FUTURE DIRECTIONS
AND
CHALLENGES
FOR
VALUATION RESEARCH
AND
PRACTICE

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1. Introduction

This is a heavily edited review of the keynote address given at the opening of the Pacific Rim Real Estate Society conference which took place in Sydney in January 2000. This version has been prepared for publication in the Pacific Rim Property Research Journal The paper reviewed the area of appraisal of real estate in the context of both techniques and their operation within markets and aimed to isolate a few themes rather than attempt to construct another research agenda.

The appraisal process can be identified as instructions (communication with clients), bases (the question to be posed), methods (the way in which the question is answered) and reporting (informing clients and third parties of the answer and all its limitations).

As both instructing and reporting can be categorised as communication with clients, the paper concentrated on various issues within these three categories of bases, methods and communication with clients. As with all classifications, some issues do not fit comfortably within them.

The paper was aimed at a wider audience than the mainstream appraisal academics and practitioners. Valuations are used to construct data used in research and some of this research would be better based if the background to the valuations was better understood. The paper discussed a number of examples to illustrate the point under the three sub headings outlined above.

2. Bases of Valuation

There has been a great deal of progress in determining world-wide agreement on bases of valuation and the work in the future will be aimed at the production of a detailed manual of valuation standards. At present, the detail within the manuals seems to decline as they move from national to international. In the UK, there is the added complication of European Standards which do not sit comfortably anywhere.

However difficult to obtain cross border agreement on standards, the model should be the detailed RICS (1995) Red Book and the API (1999) Professional Practice Manual, not the more general approaches currently adopted in the International and European Standards (however much detail has been added into the most recent drafts which were circulated after this paper was written). The different concepts of market value and worth (investment appraisal) now seem well understood. Development now needs to be towards world-wide agreement on the wording and interpretation, including world wide agreement on basic accounting requirements. If this could be achieved, lenders, owners and occupiers could be confident that valuations for similar purposes would have some consistency across borders.

However, agreed detailed standards can never achieve total consistency as local/national interpretations will always be present. The major research question is isolating these differences in interpretation, not necessarily to eliminate them but more to inform users that apparent consistency may be illusory.

A few examples of issues within concepts of bases of valuation are set out below to illustrate the overall problem.

2.1 Investment worth

Although the concept seems to be well established globally, and in a number of countries there are guidance notes on how to apply it either in existence or in course of preparation (Australia, NZ, UK for example), its use seems to be restricted to an appraisal of the value of a property to an individual rather than to a market. Research needs to address this issue globally at a very practical level with studies into how appraisals are used, the information bases applied, how they interact with market valuations and whether inputs are personal or apply to a wider set of purchasers. Cash flow models are relatively standard across the world, application and information are more interesting issues.

2.2 Sustainable value

The second major issue on concepts and bases is valuations for bank lending in general and the concept of sustainable values in particular. In bank lending, concepts of exchange price/market value are not readily accepted as being useful bases and there is a movement in some countries in Europe to using a basis called sustainable value. It is enshrined in legislation in Germany and has been recently enthusiastically accepted by the European Mortgage Federation (EMF, 1999) and in the latest draft of the European Valuation Standards. It is defined as:

The mortgage lending value shall mean the value of the property as determined by a valuer making a prudent assessment of the future marketability of the property by taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property. Speculative elements shall not be taken into account in the assessment of the mortgage lending value. The mortgage lending value shall be documented in a transparent and clear manner.

Both market value and worth are estimates of price as at the valuation date, can be defined and are occasionally verifiable by reference to actual prices. This definition of EMLV raises considerable questions regarding timing of valuation and interpretation of some of the phrases such as 'future marketability', 'long term sustainable aspects' and 'speculative elements'.

The author's view on this have been published elsewhere but suffice to say that this basis appears to suggest that values can last through time, a concept alien to most economic concepts of value (Crosby, et al, 2000). Its application shows it to be no more than a conservative market value using current value indicators which are then adjusted by reference to past trends. It is a form of already adjusted loan to value ratio. Give it a new name and somehow it takes on an increased standing. I hope valuers and real estate economists worldwide will resist any attempts by lenders to adopt it. The ambiguity surrounding this basis could help fuel professional negligence cases against valuers and the lack of clarification of the words used in these definitions and principles are an open invitation for banks to sue valuers where their lending decisions have failed. Examination of various aspects of valuation negligence in the UK and Australia (Crosby, Lavers and Murdoch, 1998 and Crosby, Lavers and Foster, 1997) suggests that there is little doubt that this definition would make a defence virtually impossible unless the valuer had used assumptions that verged on the worst case scenario for each aspect of the valuation. Is this really the intention?

