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Commercial property valuations – What have they ever done for us?

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Introduction

- The title comes from Monty Pythons' Life of Brian – "what have the Romans ever done for us?"
- The answer was "Roads, Sewers, Law and Order, etc, etc" but they were still the enemy as far as the revolutionaries were concerned.
- I am going to argue that this is the case for the valuers.
- They are a really important part of the property market but they always get blamed for everything whatever they do. They have to be a very "resilient community"

The Proposition

- Despite being a very important and integral part of the property market process, valuers always seem to be the scapegoats in the aftermath of any property market crisis.
  - Bankers don't want to know the current values and sue them for valuations done pre-crisis as "too high" – confetti letters.
  - Asset managers vilify them for moving valuations downwards too much, putting the company into default (Property Company/REITs) or for not moving them down quickly enough so causing a run on the funds (Property Unit Trusts). Source IPD/IPF Annual UK Conference, November 2008.
- Basically Valuers get it in the neck from all sides but actually are a fundamental element of market processes and should be supported rather than scapegoated every time anything goes wrong.
- Surely the real issue is what happens in the boom, not the subsequent (inevitable?) crash

Charges made against valuers in the UK

1. Bankers - Valuers **over-valued in the boom** - so bankers have sued on the basis of this over-valuation.
2. Open ended fund managers - Valuers **over-value in the recession** – UK PUTs (open ended funds) suggest that they did not reduce the valuations quickly enough in the recession so causing a run on the funds where units were bought and sold based on valuations
3. Property companies/REITs – the opposite – no evidence of falls in value (no sales except forced sales) so shouldn’t reduce so quickly as transactions are not at proper market values
4. Academia – valuers are wimps – the clients say jump and they say how high – client influence research literature.
5. Germans – UK valuers are too “volatile” – should concentrate on more sustainable aspects and smooth the boom and bust.

   I am going to address the banking valuation issue but might try and pick off a few of the others along the way if I get time

Issues surrounding these questions

- The behaviour of clients and users of valuations and the questions they ask of the valuer.
- Does the type of client and the role of the valuation influence the process and the outcome?
- Are these issues similar the world over or do they differ across the different regions?
- Need to discuss:
  - Different roles (bank lending and performance measurement)
  - Different bases of valuation (market values, investment values and sustainable values)
  - Different clients and their motivations (and do they influence the outcomes).

Setting the Context # 1
Bases of valuation available to valuers

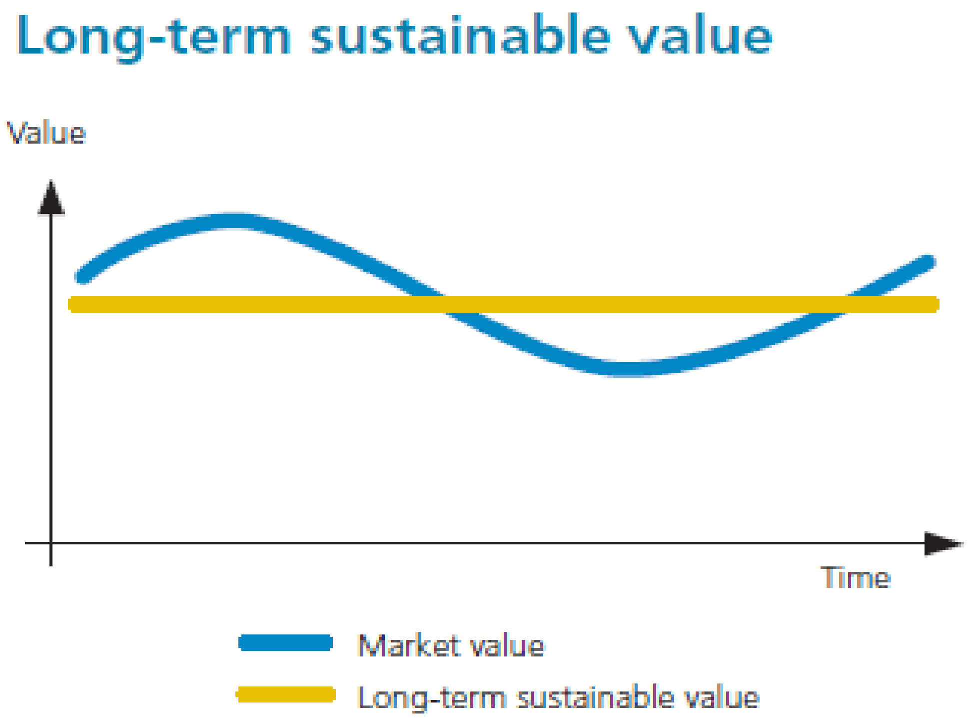
- Two main bases set out in the International Valuation Standards (IVS).
  - Market Value (MV) – best exchange price
  - Investment Value (IV) - "**the value of an asset to the owner or a prospective owner for individual investment or operational objectives.**" Supposed to reflect the underlying worth of the property to the individual (previous definitions included a wider market perspective and it is this version that has relevance for what I am going to say later).
- In addition, Mortgage Lending Value (MLV) – long term sustainable/stable value, in some countries (German based)
- In the past main discussion around the role and application of Investment Value but more recently in Europe, case for MLV in bank lending has come to the fore. (IPF, "Vision for RE Finance in the UK" discussion paper, 2013), www.ipf.org.uk.

What is Mortgage Lending Value?

"The mortgage lending value shall mean the value of the property ... 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 ……... shall be documented in a transparent and clear manner." (European Mortgage Federation, 2009, www.hypo.org.) Also see recent update.

Valuations for lending "… should be linked to [MLV] rather than current appraised value" (IPF Vision for RE Finance, 2013)

IPF Vision For RE Finance



But can MLV ever exceed MV? – not according to Ruchardt 2003, a manual on undertaking MLV valuations

So should the yellow line be drawn below the blue line???

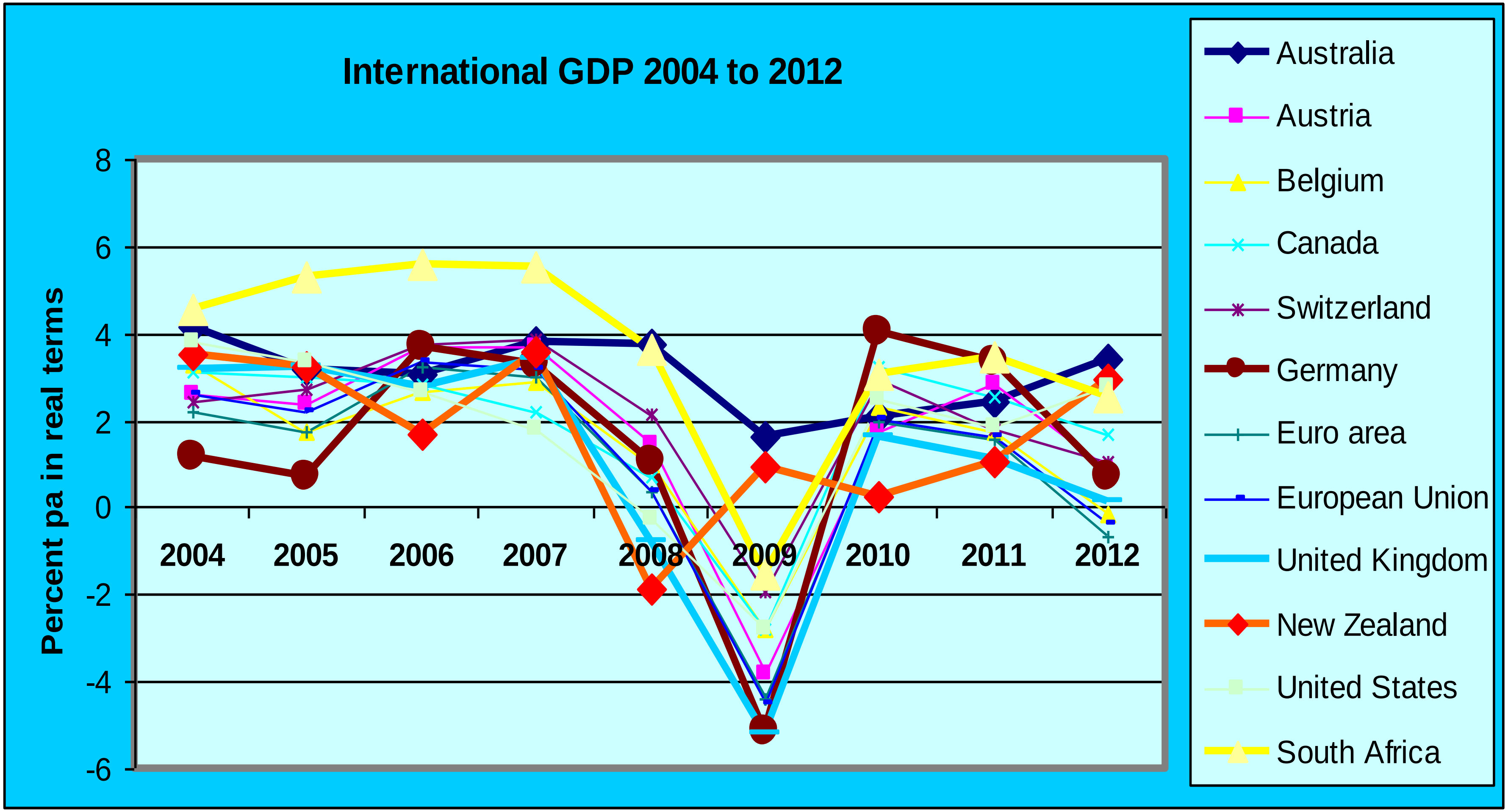
Setting the Context #2
Role of valuations

- Acquisition/sale and portfolio management
- Performance measurement and financial accounts
- Bank lending security

- Matching the role to the basis:
  - Should we use MV for everything?
  - IV used now for acquisition and sale – has it a wider use?
  - Will MLV take over for bank lending?

