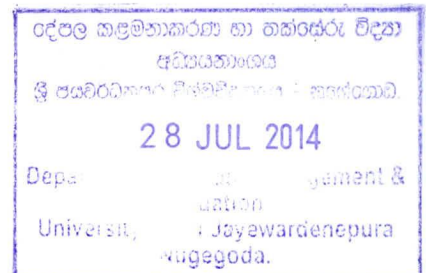


**Empirical Study on the Capitalization  
Rate for Residential Condominium  
Properties in Dehiwala Mount Lavinia  
Municipal Council Area**

**M.L.Suresha Tharanga**

**Empirical Study on the Capitalization Rate for  
Residential Condominium Properties in Dehiwala  
Mount Lavinia Municipal Council Area**

**Dissertation Submitted to the University of Sri Jayewardenepura,  
as a Partial Fulfillment of the Requirements of  
the Final Examination of the M.Sc.  
in Real Estate Management & Valuation Degree**



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**Students Declaration:**

I do hereby declare that, the work described in this dissertation was carried out under the supervision of senior lecturer Dr.U.Anura Kumara and the final report has been completed according to the instructions and suggestions made by the board of examiners. Further, any form of report based on this dissertation has not been submitted in whole or in part to any university or any other institution for another degree/examination or any other purpose.

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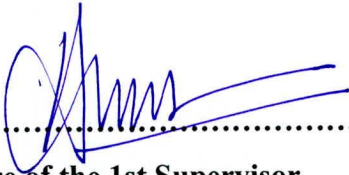
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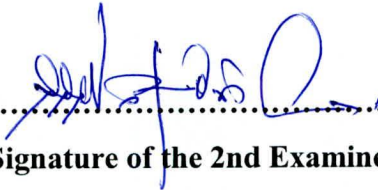
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**Certification:**

I hereby certify that, MS. Mapalagama Liyanage Suresha Tharanga, bearing Registration No.GS/MSC/REMV/3777/09 duly completed the research on Empirical Study on the Capitalization Rate for Residential Condominium Properties in Dehiwala Mount Lavinia Municipal Council Area, under my supervision and recommended the same to submit for evaluation.



.....  
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.....  
**Signature of the 2nd Examiner**

.....  
**Signature and Official Stamp of the Head**

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## **Abstract**

Estimating capitalization rate is an important step in the valuation of real estate and a vital part of the real estate investment decision-making process. It is correct to indicate that it is one of the most important steps in income approach of valuation, because small errors in capitalization rate can lead to dramatic changes in value estimates. Generally, the valuers in Sri Lanka apply income approach of valuation for valuing residential condominium property specially located in urban areas. The estimation of rent is based on market data but in practice Valuers tend to use a capitalization rate ranging from 3%-5% for residential properties as a 'rule of thumb' and a little higher rate for condominium properties where no market analysis is done in arriving at the capitalization rate. Hence there are different residential condominium properties with different property attributes this research focuses on to calculate a capitalization rate for semi luxury residential condominium properties. The objectives of the research are to calculate a capitalization rate for residential condominium properties from transaction data and to derive unsystematic risk, to identify the attributes of residential condominium property which contributes to the unsystematic risk and to examine the effects of the attributes and evaluate the level of contribution to the unsystematic risk. There were two approaches followed; the comparable approach and theoretical approach to accomplish the research objectives. Through the analysis a capitalization rate of 3.79% had been derived for semi-luxury condominium property and a predictive regression model is established which shows the effect of property and locational attributes on unsystematic risk. The author recommends to use the theoretical approach as the heterogeneity of property types can be better considered and such a rate derived should be compared with the capitalization rate obtained through comparable approach.

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# CHAPTER ONE

## Introduction

### 1.1 . Background of the Study

Real estate appraisal, property valuation or land valuation is the practice of developing an opinion of the value of real property, usually its Market Value.

The market value can be defined as;

*'The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.'* (Royal Institution of Chartered Surveyors Valuation Standards,2010)

There cannot be a centralized setting for the trading of property assets, as the stock market. The absence of a market-based pricing mechanism determines the need for an expert appraisal/valuation of real estate/property.

*'The need for appraisals arises from the heterogenous nature of property as an investment class: no two properties are identical, and all properties differ from each other in their location - which is one of the most important determinants of their value.'* (Chandrashekar & Young, 2000).

A valuer is called upon to give his opinion as to the value of many differing types of interest in many differing types of property for many differing purposes. Amidst of such a multiplicity of situations the approaches to the determination of value have evolved over the years.

*'An appraisal is an estimate of market (or other specified) value under the property, market, and other conditions that prevail at a given date. The amount of income that a subject property is expected to generate over its*

*expected holding period is a key element for estimating its market value.'*  
(Kang, 1999)

There are five methods of valuation ; the comparative method, the investment method, the residual method, the profit method and the cost method.

One or more valuation approaches may be used in order to arrive at the valuation defined by the appropriate basis of value' (International Valuation Standards, 2011). There are three approaches described and defined in the International Valuation Standards, 2011 to be used in valuation.

- The cost approach
- The market approach and
- The income approach

The cost approach is also called the summation approach. The theory is that the value of a property can be estimated by summing the land value and the depreciated value of any improvements. The value of the improvements is often referred to by the abbreviation RCNLD (reproduction cost new less depreciation or replacement cost new less depreciation). Reproduction refers to reproducing an exact replica. Replacement cost refers to the cost of close substitute building a house or other improvement which has the same utility, but using modern design, workmanship and materials. In practice, appraisers use replacement cost and then deduct a factor for any functional dis-utility associated with the age of the subject property.

The sales comparison approach in a real estate appraisal is based primarily on the principle of substitution. This approach assumes a prudent individual will pay no more for a property than it would cost to purchase a comparable substitute property. The approach recognizes that a typical buyer will compare asking prices and seek to purchase the property that meets his or her wants and needs for the lowest cost.

The income capitalization approach (often referred to simply as the "income approach") is used to value commercial and investment properties. This approach is generally considered the most applicable valuation technique for income-producing