One model for research identifies a particular practical problem and sets out to suggest solutions to that problem. There is no doubt that the whole area of valuation bases which are useful to banks in the lending process is one which requires some academic input to lay alongside these developments in practice. The issue is linked to wider questions of what methods to use, what information is needed to operationalise the methods and how this information should be incorporated into valuation reports to better inform lenders.

But fundamentally, it should be the property profession which researches and identifies the service which they can offer to bankers and the things that valuations and reports cannot do, i.e. the limitations inherent in the process. If they do not do this, banks will continue to suggest ways they think the valuation service can better inform the lending decision and continue to complain when that service is not delivered.

2.3 Open market rental value

It is only recently that the Red Book in the UK and the Professional Practice manual in Australia attempted to deal with the problem of rental values. Rental value as a definition is much more complex than capital value and additional items which need consideration are the terms of the lease and the treatment of incentives. This is a very good example of where a consistent basis may introduce various interpretations, but also where a consistent international standard may be very hard to achieve.

For example, the Red Book has included a formal definition while the Australian manual has described how rents could be assessed in different circumstances.

The problems with rental value assessment have recently come to a head in the UK with the problem of reconciling rental values determined for specific valuations and then being used for performance measurement purposes. The Investment Property Databank is an extremely large and sophisticated commercial property performance measurement system which generates rental value indices, valuation yield and reversionary potential indicators. It does so from the rental value indicator supplied to it by property owners. They generate these indicators from the periodic valuations and, although the IPD ask for a rental value based upon the Red Book definition, recent research suggests they are getting a variety of variations; sometimes the rent the owner thinks could be supported at a rent review in the lease, sometimes the headline rent at new letting after a number of incentives are given and sometimes the rent at new letting if no incentives to let where given.

The problem for performance measurement does not stop with indices based upon real properties. Some other rental value indices not based upon actual properties (CB Hillier Parker Rent Index) are based upon headline rents and therefore did not record the true level of rents in the recession. Australia has the same problems of the use of incentives so it could have the same level of inconsistency in performance measurement indicators.

2.4 Valuation for owner-occupiers in financial accounts

There is a less conceptual, more detailed research question to be answered here. Again it is a question of consistency of application of exiting use assumptions across and within countries.

The notion of market value for existing use is accepted in both the UK and Australia but the applications appear to be very different. The research that needs to be done is to determine just how different these applications are and which solutions are working the best. A comparison of the UK and Australia would be interesting as, in the UK, the notion of an assumed sale and leaseback, at prevailing market rents and terms and conditions to the occupying company, is specifically excluded, but appears to be actively encouraged in Australia. How do these applications fit in with applications in other countries operating under similar accounting regimes? The UK committee which writes the Red Book has this issue on its agenda currently and a study analysing the Australian approach would be, at very least, informative.

3. Methods of Valuation

This is a more difficult area to discuss in detail as the number of possible topics which are screaming for attention is greater. However, it seems to me that one is screaming louder than some others. This may be more apparent in the UK than elsewhere, but it is the sea change that has occurred in some countries for a permanent shift towards landlords taking more of the risk of property ownership and not being able to pass as many liabilities onto the tenant as in the past. Tenants increasingly want the flexibility to enter and exit premises quickly at low transaction costs and will pay for that flexibility while using the premises. This raises many questions; including (amongst others) the use of finance market techniques in general and option pricing in particular in real estate markets, and the issue of pricing based upon a thorough understanding of the business cash flow and profitability.

3.1 Option pricing

In the UK, option pricing is particularly aimed at pricing diverse lease terms since, for many years, the need to price diversity in leases did not exist as the vast majority of better quality property in the UK was let on standard terms and conditions. The 1990s has seen a significant change to this as can be seen in Figures 3.1 and 3.2.

