Box 3.1

Methodology of compiling property price and rental indices*

The official property price and rental indices are compiled by the Rating and Valuation Department (R&VD) and published on a monthly basis. The indices now cover 4 major types of property viz. residential property, office space, shopping space and flatted factory space. A brief introduction to the methodology underlying compilation of these indices is given below, with a view to facilitating the use of these indicators to analyse market changes.

Common mis-perceptions

There is a quite common approach to analyse property market performance by referring to the movements in average price/rental per measurement of floor area (referred hereafter as average price/rental for simplicity sake) for transacted properties. However, this approach is very broad-brush in nature and sometimes may produce misleading indications. The main reason is that properties transacted in different periods may differ substantially in qualities and characteristics, such as floor level, view, location and age. These differences can give rise to movements in average price/rental that hardly represent actual change in market condition.

In order to more accurately reflect market changes, comparison of property price/rental over time should be made with the effect due to the factors of quality and characteristics being discounted as far as possible. This can ideally be achieved by frequently updating the potential saleable/leasing value of properties. However, massive resources in conducting valuation would be involved, thereby imposing practical difficulties.

Rateable value approach to compile property price and rental indices

Nevertheless, the rateable value (RV) approach currently adopted by the R&VD provides a technically viable and economical solution. This approach relies primarily on the RV that is an estimate of annual open market rental value of a property assessed for rating purpose. It is reviewed on the same date annually for all completed properties, with due regard to the prevailing market condition generally and the quality and characteristics for different properties specifically. The RV approach comprises 3 major steps :

(i) The price/rental of a transacted property in a given category (by sales/leasing and by major property type) is divided by its RV to calculate a “factor” in that category. As the market prices/rentals as well as the RVs of different properties have already reflected the vast differences in quality, the “factors” can enable a like-with-like comparison of different property transactions in the same category.

(ii) The “factors” for all transacted properties in the same category and in a given period are pooled together and averaged in equal weighting to generate an average “factor” for the category in the period concerned.

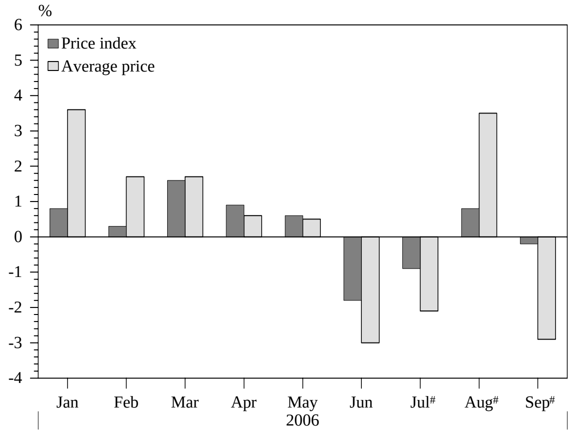
(iii) The average “factors” for a given category in different periods are then used to construct an index that reflects price/rental change over time.

For residential property and office space of which more than one sub-category is featured, step (ii) involves a weighting process in compiling the composite price or rental indices for the category. The weights are based on the number of transactions for different grades of residential property, and the floor area for different grades of office space, in the latest 12 months on a rolling basis to remove the seasonal effects.

Box 3.1 (cont'd)

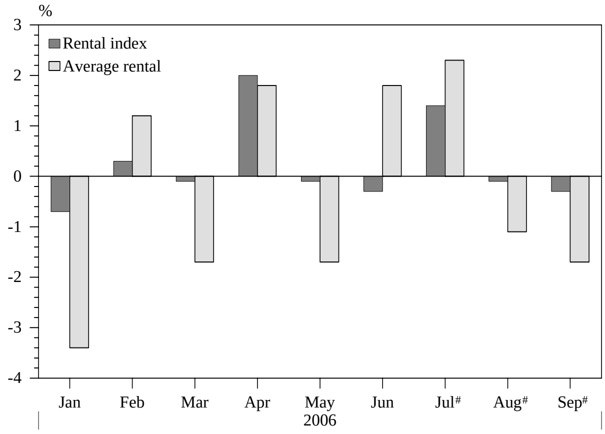
For illustrative purpose, the following diagram compares the recent month-to-month changes of the property price/rental indices compiled by R&VD vis-à-vis the average price/rental levels. Generally, the price/rental indices exhibits a more stable movement that matches with the steady state of the private housing market so far in 2006. On the other hand, the average price/rental exhibits greater fluctuations that do not quite tally with the actual situation.

Residential property prices
(month-to-month rate of change)



Note : (#) provisional figures

Residential property rentals
(month-to-month rate of change)



Note : (#) provisional figures

Sources of data

The data on property prices are obtained through the scrutiny of sales transactions by R&VD for stamp duty purposes, and from the Day Book of the Land Registry. The data on property rentals are mainly sourced from the returns on leasing information submitted to R&VD.

Other technical issues and caveats

The price indices do not cover primary market transactions for two major reasons. First, RV is not yet available for most of the properties traded in the primary market that are not completed. Second, there often exists a variety of concessions tied to different price levels set by the developers, in respect of payment terms, interest rate subsidy, cash rebate, etc, making like-with-like comparison of prices for different transacted properties very difficult.

In compiling the rental indices, the underlying rental data is analysed on a net basis, exclusive of rates, management fees and other charges. If the rental charged to tenants already covers such expenses, adjustment is made to enable like-with-like comparison of different transactions. By the same token, the effect of rent-free period granted to tenants is discounted if known. However, the effect of concessions not specified in the contracts cannot be adjusted in the absence of details.

Both price and rental indices are statistical presentations to indicate a general market trend only. It is therefore not advisable to use the indices as a substitute for valuation of individual properties.

(*) This article is jointly prepared by the Rating and Valuation Department and the Economic Analysis Division.