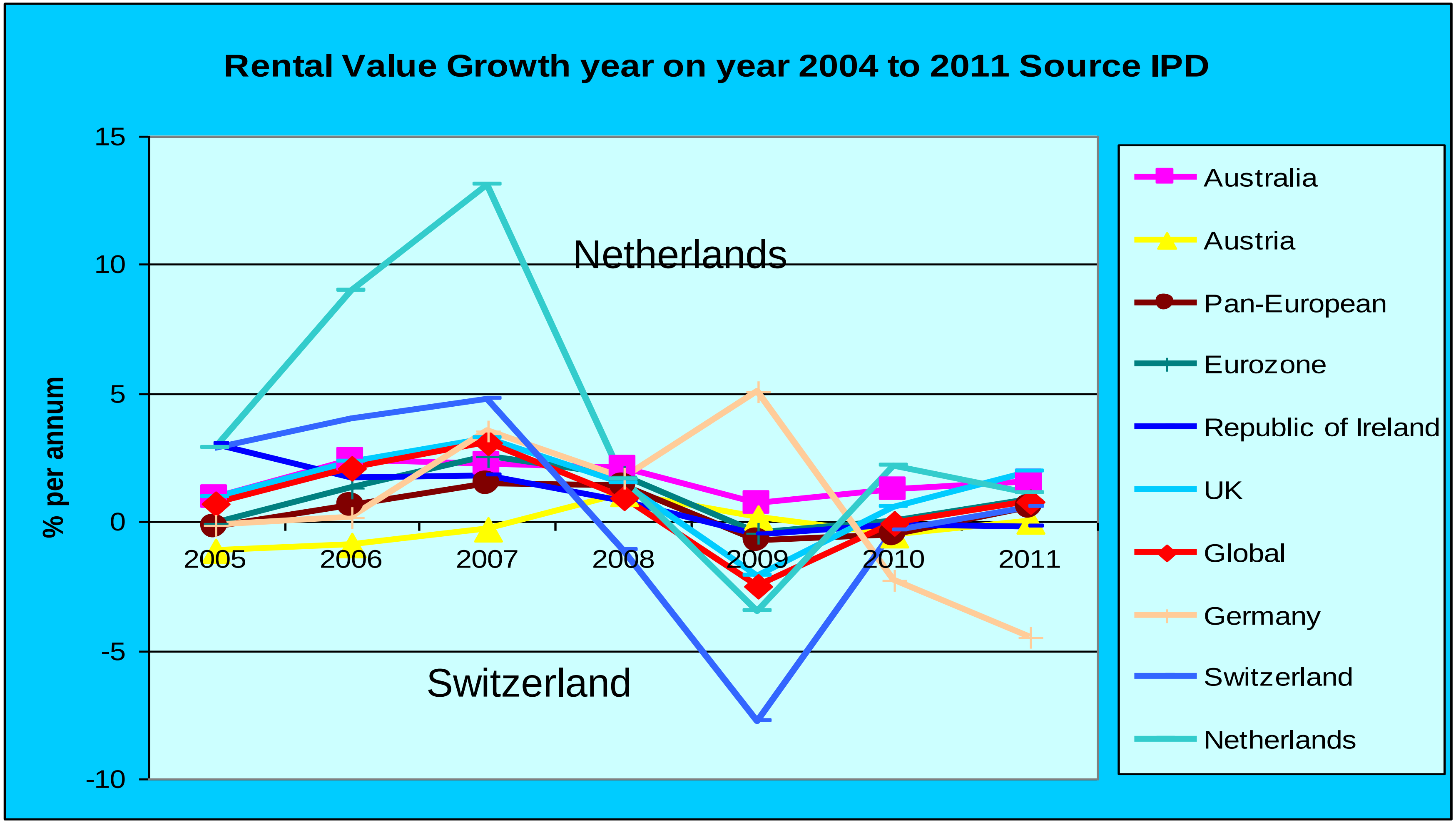
Setting the Context #3
The Market Context

Source World Bank



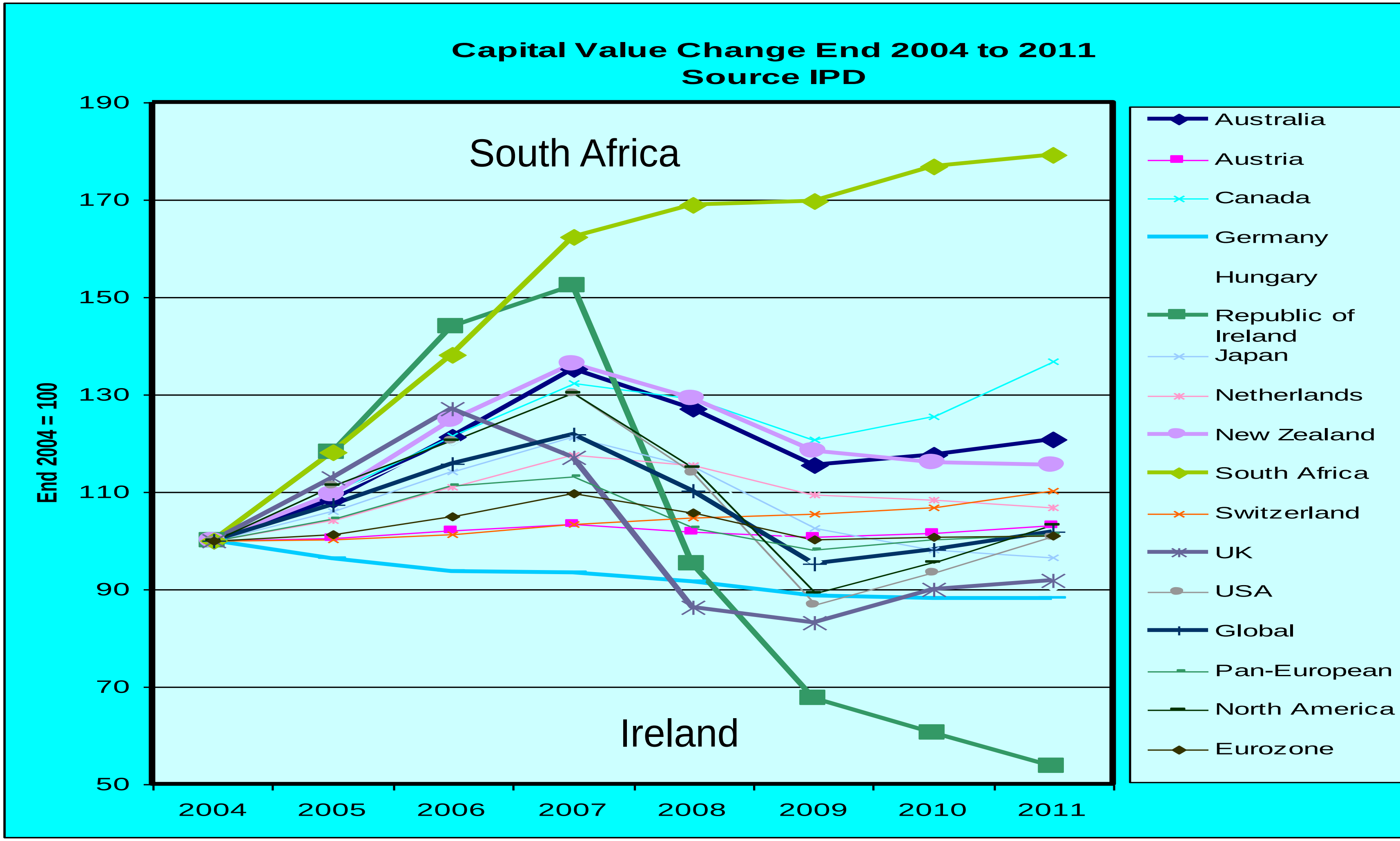
IPD Rental Value Growth 2004 to 2011

Few outliers but a dip in 2008/09 in line with GDP
UK, Australia and Switzerland highly correlated with GDP, Germany and Austria not at all