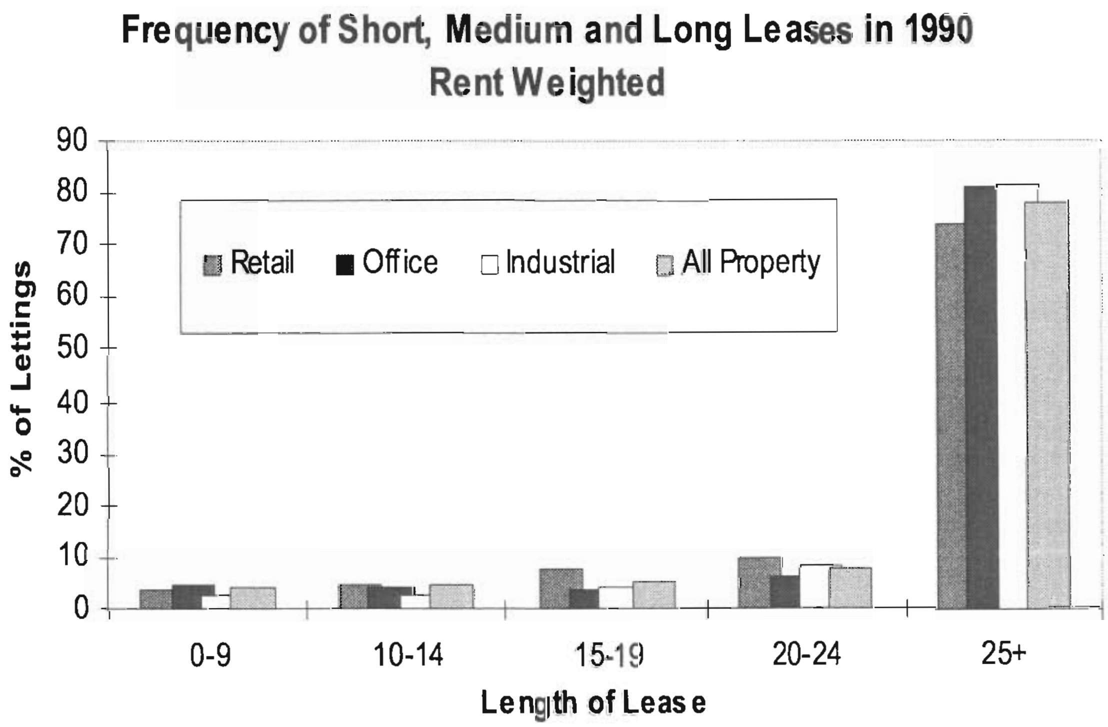

Figure 3.1 : Rent Weighted Frequency of UK Short, Medium and Long Term Lettings 1990

