, these clauses regard: facilities of the rent; the allocation of the expenditures between properties and tenants; renewal options; escalation clauses; buying options, annulment clauses; continuous occupation clauses; arrangements of tenants; other clauses.

8. The rent, incomes generated by the real estate properties originate from rents. The main rent types are: market rent, contractual rent, effective rent, surplus rent, adverse rent, percentage rent and additional rent.

9. Future incomes, use different revenue forms and cash-flows, such as: potential gross income, effective gross income, net operating income, available cash-flows before taxation, available net income after taxation, terminal value.

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[137] Grosman M., Evaluarea rezultatelor activitătii dec marketing în baza implimentării sistemului de indicatori manageriali, Revista „Studii economice", ULIM, nr. 3-4 decembrie 2012

[138] Mihăilescu Mădălina Elena, Sanctiuni contraventionale, Aspecte de drept material în dreptul românesc și comparat, unic autor, Editura Hamangiu, București, România, 2013, ISBN 978-606-678-666-9;

10. Operating expenditures, include all the expenditures needed to maintain the property within normal functioning standards and to generate estimated revenues. The most frequently used are the fix, variable expenditures and renewal allocations.

11. The income rate and the profitableness rate, due to the fact that revenues originating from real estate properties can have various forms, the evaluator uses more rates of the attained benefits, such as: income rates-reported between the annual income and the value, being used to convert the income in value; the capital profitableness rate – example: the effective interest rate, the actualization rate or the internal profitability rate.

12. Risk estimation, being a very important element which is considered when applying the income based methods, the risk anticipates the cashing of future earnings, creating value, and the possibility of losing gains lowers the value. For an investor in the real estate field, the risk represents the chance to a financial loss and the uncertainty of gaining future estimated incomes. Many investors avoid risks in the favor of certainty, expecting a reward in exchange for risk assumption.

13. Income approach procedure, an real estate evaluator, by applying the income approach procedure, can use two evaluation methods of a real estate good, which generates incomes, namely: direct capitalization – annual income is reported to an income rate or is multiplied with an income multiplier to attain value information; discounted cash-flow, analyze of the actualized cash-flow – it considers future cash-flows and the terminal value, being converted to property value.

14. Case study regarding the evaluation of real estate goods through the market and income approach

14.1 The market approach, through the method of direct comparison is given as an example based on the evaluation of a 2 room apartment in Galati, area A. the apartment is located downtown, behind Vega hotel, year of building 1958. The apartment has medium adjustments, namely: cellular inside joinery, external woodwork, moquette, sandstone and faience in the bathroom and kitchen. The apartment is uninhabited

The corrections that are established in the direct comparison methodology, considering that they are attained through quantitative techniques and are applied to comparable transactions, either as a percentage or absolute value.

The evaluator uses logical calculus to make corrections, but mathematics don't have to replace the professional thinking of the evaluator. The use of the calculator and programs improve the speed and accuracy of the calculus, but the estimation of the market values is determined not only by precise calculus. The evaluation also has a creative aspect where the evaluators use their professional thinking in the analysis and the interpretation of quantitative data. The percentage correction is used to display the changes in the market conditions and the location differences.

The evaluator must be consequent regarding the expressing method of the relation between the comparable propriety and the evaluated one, and the correction must be made in a manner that corresponds to the way it is perceived by the market.

As we only know the price of the comparable transaction, the correction is made on that price in order to reach the estimation of the market value of the evaluated property.

The absolute correction is calculated in monetary units that is summed up or subtracted to/from the price of the comparable transaction.

The order in which the corrections are applied to the prices of comparable transactions is determined by the market data and the analysis of the evaluator.

Percentage corrections, which are applied on comparable transactions reflect the superiority or inferiority of the comparable property, considering the elements of the comparison.