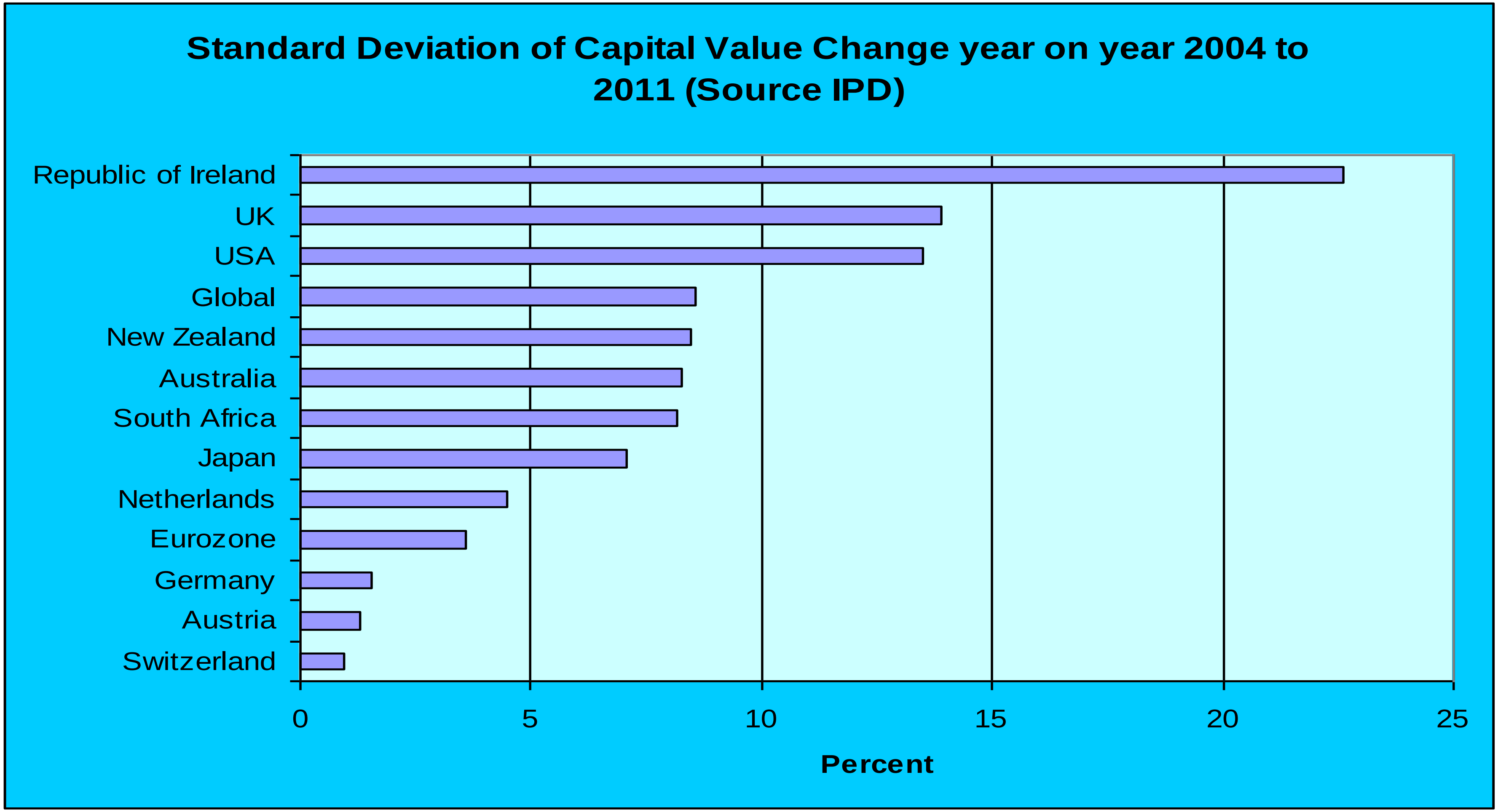


Market Context : Capital Values

Ranging from the volatile UK/Ireland to the flat Germany, Austria and Switzerland



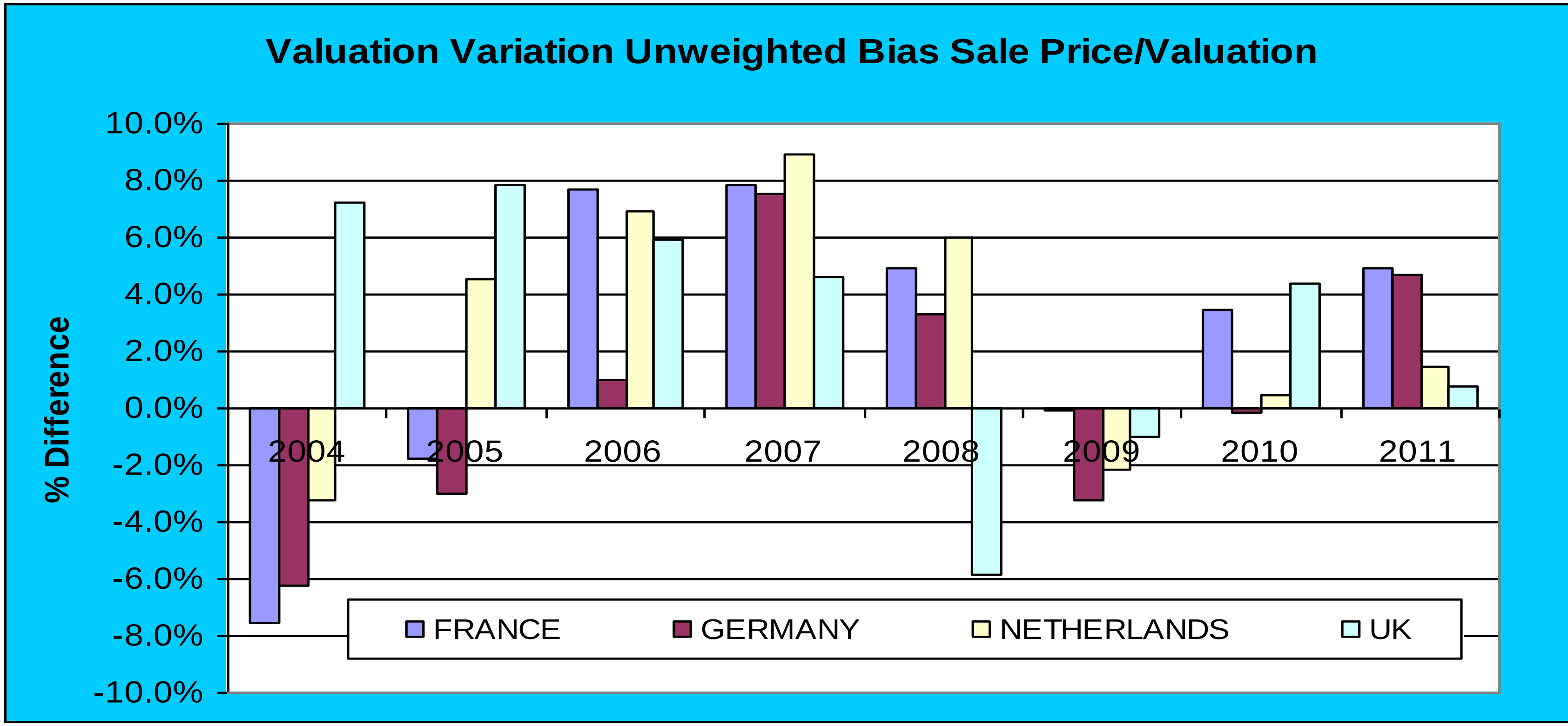
Volatile v stable markets? Or are they? Are the differences part *valuation* induced or just *value* induced?



Is there any evidence of how valuations differ from prices?

- Does this suggest **over valuation in the boom**, (bankers charge) or does it suggest valuations lagging markets – a more rational hypothesis.
- Does it suggest over **overvaluation in the recession** (open-ended, PUTs charge) or **undervaluation in the recession** (Property companies/REITs suggestion to keep valuations up when no "evidence of falls)

Over and under valuation at various stages in the cycle?