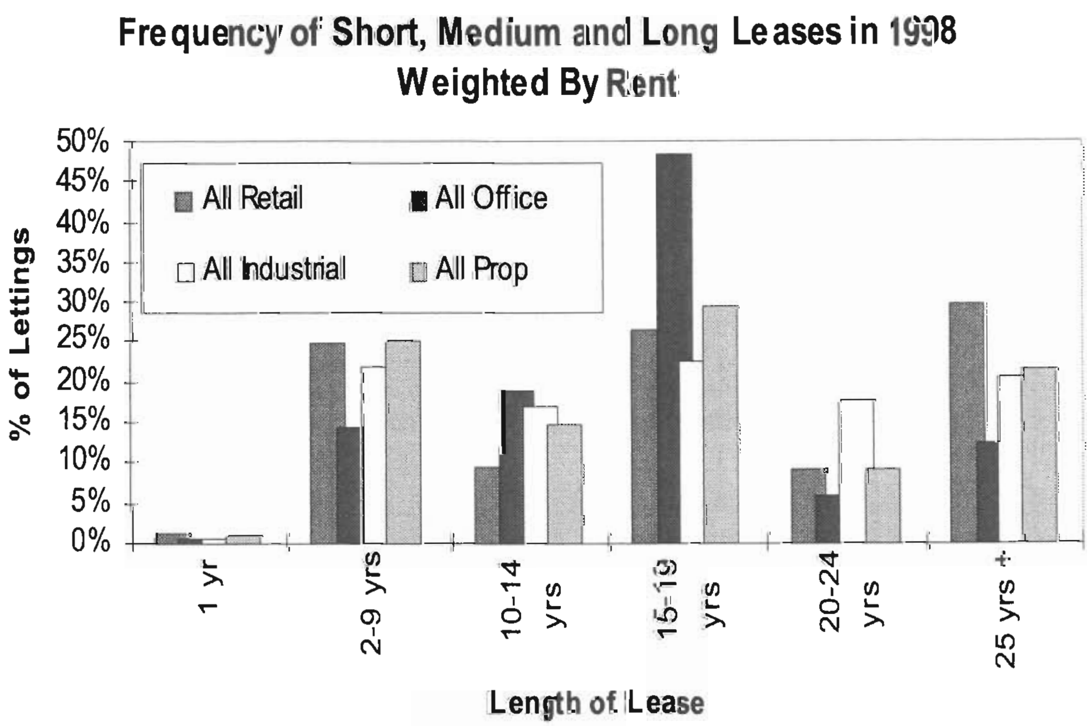

Figure 3.2 : Rent Weighted Frequency of UK Short, Medium and Long Term Lettings 1998
Source Data Figures 3.1 and 3.2 : Investment Property Databank

The introduction of break clauses within these already shorter leases increases the diversity of lease product and so comparisons between transactions are harder to resolve. Before 1990, properties were compared for physical and locational differences as the leases were virtually identical in every case and single let properties were plentiful. Now different lease clauses need individual pricing; both for rental and capital value.

During the 1990s, there has been a number of papers on the use of option pricing to appraise various lease clauses, particularly the upwards only rent review (for example, Ambrose, et al, 1998; Grenadier, 1995; Ward and French, 1997). Ironically, of all the changes in lease structures, this has been the one clause that has been left virtually intact in the UK so the need to price this one is less than the others; i.e. breaks, shorter leases, etc. However, most of these papers seem to offer an alternative to traditional cash flow approaches which take into account the volatility surrounding the future estimates of cash flows and adopt risk neutral approaches to discount rate choice. However, the problems of operationalising these models should not be overlooked. Ward in Crosby, Lizieri, Murdoch and Ward (1998) suggests:

"There are considerable difficulties to be faced when attempting to operationalise such models in property markets. These have been, to a large extent, glossed over in published work"

He then goes on to use the example discussed above concerning different rents at review, renewal of leases and new lettings to illustrate an institutional effect which the finance literature applied to property has ignored. He concludes:

"In principle, it would be possible to accommodate these institutional influences within pricing models. It would, however, require empirical evidence of the difference between renewal and new lease rents, the volatility of that difference and its relationship to market variables. This adds considerably to the complexity of modelling."

The research agenda for option pricing is clear. Having applied this and other financial models to property at a largely simplistic level, the time has come for those suggesting that option pricing and other finance models are superior to existing cash flow approaches to operationalise them in conjunction with those who understand the institutional and behavioural influences on values, valuations and valuers.

3.2 Business valuation

The Mallinson (1994) Committee in the UK came up with the notion that valuers should take adequate steps to "know their clients", i.e. understand their business. This was actually in the context of communication with clients but the emergence of tenant demand for flexible space such as serviced offices/business centres reinforces the need to be able to model the business operation carried on within the property to understand the property value.

This is nothing new in the field of so called specialised properties such as hotels, leisure, etc, but increasingly it is being applied to shopping centres and other mainstream commercial property investments.

This has two major implications for valuers. First, if they need to understand the business run from the property, will valuers have to become more and more specialised on similar property types. This is becoming ever more important in the UK because of the pressure for landlords to take on more of the risks of property ownership discussed above.

Serviced offices are an interesting new form of occupation and raises a number of questions which research into business valuations has not quite satisfactorily answered. The main one is the distinction between the value of the business run from the property and the underlying property value But other questions are who is the occupier; is it the individual who owns or rents the property as a traditional office before putting in fixtures and fittings, adding services and then letting out rooms and/or suites on short term lettings? Or is it the individual tenants of the rooms and suites.