The mean of correction is the market grid. The evaluator can estimate the comparability of made transactions reported to the evaluated property and select the final value. Transactions that require the smallest corrections will have the biggest importance in choosing the final value. At the same time, this importance will also reflect the trust the investor has in the data regarding the comparable transactions. The choice of the final value is the last stage of the analysis, where two or more values appear and an opinion regarding the value that would lead to the most probable price is to be expressed.

This opinion can be expressed as a value interval or as a single value/punctual value. It is important that the evaluator considers the strengths and the weaknesses of each result, examining the credibility and the accuracy of the market information that stood at the base of the value, as well as the used technique. The evaluation report must clearly emphasize the arguments through which the evaluator reached the conclusion.

In the case of the direct comparison method, the choice of the value can include two analysis levels. The first level means the reaching of a value from the price correction of two or more comparable transactions, considering a single comparison criterion (for example price/sqm). The second level is the analysis of the attained values, considering more comparison criteria. In the selection process of the final value there are two extremely important elements:

- The firs one consists of the fact that the evaluator must be sure that the estimated value corresponds to the objective of the evaluation and is correlated to the values that have been obtained through other methods. High attention will be paid to the correlation of the evaluation date with the data when the comparable transactions happened.
- The second element consists of the fact that the evaluator must consider the differences regarding the ownership rights that were transferred through the comparable transactions. In most cases, these differences lead to the exclusion of certain transactions from the comparable ones and any carelessness in the analysis of this aspect might lead to wrong conclusions.

Table no 1

Comparison elements	**subject**	**comparable 1**	**comparable 2**	**Comparable 3**
Ad/date		Real estate agency July 2010	Real estate agency August 2010	Real estate agency July 2010
Selling price	?	930	813	750
Transfered ownership right	DPI	DPI	DPI	DPI
Correction		0%	0%	0%
Corrected price	?	930	813	750
Financing conditions	market	Market	Market	Market
Correction		0%	0%	0%
Corrected price	?	930	813	750
Selling clauses	Normal	Normal	Normal	Normal
Correction		-5%	-5%	-5%
Corrected price	?	884	772	713
Market conditions	Stagnating market	Stagnating market	Stagnating market	Stagnating market
Correction		-5%	-5%	-5%
Corrected price	?	839	734	677
Location	Downtown near Faleza	Downtown Romarta Veche	Downtown near Faleza	Downtown near Faleza
Correction		0%	0%	0%
Corrected price	?	839	734	677
Useful area –sq m	41,37	43,00	43,00	44,00
Correction		0%	0%	0%
Corrected price	?	839	734	677
No. Of rooms	2	similar	similar	similar
Correction		0%	0%	0%
Corrected price	?	839	734	677
Floor	5/7	2/7	5/7	7/7
Correction		-6%	0%	5%
Corrected price	?	789	734	711
Building year (P.I.F. year)	52	41	52	52
Correction		-4%	0%	0%
Corrected price	?	757	734	711
Internal adjustments	Average	Average	Average	Average

Comparison elements	subject	comparable 1	comparable 2	Comparable 3
Correction		0%	0%	0%
Corrected price	?	757	734	711
Additional equipment Own heating plant Air conditioning	- - -	- - -	- - -	- - -
Correction		0%	0%	0%
Corrected price	?	757	**734**	711
Total gross corrections		173	79	107
Adopted market value:: *COMPARABLE 2, with the smallest total gross correction*				
Estimated market value	**30.355**	euro with VAT		
Estimated market value	**133.860**	lei with WATT		
Estimated market value	**24.479**	euro without VAT		
Estimated market value	**107.947**	lei without VAT		
Exchange (31.03.2015)	**4,4098**	lei/euro		

Comparable 1: 2 room apartment, Block P, Us = 43 sq m, average finish, floor 2/7, heating
Price: 40.000 eur (930 eur/ useful sqm)

Comparable 2: 2 room apartment, Block on the Faleza, Us = 43 sqm, average finish, floor 5/7, heating
Price: 35.000 eur (813 eur/ useful sqm)