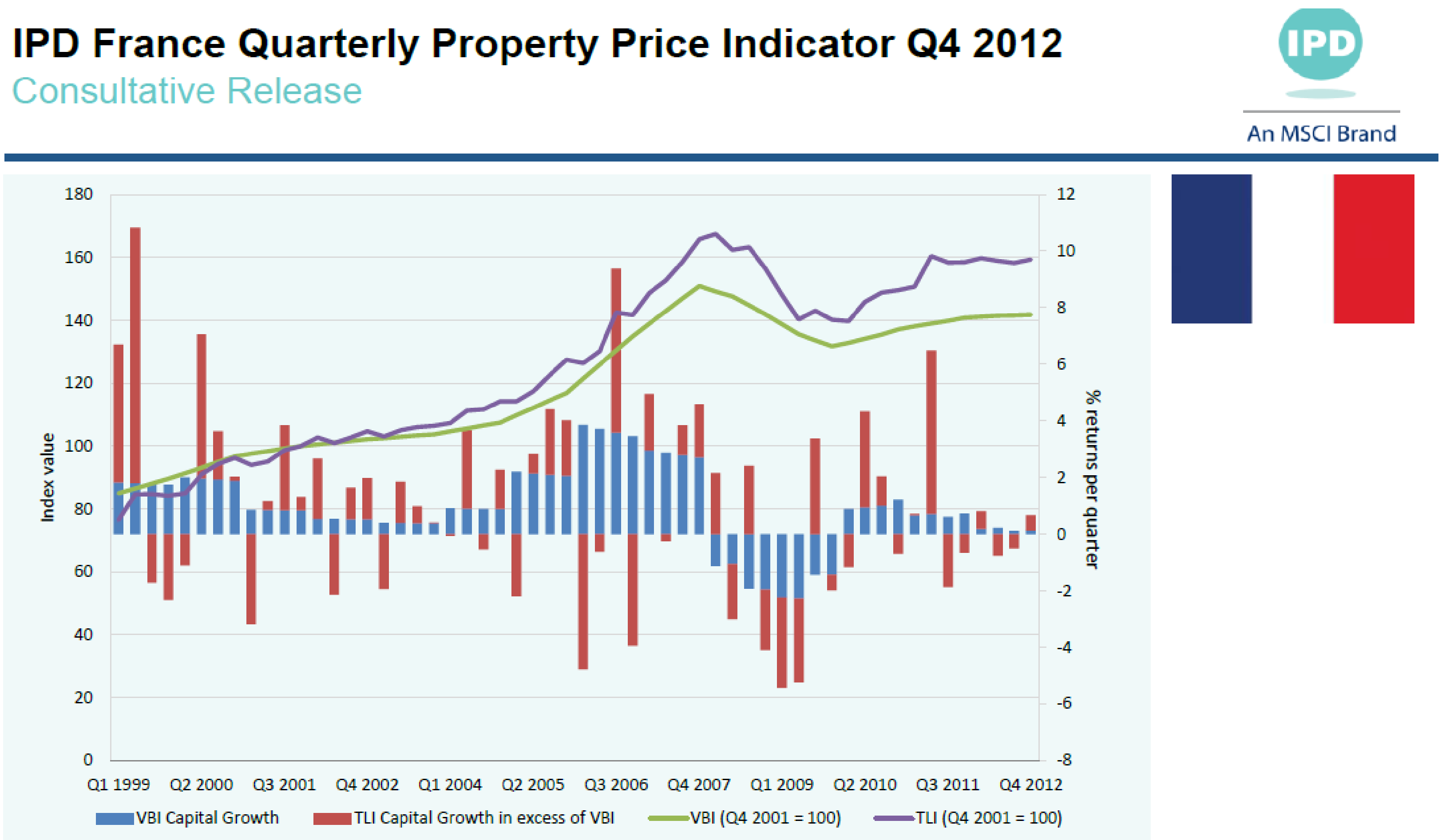


Source IPD

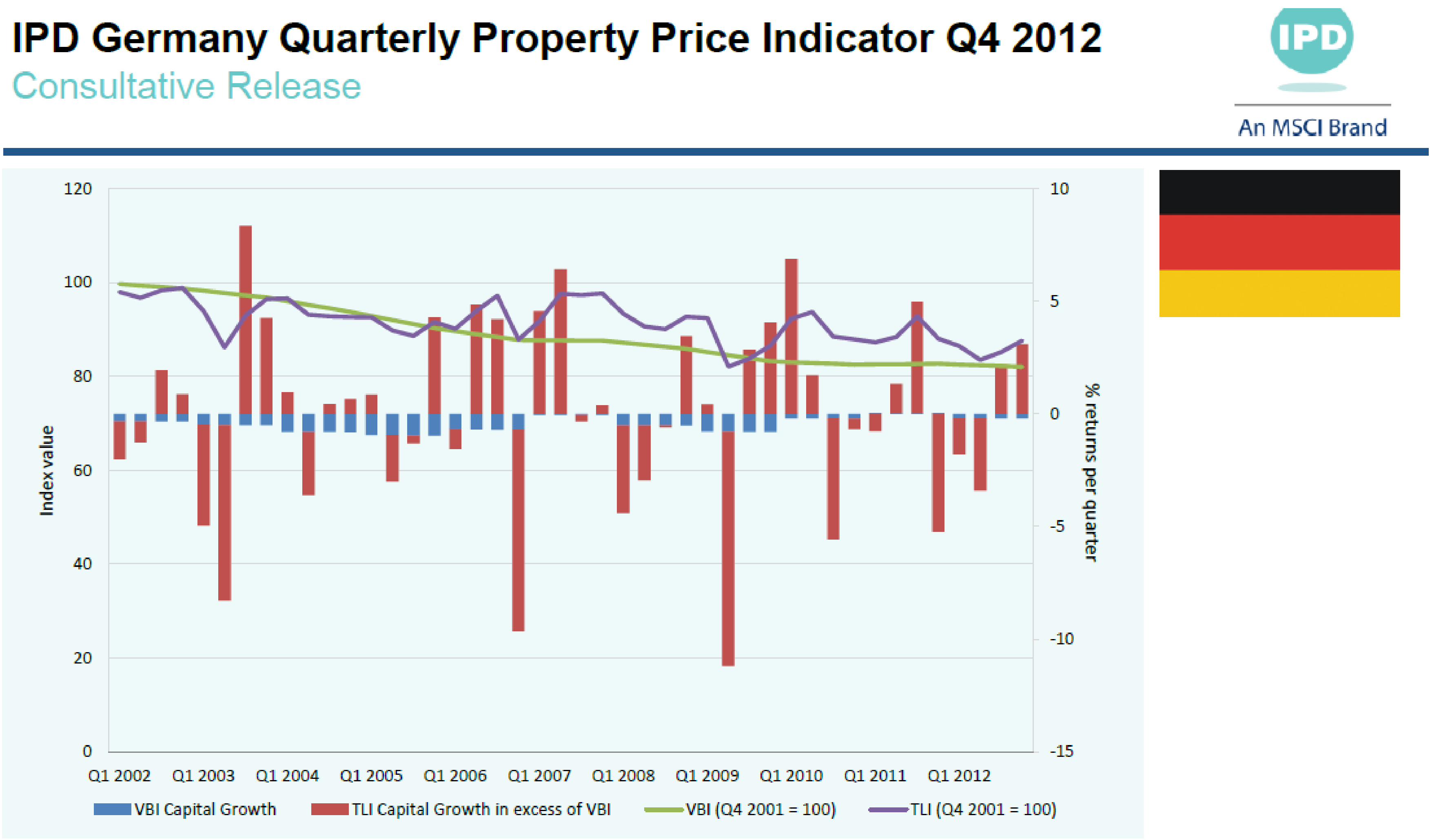
If you believe this type of study, then it suggests that generally there is undervaluation in booms and over-valuation in recessions after a suitable lag (which is what you would hypothesize suggesting that valuers lag the market).