The research agenda is the whole of business property valuations which, apart from the US (see, for example a forthcoming paper by Kinnard, et al, 1999), has been either badly or under-researched. The distinction between property value and business value has been blurred and RICS and API guidance notes do not seem to help. The implications for lending are important. For example, taking the case of the serviced office, if they are seen to be a business run from a property, they will be treated like any other company occupying or owning property and generating profit. The underlying property asset can be collateral for a secured loan while the company can borrow additional sums against its business operation from the corporate section of the bank. But if it is seen as a property business, the loans will be based upon property assets only; and valuers will no doubt relate the property value back to the vacant office in traditional use.

So not only have landlords taken back some of the responsibilities of ownership, they are now participating in the profitability of the business run from the property. As indicated before, these changes may be far more important and far reaching for the UK than elsewhere and comparative studies in countries with greater experience of landlords and banks sharing risk could inform the UK.

4. Communications with clients and behavioural influences on valuations and valuers

If the banks in the UK have learnt anything from the crash of 1988 in the residential market and 1989/90 in the commercial market, it is that they need to participate in the valuation process more closely and instructions and reporting hold the key to this participation. In the period since then, a number of initiatives have taken place including Mallinson (1994) and the latest version of a British Bankers Association/Royal Institution of Chartered Surveyors guidance booklet to valuers and lenders, which discussed the formalisation of the instruction process. This has been mirrored elsewhere and many detailed valuation standards now include model instructions (for example "Client Focus 2" in API, 1999).

Second, and more interestingly for a research agenda, it raises the spectre of client influence. The closer the liaison with clients, the more likely that clients will influence the outcome of the valuation. This in turn raises the whole area of behavioural valuation research.

This breaks down into two areas.

First, there is the influence on the valuers of external institutional factors such as guidance notes, professional negligence decisions and the influence of procedures set out by statute, tribunal decisions or lease provisions (i.e. third party determination processes). These will all impact on how valuers operate and the answers they come to in certain situations (Quan and Quigley, 1991).

There are a number of compelling reasons for expecting valuations to be influenced by procedural issues. First there is a view amongst some that conventional market valuation definitions are by nature backward looking due to the marketing period preceding the valuation date. In addition legal precedents and procedural norms will have an impact. These include the effect of statutory intervention and third party rental determination; regulatory requirements within professional guidance; and the requirements of competent practitioner tests within negligence cases.

Precedent effects the behaviour of professionals and the way in which they may be judged in the event of a challenge to the competency of the task undertaken. "Correct" procedures and hierarchies of evidence relating to the use of comparables are reinforced by tribunals and courts (advised by leading proponents of these valuation "rules of the game" acting as expert witnesses). A valuer strays from these norms at his or her peril and will be found negligent if either the approach or the result is too far away from the approach or the result obtained using all of these rules. These influences may all lead a valuer to place heavy reliance on hard transaction information (or a previous valuation or agreement that appeared to be hard information).

Anecdotal and valuation evidence exists that such effects manifest themselves in the commercial lettings market where new lettings tend to lead rent agreements at rent review by significant amounts. Valuation evidence suggests by an average of around 10% in rapidly changing markets in the UK and that, in falling markets, the rent determinations are higher than the level of new lettings, a strong lagging effect (Crosby and Murdoch, 1997). There is also a wealth of evidence that lagging occurs in periodic valuations, where valuers anchor on their previous valuations by placing weight on the previous valuation even though theoretically they should ignore it.

In a series of studies in which appraisers were required to simulate their everyday behaviour, Diaz (1990a; 1990b; 1997; Diaz and Hansz, 1997; Diaz and Wolverton, 1998) has shown that they:

- fail to follow the procedures in which they have been trained[1];
- do not always examine all available information[2];
- are influenced by knowledge of another person's valuation, but only when valuing in an unfamiliar area[3]; and
- inadequately adjust from their previous appraisals in performing current valuations[4].

Using a similar approach, Gallimore and Wolverton (1997) studied how knowledge of a pending sale price affected the choice of comparable sales to support a valuation. They found that in both US and UK, pending sale price knowledge had an anchoring effect, although the nature of this differed between the countries. They suggest that this difference is attributable to differences in data availability and reporting requirements. Gallimore (1994) surveyed valuers and in a series of questions and simulated tasks found evidence of anchoring behaviour and also of a tendency to give greater weight to more recent items of evidence[5]. In a later survey, Gallimore (1996) investigated whether valuers were prone to confirmation bias (a tendency to act so as to confirm existing views or judgements). He did not find confirmation bias to be a significant facet of valuer behaviour, although almost half of the valuers in the survey exhibited "precipitance" (a tendency to form judgements very early in the valuation process). This behaviour appeared to be present equally in both residential and commercial valuers.

