

INSIGHT · COMMERCIAL & MIXED USE

Beyond Bricks and Comparables

How to value commercial and mixed-use units when appraising a deal

By Kiran Patel ACA, Co-founder, Venture Finance

> *Shops with flats above, small office buildings and mixed-use parades can offer stronger yields than residential property. But they are valued in a completely different way, and investors who appraise them like houses often overpay. Chartered Accountant and property investor Kiran Patel ACA explains how lenders and valuers get to a number.*

Most residential investors value property the same way: find similar houses that have sold nearby and compare. That works well for a terraced house. It works badly for a shop, an office or the ground floor of a mixed-use building.

Commercial property is valued mainly on the income it produces and how secure that income is. Two identical shops on the same street can be worth very different amounts, depending on who the tenant is and how long the lease has left to run. As an accountant, I find this the most logical part of property: the value comes from a cash flow, and you can test every assumption behind it.

This article explains how that works, and how to apply it when you appraise a commercial or mixed-use deal.

How commercial property is valued

The usual starting point is the investment method. The valuer takes the net annual rent and divides it by a yield that reflects the risk of that income.

Value = Net annual rent ÷ Yield

The yield does all the work. A lower yield means the market sees the income as safer, so the property is worth more. Small changes in the yield make large changes in value. Here is a shop let at £12,000 a year at different yields:

Yield	Value	Change from 8%
7%	£171,400	+£21,400
8%	£150,000	—
9%	£133,300	–£16,700
10%	£120,000	–£30,000

Illustrative figures, before purchaser costs.

A one-point move in the yield changes the value by more than 10%. That is why the yield is the number to question hardest in any commercial appraisal, whether it comes from the agent, the seller or your own spreadsheet.

What drives the yield

Valuers and lenders look at the quality of the income, not just its size. The main factors are:

- **Tenant strength.** A national retailer or established local business with good accounts is a stronger covenant than a new start-up. Ask for the tenant's accounts and trading history.
- **Lease length.** Years remaining until the lease ends, or until the tenant can break it, matter more than the original term. A shop with eight years left is worth more than the same shop with eight months left.
- **Lease terms.** On a full repairing and insuring lease the tenant pays for repairs and insurance. On an internal repairing lease the landlord carries more of the cost, which reduces the net income.
- **Rent against market rent.** If the rent is above what a new tenant would pay, the income may fall at the next review or re-letting. Valuers will look through an inflated rent.
- **Location and demand.** How easily the unit could be re-let if the tenant left: footfall, nearby vacancies, parking, and the strength of the local high street.
- **Condition and energy rating.** Commercial properties generally need an EPC of at least E to be let. A unit with a poor rating may need spending on before it can be re-let.
- **Flexibility of use.** A unit in Class E can switch between shop, office, café and clinic without planning permission, which widens the pool of future tenants.

Mixed-use: value the parts, then the whole

A shop with flats above is really two investments under one roof, and each part is valued in its own way:

- **The residential part** is usually valued on comparable sales of similar flats, or on its rental income if it is let.
- **The commercial part** is valued on its rent and a yield, as above.

Add the two together and you have a sum-of-parts value. A lender's valuer will then consider whether a buyer would pay that much for the building as a whole. Often the answer is a little less, because the pool of buyers for mixed-use property is smaller than for houses or flats.

The balance between the two parts also affects how you can borrow. Many lenders treat a building as semi-commercial when the commercial element is a minority of its value or floor area, and as fully commercial above that. Semi-commercial lending is often more flexible and closer to residential pricing, so the split is worth checking before you make an offer.

Worked example: a shop with two flats above

Take an illustrative mixed-use building: a ground-floor shop and two one-bedroom flats above.

- **The shop** is let at £10,000 a year on a full repairing lease with five years remaining. Similar shops locally trade at a yield of around 8.5%.
- **The flats** are let at £650 a month each, £15,600 a year in total, and similar residential investments sell at a gross yield of around 7.5%.

Now compare the value with the shop let, and with the shop empty.

	Shop let	Shop vacant
Shop	£117,600 (£10,000 at 8.5%)	About £88,000 after allowing for a void, rent-free period, letting costs and empty rates
Flats	£208,000 (£15,600 at 7.5%)	£208,000
Sum of the parts	**About £325,600**	**About £296,000**
Loan at 70% of value	About £228,000	About £207,000

Illustrative figures for a fictitious property. Real yields, voids and lending terms vary by location and lender.

The same building is worth around £30,000 less with the shop empty, and the loan available falls by about £21,000. If you pay a "let" price for a building whose tenant is about to leave, that gap comes straight out of your equity. Always ask when each lease ends and whether the tenant intends to stay.

Appraisal checklist for commercial and mixed-use deals

Before making an offer, I would want to see or check:

1. **Every lease, in full:** rent, review dates, break clauses, repairing obligations and the end date.
2. **The tenant's accounts and payment history,** including any arrears.
3. **Market rent evidence** from recent lettings of similar units nearby, to test whether the passing rent is sustainable.
4. **Yield evidence** from recent sales of comparable investments, not just the agent's quoted figure.
5. **The EPC rating and condition** of the commercial unit, and the cost of any works needed to re-let it.
6. **Business rates and service charges,** and who pays them if the unit falls empty.
7. **Planning use class and title,** including whether the flats could be split onto separate titles in future.
8. **Lender appetite** for the property type and the commercial share, before you commit to a price.

Value the income, not the building

Commercial and mixed-use property can be some of the best-value assets in a portfolio, precisely because many residential investors do not understand how to price them. The investors who do well treat each unit as a stream of income and ask how secure it is, how long it will last and what happens if it stops.

> *Get the yield right, test the lease, and plan for the void. Do that, and the numbers will tell you what the building is really worth.*

About the author

Kiran Patel ACA is a Chartered Accountant and co-founder of Venture Finance, a Sheffield-based debt capital advisory firm arranging real estate debt for developers, investors and landlords. His background spans audit, in-house accounting and hands-on property investing. Alongside his wife and co-director Joanne Patel ACA, he has built the couple's own property portfolio from the ground up.

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