Does the IPD transactions based indices support that hypothesis

Valuation v Transaction based indices France



Valuation v Transaction based indices Germany

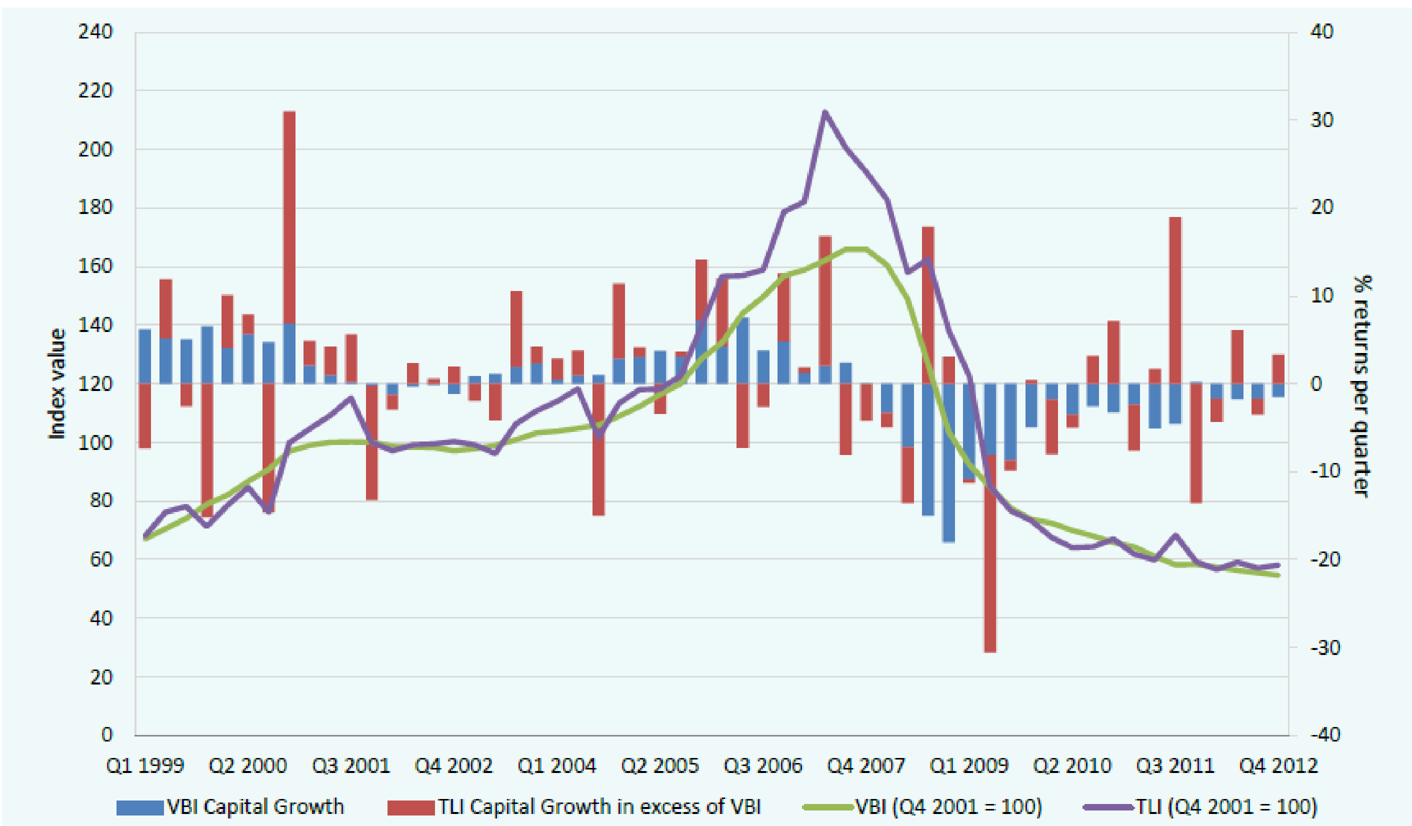


Valuation v Transaction based indices Ireland

IPD Ireland Quarterly Property Price Indicator Q4 2012

Consultative Release

An MSCI Brand



Valuation v Transaction based indices Switzerland

IPD Switzerland Quarterly Property Price Indicator Q4 2012
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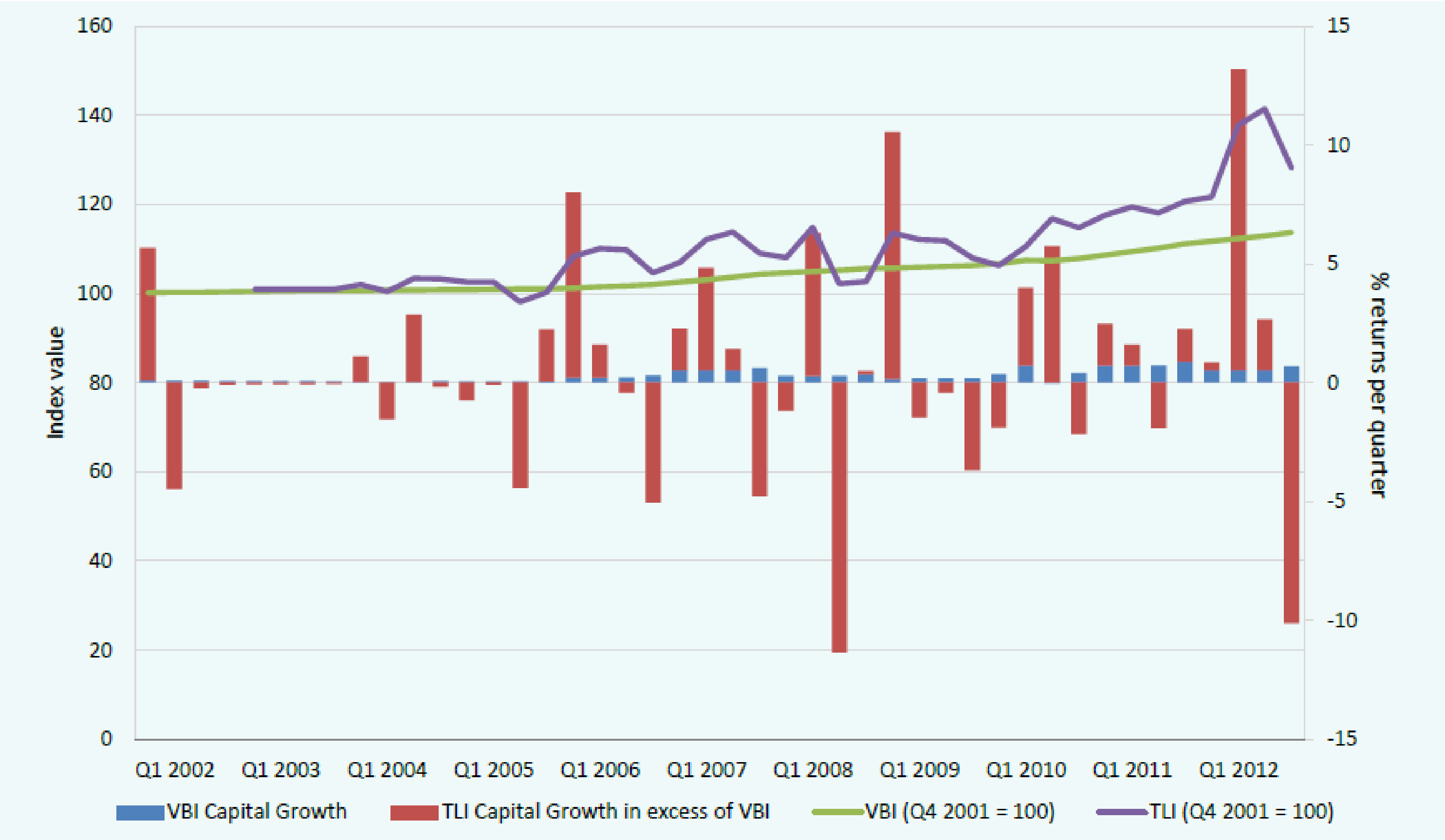
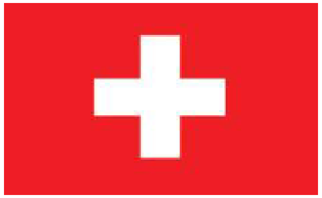


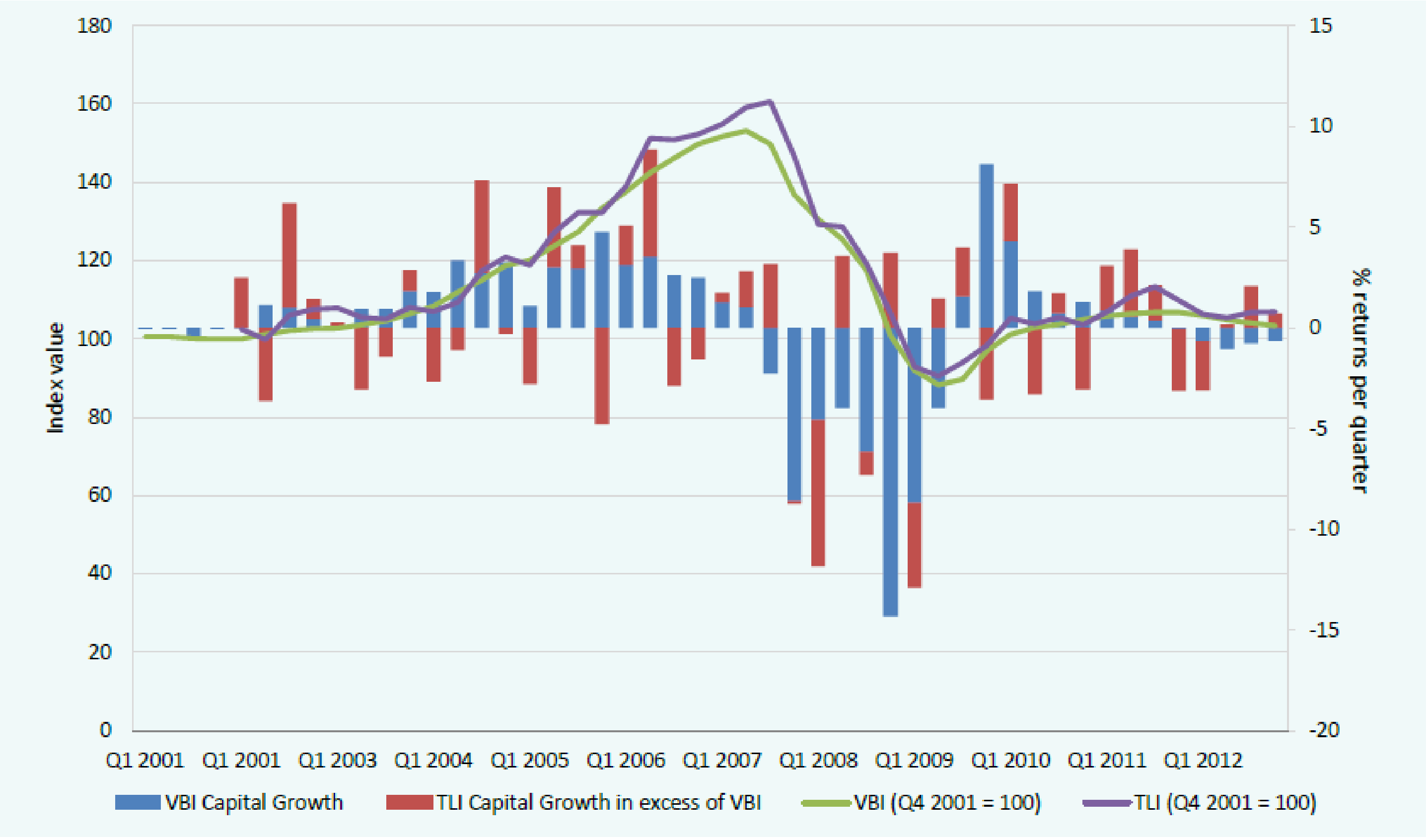


Valuation v Transaction based indices UK

IPD UK Quarterly Property Price Indicator Q4 2012

Consultative Release

An MSCI Brand



These individual country wide studies suggest ...

- The valuations do lag behind/are under prices normally.
- But that the turning points are NOT lagged.
- Valuations grow at less than prices but fall less as well so any over-valuation is lagged behind the turning points as the prices fall more quickly but from a higher base.
- In a few countries the valuation and transaction indices seem less well related but both TBI and VBI suggest less volatile markets in these countries.
- Is this a true reflection or a function of fund rules that suggest that properties cannot be sold at less than or too far away from book value.

So Banks cannot suggest that over-valuation was the problem. But they still …….

- Sue for negligence –
  - RICS in UK currently concerned at the number of “confetti” letters from bank lawyers to valuers putting valuers on notice that they may be sued for valuations undertaken in the boom period.
  - Valuers obliged to tell their insurers.
  - Insurers are paying out smaller claims rather than fighting the cases.
  - Getting the money back by increasing premiums.
  - Small valuation firms are giving up their valuation business as too risky a past-time

Banks cannot suggest that over-valuation was the problem. But they still …….

- Are party to manipulation of the valuation procurement process -
  - In 2004/5, we found Mortgage Brokers/borrowers opinion shopping, forcing valuers to compete with free desktops and manipulating bank valuer panels to maximise valuations and loans.
  - Individuals within the bank paid on a bonus structure for doing the deal, brokers paid for doing the deal and borrowers wanting to secure the cash. Who has a vested interest in being cautious or taking a longer term view?!
- Valuers caught between a lot of rocks and hard places

So has property valuation a role in the regulatory solution to banking crises?

- Real estate is at the heart of the financial crisis
  - *"The shock from the fall in property **prices**, even from their inflated levels of a few years ago, should not have caused havoc on anything like the scale experienced. Rather than suffering a 'perfect storm', we had severe weather that exposed a damagingly rickety structure".* (Vickers,* 2011, p2)
- In the UK International Commission on Banking (ICB) interim report real estate is mentioned 5 times as a problem, but never in terms of solutions.
- In the ICB Final Report real estate is mentioned 7 times, but again does not feature in solutions (in Ireland over 250 times)
- Property *valuation* issues feature 0 times (in Ireland they discuss it 5 times)

*Chair of UK Independent Commission on Banking – at least he didn't say "fall in property **valuations**" like the Bank of England)

Bubbles and Crashes – Efficient markets?

- Market bubbles survive due to the behaviour of actors who are subject to "animal spirits, fads and fashions, overconfidence, trend chasing and related psychological biases that might lead to momentum trading, trend chasing and the like." (Abreu and Brunnermeier 2003;173)
- Buyers with outcome-based fee structures take part in "frenzied acquisitions and overbidding" (Graff and Webb, 1997;30)
- **The use of debt** and limited liability encourages investors to take risks and ride the wave. (Allen and Gale 1999)
- Outstanding debt secured on the UK Commercial Property Market rose from under 10% in 2000 to over 20% of annual nominal GDP at the height of the boom (Bank of England).

The regulators response

- "Monitor" commercial property lending and use liquidity ratios to control the banks.
- Literature suggests pro-cyclical behaviour needs counter-cyclical measures to curtail it
- UK looked at Loan to Value ratio to do that (Turner Review, 2009) but kicked that into touch (FSA, 2010 indicates reluctance to engage in direct product interference)
- Could a different valuation regime have a role in this regard?