A major issue for this area of research is methodology. At present, some of the work is undertaken by setting up experiments, sometimes with students, so that the environment is controlled. Do valuers behave differently in these situations than they do in practice and can these manufactured situations mimic real conditions? And do these kinds of experiments really inform us of the less obvious influences which take place in the valuation process?

The second area for additional research is the effect that such issues have on valuations themselves and the extent to which valuations are smoothed and lagged, and the implications of any smoothing and lagging for areas such as performance measurement which use the valuations. Much work has been done but much is still to be done.

The second major area of behavioural research is client influence on the valuer and the valuation and this is a more difficult area altogether (Kinnard, *et al*, 1997; Schuck and Levy, 1999). It encompasses situations where draft portfolio valuations are discussed with clients who can, in various ways, either innocently or maliciously affect the final outcome. There are instances of new managers being appointed, influencing the next years valuation and changes in valuers also leading to significant changes in the valuation.

In the bank lending arena, the conflict of interest is obvious where the lender allows the borrower any input into the valuation process. At worse, the valuer undertakes the valuation for the borrower who then takes it to various lenders who rely on it. The research issue is whether there is enough evidence of abuse in this process to prove that it impacts adversely on the efficiency of the lending process. There is certainly some legal evidence of its effect. (Crosby, Lavers and Murdoch, 1997).

This whole area of behavioural research, regardless of whether it is focused on procedural influences or on the area of communication and formal relationships with and influence by clients appears is fundamental in informing the more traditional areas of valuation research such as bases, methods and reporting.

1 Based on a residential appraisal.
2 Based on a residential appraisal.
3 Based on an industrial appraisal.
4 Based on the appraisal of residential apartments.
5 Based on a commercial property, though not differentiating responses by type of valuer (i.e. residential or commercial).

4.3 Reporting

There has been a lot of research done already on the sort of detail that should be in valuation reports. This research tends to suggest that the valuers are very good at providing the factual information on the building, location and leases but are much less willing or able to give market information on lettings and property investment markets and valuation methods and comparables, and even less willing to give information or commentary on wider markets such as the investment market. However, the research does suggest that the client's view of reporting is that it has improved considerably.

The research question raised is whether the introduction of new and improved valuation techniques will enhance the ability of valuers to report more fully on the market information which puts the valuation figure into context. Reporting of single point estimate remains intact even though there is increasing evidence concerning the extent by which valuations vary from one another and from the sale price. Incidentally, all of this evidence suggests that valuers in the UK vary by almost twice that of valuers in the US and Australia. That is another research question in itself.

5. Conclusions

In this paper, the definition of valuation has been drawn very tightly so that a small number of issues can be defined as research agenda items. The reality is that valuation could encompass anything that impacts on the value of property assets and practical items such as depreciation and its causes or more conceptual market efficiency issues could all be classed as "valuation" issues.

One of the fundamental drivers is that clients are demanding an ever more sophisticated service. Research and development is vital to the delivery of that sophisticated service. In the past, research in valuation tended to concentrate on methods but in the last ten years this has changed and the whole valuation process provides a wealth of research questions. This paper has only touched on a few illustrations.

There are implications for researchers, educators and valuers. More sophisticated services require more specialised professionals. This in turn requires more detailed research and education. Increasingly, single researchers cannot range across the width of skills necessary to produce research which encompasses all issues within a topic. Research collaborations are the answer both within and across institutions. The same happens in practice with increasingly large organisations merging a range of skills to develop practice solutions. And yet in real estate education, in both Australasia and the UK, we continue to produce real estate professionals with a syllabus which ranges across a variety of standardised topics with increasingly less resources to offer variety and specialisation. Are we producing more general graduates for a more specialised world? It may be that research and practice is moving ahead of education in our three countries and individual institutions should start to concentrate on different core markets, underpinned by their research specialisms within the staff. If not, we may not be up to any of the future challenges in appraisal research, education and practice.

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