Comparable 3: 2 room apartment, Block P, Us = 44 sqm, average finish, floor 7/7, heating
Price: 33.000 eur (750 eur/ useful sqm)

Needed corrections are displayed in the following table:

Table no 2

Selling conditions	-5%	The applied negotiation margin currently on the market given the conditions of normal selling
Market conditions	-5%	Stagnating market. Consistent offer, low demand, high exposure period, rare transactions. Though owners have generally adjusted the offers expressed in Eur, the depreciation of the national currency really makes the price decrease in a more reduced manner. The market is featured by the lack of liquidities and imbalance in the favor of the buyer.
Location		No correction was made
Useful surface	-5%	Adjustments according to the current market requirements
No. of rooms		No corrections were made
Floor	-6%; 5%	Corrections depending on the market survey regarding apartments
Building age	-4%	Corrections using the P135 Regulation
Finish		No corrections were made
Additional equipment		No corrections were made

14.2. The income approach

This approach, which is included in the yield methods, is based on the ability of the asset to generate revenues. The estimated value expresses the current market value of the real estate property assuming that it is functional and generates revenues from the use disposal to a third part. The method is based on the ability of the propriety to produce benefits through leasing, considering the location and equipment. We consider that the best use of the analyzed property is leasing. From the data attained by the evaluator, three comparable properties are displayed below, rented with the prices displayed in the table. Then, the multipliers of the gross rent were established (the ratio between the selling value and the monthly rent), their average was calculated, then, using the attainable monthly rate in the case of the evaluated property, the market value of the subject was reached. This procedure is according to the International Standard of Practice in Evaluation.

Table no 3

Calculus elements	Subject	Comparable 1	Comparable 2	Comparable 3
Number of rooms (similar)	2	2	2	2
Market selling prices(EURO)		40.000	35.000	33.000
Monthly gross rent (EURO)		300	300	300
MGR (Multiplyer of gross rent)		133	117	110
Media MCB		120		
Attainable monthly rent in the case of the evaluated property		250		
Exchange (31.07.2010)	LEI / 1 EURO	4,4098		
PROPERTY VALUE	**EURO**	**30.000**		
	LEI	**132.294**		

14.3. Value reconciliation. As a result of establishing the market value through both methods, the evaluator decided, depending on the evaluation objective, that the most relevant market value is the one determined through the income based approach.

Conclusions

Excepting the structural inefficiencies, inherent in most of the real estate markets in the world, the Romanian market is exposed to additional risks, due to the foreign currency transactions, the decrease of the population number and the significantly high number of houses inhabited by owners (reduced leasing market). This situation is amplified by the lack of transparency on the market (the lack of an official estate index), high costs and low speed of transactions, as well as by the excessive bureaucracy in the field of constructions. The specific of the real estate market is mainly determined by two elements: the characteristics of the properties and the behavior of the market participants. Due to this factors, the real estate market distinguishes itself through: informational asymmetries, rigid prices, significant liquidity fluctuations, lack of transparency and economic insufficiency. Thus, significant risks are generated for the financial system, which is highly connected to the real estate market through the mortgage warranties, as well as for the rest of the economic system, by the influence on the investment process and the mobility of the work force. The evaluation methods are a simple calculus mean. They generate values that can be used both reasonably and unreasonably. It is the evaluator's duty to explain as accurate as possible that the calculated value is and, more important, what it is not. The evaluation is just a part of the decisional process and we expect that the players on the market to learn from the past experiences. We believe that on medium term, practices such as the use of the residual method or of the liquidity values for financing or acquisitions will represent simple "accidents" and not a market rule. We also believe that questioning the information quality and its sources on a market that lacks transparency like the one in Romania will reposition the evaluation process from a simple formality to an important part of the process of determining the high risk degree. This fact, for its part, should support the avoidance of another crisis, similar to the current one.

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