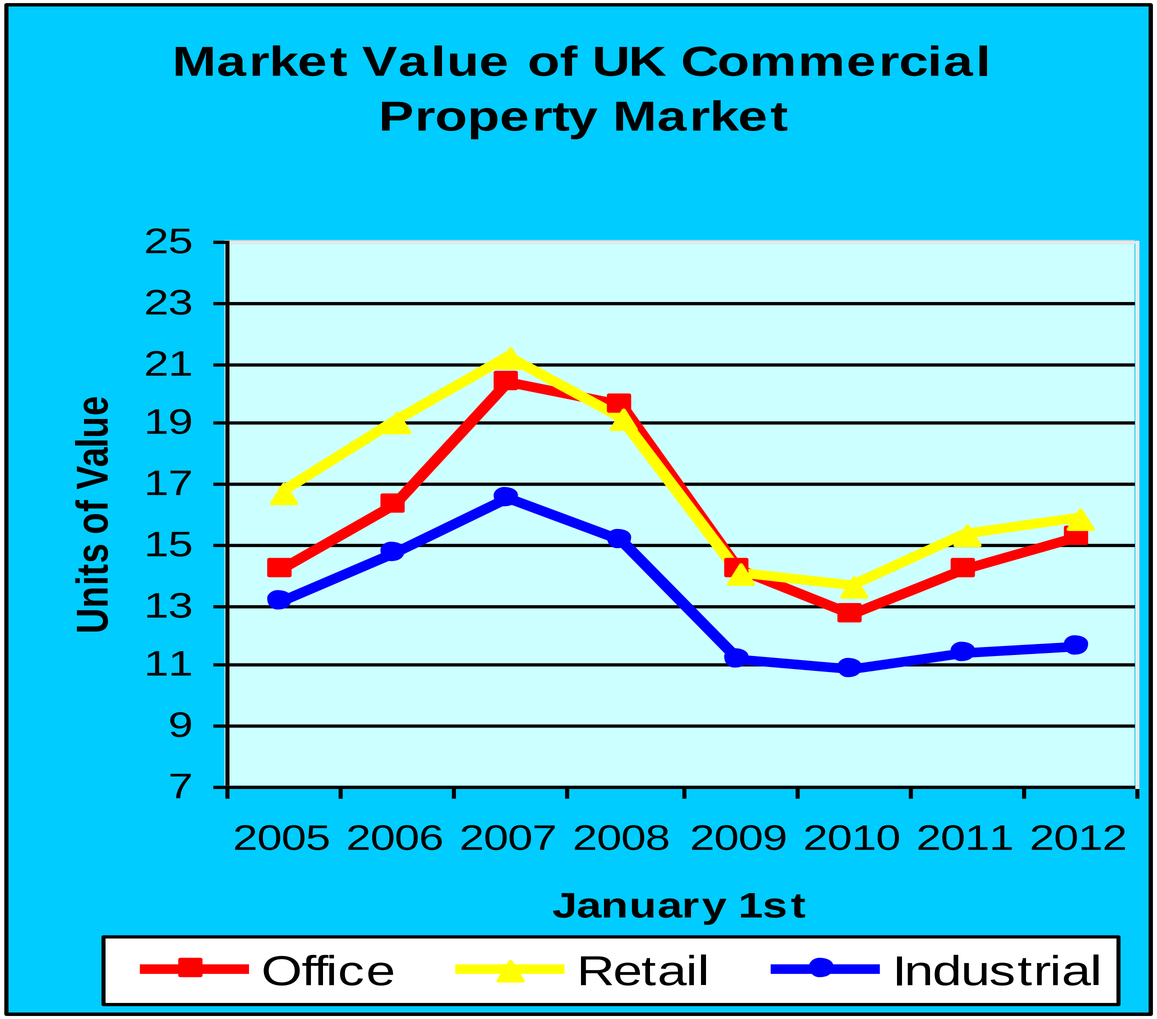
Modelling valuations through the cycle

- What would have been the impact of having each of the three valuation methods applied to UK property valuations in the last boom and bust - MV, IV and MLV?
- Valuations of the three main UK market segments – Office, Retail, Industrial – end 2004 to end 2009.
- Data
  - Cap rates from IPD current and historical series
  - Target rates from DTZ/IPF surveys of UK investors
  - Growth rates from IPF consensus forecasts
- No hindsight used at any point.

Assumptions behind the analysis

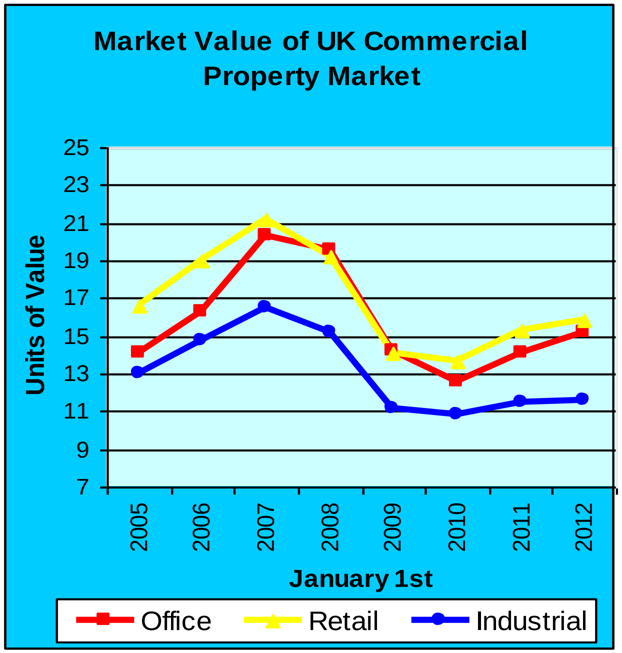
- MV - comparison based using current cap rates (IPD) and current rental values grown at IPD CRV index each year
- For IV - target rate (source mid term bond yield plus DTZ and IPF survey evidence for Risk Premium), forecast of growth (IPF consensus), holding period (5 years) and exit yield (Long term IPD average looking backwards from the entry date) for each of the three main segments of retail, office and industrial
- Valuation date (beginning of year 2005 to 2012).
- MLV – Ruchardt, 2003; EMF, 2009 basically can be interpreted for UK to use current RV and a long term cap rate (as above) but add 15% to the Cap Rate because UK doesn't take off for depreciation outgoings, etc.
- Varying the sources of the major assumptions has no impact on the general shape of the findings.

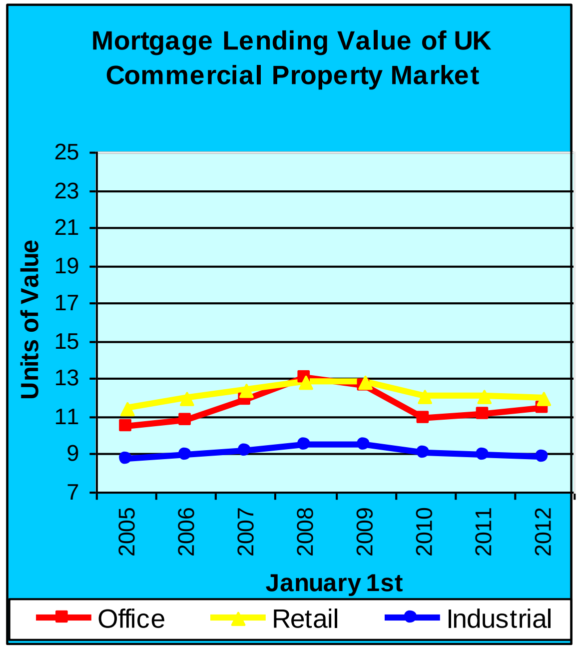
Market Values of Commercial Property in the UK - beginning of 2005 to 2012

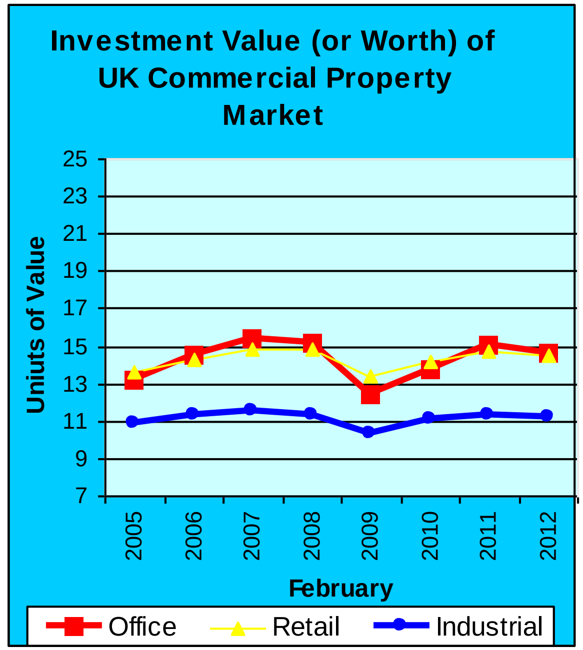


From the end of 2004 to the end of 2006 values rose by 40% for offices and 25% for retail and industrial. They fell by around 40% in all three sectors over the following 3 years

Market Value, Mortgage Lending Value and Investment Value

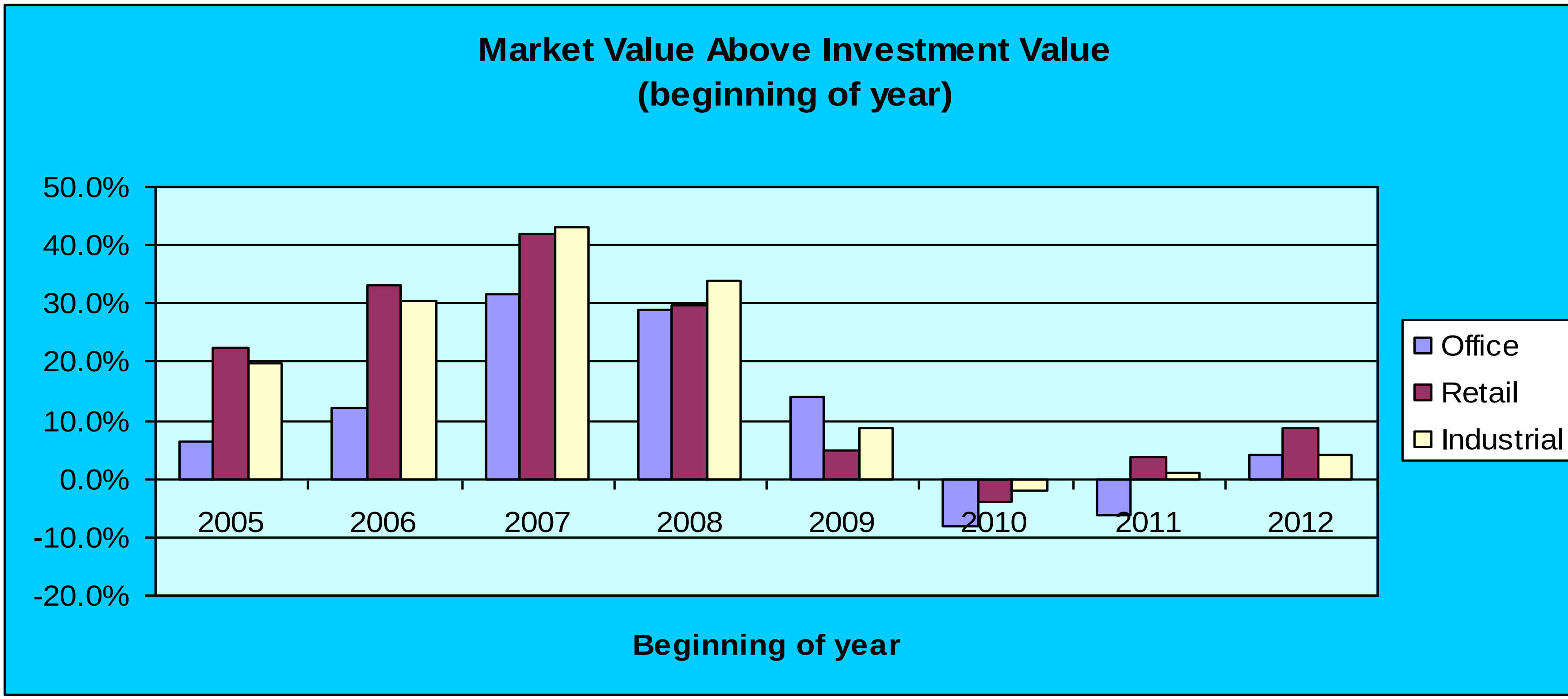






In contrast, both IV and MLV have smoothed the bubble and the crash significantly so both appear on the surface to be the countercyclical solution to curbing bank lending in the boom

Investment Value v MV



This suggests that IV identified the bubble from the end of 2004 onwards and that the correction was not really an over-correction until end 2009

Bank Lending Valuation Basis Summary

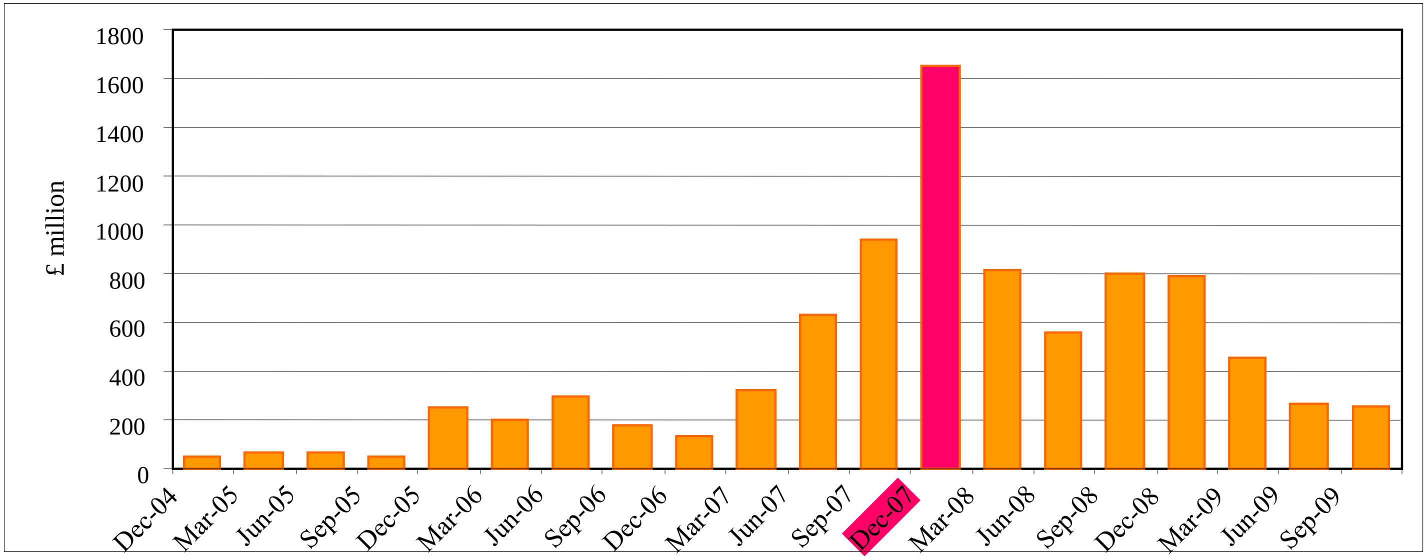
- IF banks want long term sustainable loans then using cash flow based *investment values* or *mortgage lending values* give better information for lending and risk management.
- They would lean against the bubble by restricting the amount lent in the bubble and "allowing" much higher levels of loan to *market value* in the downturns.
- Both can be done at individual property but also at different segment levels as per this example as part of risk management.
- IV does everything claimed for MLV and is in the IVS so valuers have no excuse for not being able to do it
- IV is not perfect – but are market values as objective as is claimed and is IV as variable as we think – needs to be investigated further.
- But valuation is not on the UK regulatory radar let alone the IV basis of valuation. The only one that might be is MLV - but an incomprehensible definition and cook book routines.

Some of the other charges made against valuers in the UK

- Open ended fund managers - Valuers **over-value in the recession** – UK PUTs suggest that they did not reduce the valuations quickly enough in the recession so causing a run on the funds where units were bought and sold based on valuations.
- But Germans say they are too responsive and should ignore the more knee jerk reactions to boom and bust
- And academia say they do react to what their clients say and/or want – valuers are wimps – the clients say jump and they say how high – client influence research literature.
- Question
  - Do different valuers get to different answers in the same market because they are either smoothing more than others or reacting to pressure
- If answer is yes, how can we do any global market analysis if all of the valuation based data is created off a variable base

Effect of ownership on capital value change

Figure 3 : Property Unit Trust Primary Redemptions December 2004 to September 2009

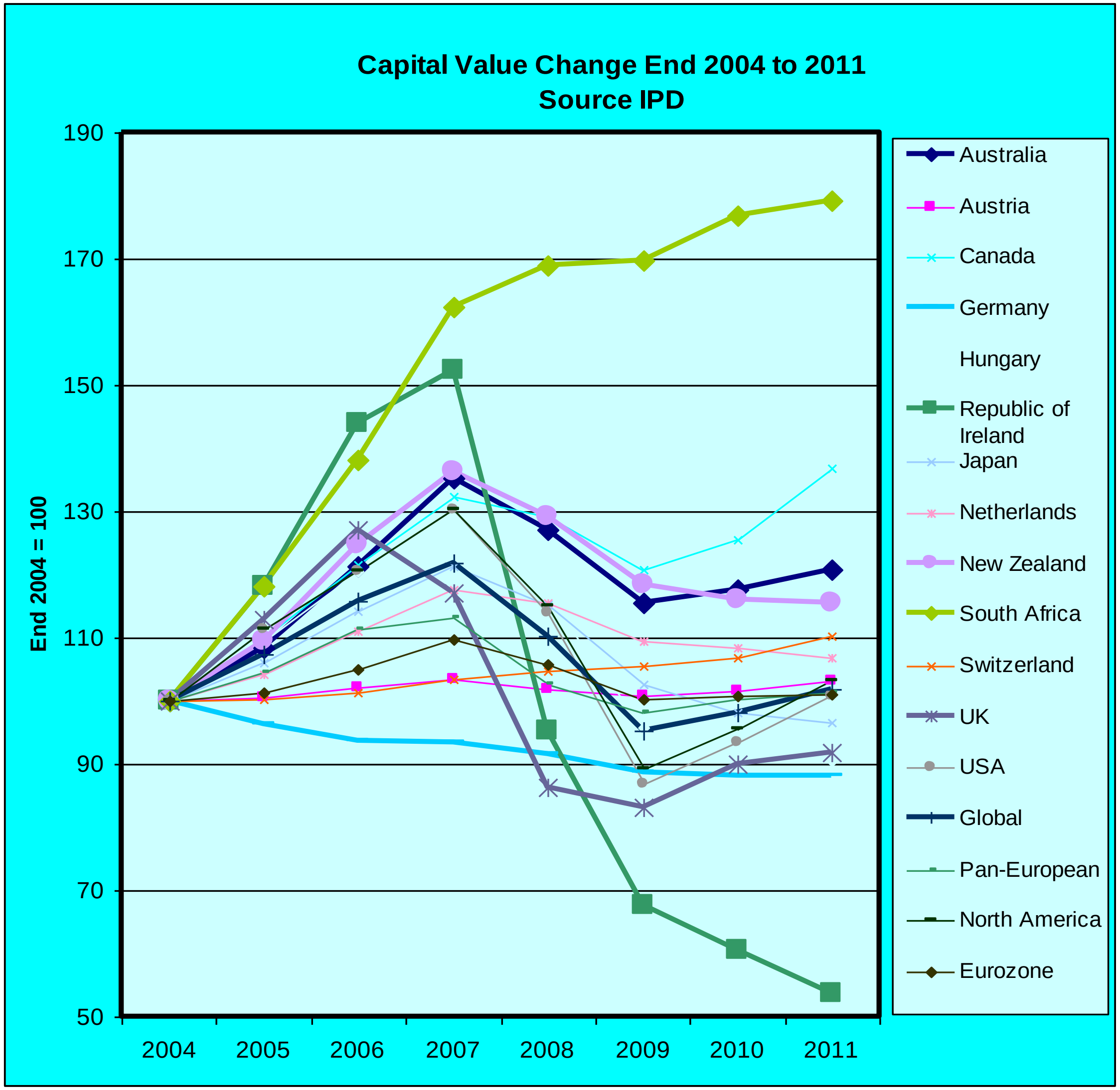


Source : Association of Real Estate Funds

Evidence of capital value change in the 2 years after the beginning of the downturn in Q3 2007 in the UK is suggesting that PUTs (unit priced by the valuations) fell quicker than pension fund properties in Q4 2007 while Property Company/REITs values fell significantly less. (Crosby, Lizieri, McAllister, 2010)

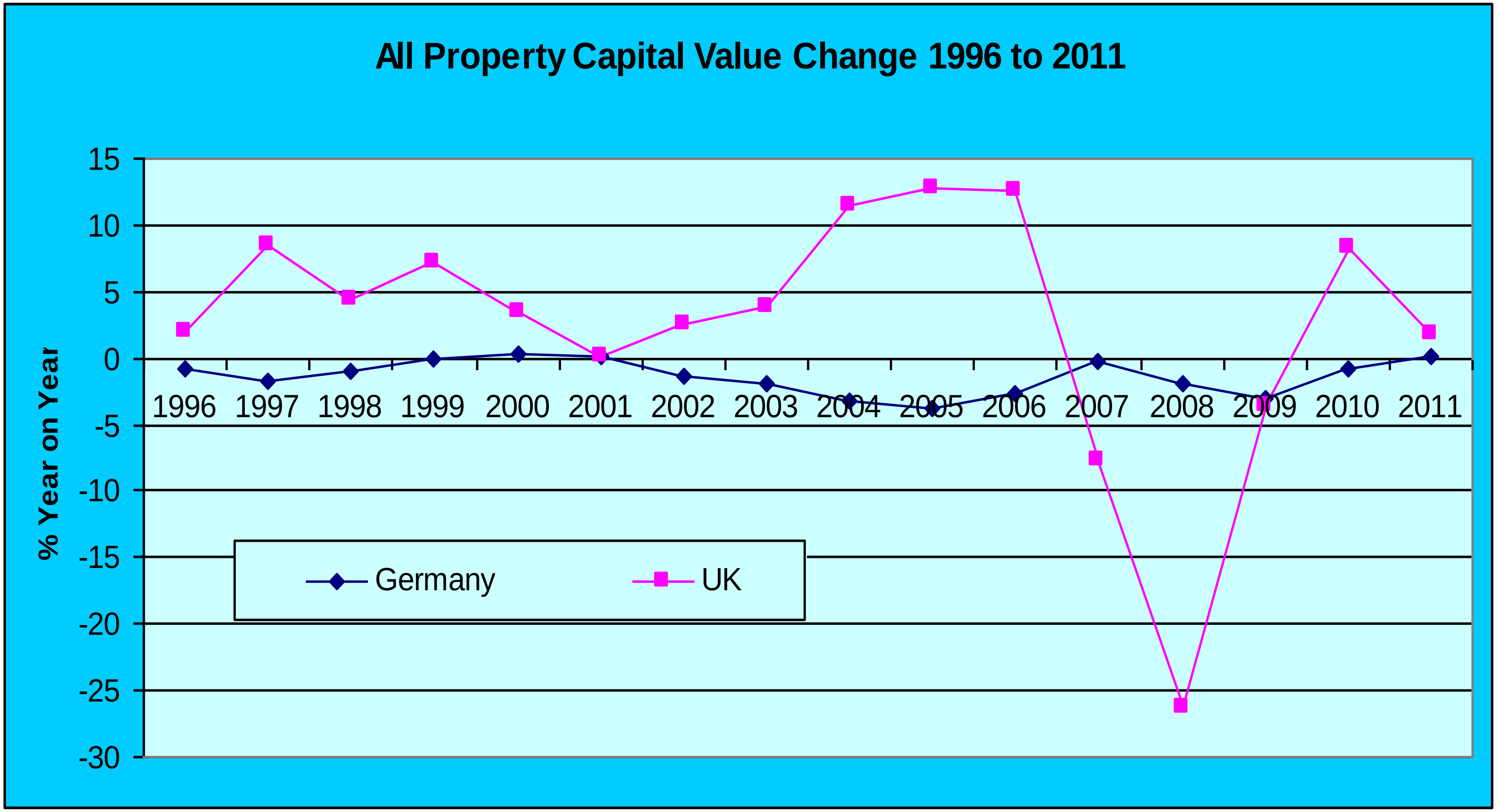
Follows a client influence hypothesis too closely for valuer comfort – some retrenchment in later quarters once into the recession

The bigger picture is fundamental differences between the valuations in one country and another

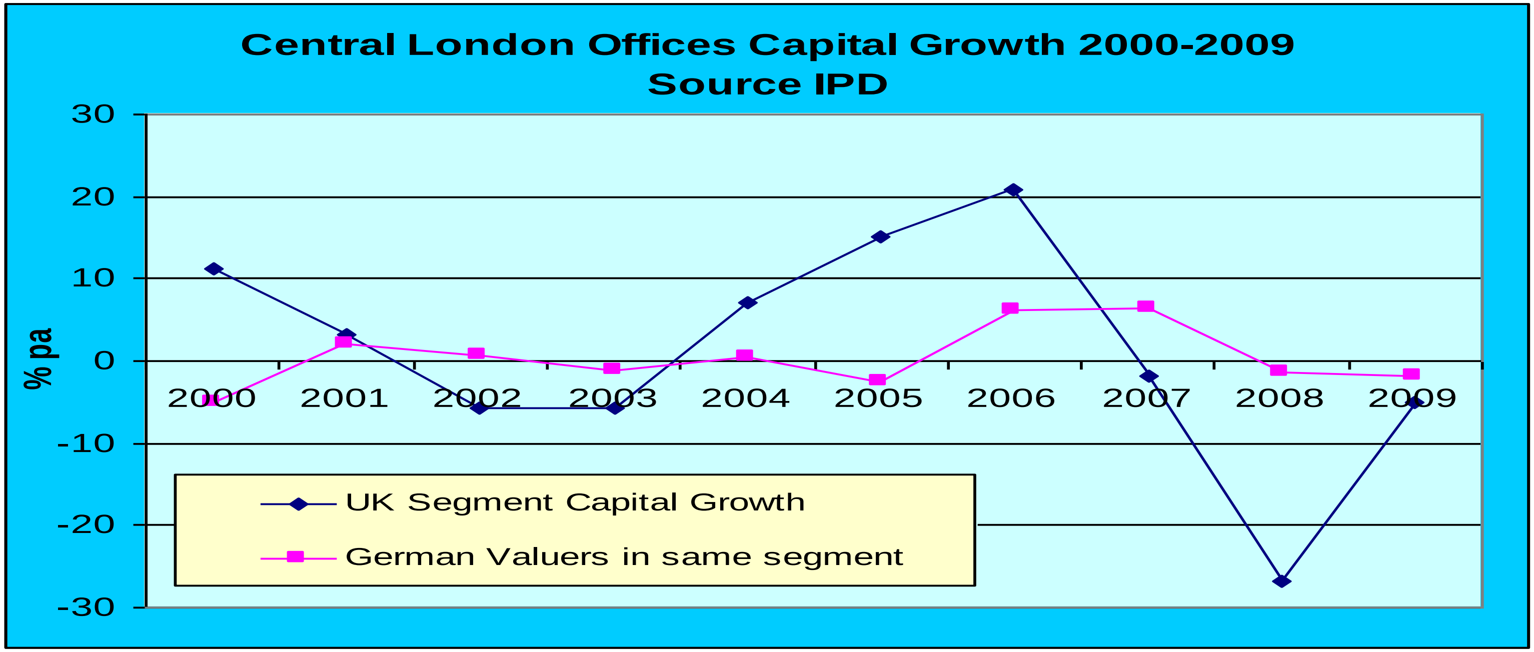


- We have already seen the variation between different countries.
- Is this because the countries are different or the valuations are different?
- The obvious response is that it is the countries.
- If not, global property market measurement and any subsequent analysis is threatened

A very volatile v very stable market
UK v Germany



But what about when valuing in the same market? They should show very similar results



2000 - 2009	All Property Home Market		Central London Office Market	
	Average	Stan Dev	Average	Stan Dev
Germany	-1.76% pa	1.49%	0.37% pa	3.67%
UK	0.92% pa	11.76%	1.2% pa	13.54%

Conclusions on the charges

2. Open ended fund managers - Valuers **over-value in the recession** – UK PUTs suggest that they did not reduce the valuations quickly enough in the recession so causing a run on the funds where units were bought and sold based on valuations

   Probably yes (after a pewriod for catch up) - as valuers have great difficulty keeping up both up and down but seem good on turning points.

3. Property companies/REITs – the opposite – no evidence of falls in value (no sales except forced sales) so shouldn't reduce so quickly as transactions are not at proper market values

   They would say that wouldn't they – do they pressure the valuers?

4. Academia – valuers are wimps – the clients say jump and they say how high – client influence research literature.

   Case probably quite strong – lot of experimental, survey and now empirical evidence to suggest yes

5. Germans – UK valuers are too "volatile" – should concentrate on more sustainable aspects and smooth the boom and bust.

   Real issue here – what is the role of the valuer – to keep score (MV) or to value to a different (rational market?) concept – There is evidence of significantly different INTERPRETATIONS of market value; we must sort this out if comparative market analysis is to mean anything.

Papers

- Bank lending basis issues based on:
  - Crosby, N. and Hughes, C. (2011) The basis of valuations for secured commercial property lending in the UK, *Journal of European Real Estate Research*, Vol. 4(3): 225 - 242.
- Client Influence issues based on:
  - Crosby, N. Lizieri, C. and McAllister, P. (2010) Means, Motive and Opportunity? Disentangling Client Influence on Performance Measurement Appraisals: *Journal of Property Research* 27(2): 181-201.
- See www.ipd.com for downloads of the transaction based indices and valuation variation papers