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Valuation uncertainty in troubled property markets

The Global Financial Crisis has had a rapid and negative impact on economies around the world. This impact of the global credit crisis has had a relatively immediate flow on effect to property markets throughout Australia. Most classes of real estate have been and continue to be impacted in different ways. Some relief has been brought to certain markets where Commonwealth economic stimulus funds have found their way to the markets.

The most noticeable immediate impact on investment and development property markets was felt in a virtual cessation of market transactions in the latter half of 2008 and the first quarter of 2009 calendar year as market participants watched in almost disbelief at the outfall. Now mid 2009 we are beginning to see market transactions occur where some banks are willing to lend. These transactions are however beginning to occur at new price levels as markets correct.

The ability to be able to value assets, particularly property, in the current market where prices are correcting and there is a perception that, in some instances, those sales are forced or distressed sales has been the subject of considerable debate. The debate as to reasonable time to achieve a sale under the long held (and constantly retested) *Spencer* doctrine is also being actively debated as it was in the early 1990's.

Many questions are front of mind for valuers in this climate including:-

- How does one value without market evidence or where there has been a sharp reduction in the limited available market sales evidence?
- Is the High Court decision in *Spencer v The Commonwealth of Australia* still relevant?
- Are valuations of no value and are they causing harm in the current climate?



The questions go on but the answer remains the same. A current valuation of an asset is a fundamental requirement for transparency and comparability in our economic and financial systems.

There is current discussion about whether the principles set out in the *Spencer* case 102 years ago are still relevant today and whether there should be greater debate about the modernization of valuation practices. To quote from a recent article in the *Australia and New Zealand Property Journal* by Grant Allan and Paul Walker - "The *Spencer* test is an impregnable fortress of judicial wisdom which continues to be applied today because in the 100 years since it was formulated no judge, barrister, academic, valuer or politician has been able to improve upon it. For every valuer, the *Spencer* test remains as the only complete answer to that most frequently encountered and difficult of questions: *What is the market value of this property?*"

This means the definition of Market Value (Fair Value, except for some special purpose assets, is generally equated to Market Value) remains as valid in a downward market as it does in any other market. All members of the Australian Property Institute should refer to the *Australia and New Zealand Valuation and Property Standards* manual with particular emphasis on International Valuation Standards I – Market Value Basis of Valuation. The Attachment to this advice is an extract from IVS I and is a most relevant Discussion in considering the concept of market value in the current climate.

As Chris Thorne, Chairman of the International Valuation Standards Board wrote in the March 2009 newsletter of the European Public Real Estate Association:

"The job of the valuer is to understand the market in which they operate. When transactions are thin on the ground, this means understanding the collective mindsets of would-be buyers and sellers, and of the fundamental economic drivers of that market. It means understanding why property that is being offered is not selling and at what price level buyers would enter the market. A market valuation is a proxy for a price, and prices in the real world are not established by what has gone before, but by buyers' and sellers' future needs and expectations. The valuer has to understand and replicate those needs and expectations and reproduce them in their valuation model.

No one should pretend that valuation in an inactive market or when values are moving fast is a simple task. But even

though empirical transactional evidence may be lacking, a figure arrived at using a robust rationale based on thorough market understanding is generally more reliable than one based on the stale comparable transaction. I have heard cynics complain that valuers are now valuing on sentiment rather than fact. This misses the fundamental point that real prices in real markets reflect sentiment, and that market sentiment is itself a fact that should be reflected in the valuation."

He goes on to say –

"Another threat to the integrity of the valuation process arises from flawed understanding of the valuation objective. It is sometimes argued that market value is either irrelevant or too low because the market value definition (which for all practical purposes equates to fair value under IAS 40) requires there to be a willing seller. Since the current owner would not be willing to sell at that price, it is of no relevance to the company or its shareholders. This is not the place for a lengthy dissertation on the concept of market value. However, the International Valuation Standards make it clear that a 'willing seller' in this context is simply a seller motivated to sell at the best price obtainable on the valuation date. Because market value is a hypothesis, the circumstances or policies of the actual owner are totally irrelevant. The owner may be able to demonstrate that the property is worth more to them than could be obtained from a sale on the valuation date. This is a perfectly valid proposition, but it does not invalidate the market value.

A variation on this theme is the argument that the only sellers in a falling market are forced sellers because no one willingly sells in a falling market, and therefore those sales are not evidence of the price between a willing buyer and seller. Again this confuses what may be rational behaviour by an owner in the real world with the hypothetical world in which market value is created. There has to be a hypothetical seller willing to transact, and strange though it may seem, that seller is under no duress or compulsion. In fact very few sales are truly forced, ie where the seller is under compulsion to sell in a timescale that does not allow for proper exposure to the market. Neither are sales by liquidators, receivers or mortgagees normally forced; indeed this type of seller has a duty to the general body of creditors to act reasonably and obtain the best price. Only in very specific circumstances would a sale at below market value be justified."

Some observers have recently suggested that the definition of market value assumes an equal number of buyers and

sellers in the market at anyone time, and because we now have many more sellers than buyers any price being achieved is a distressed price and therefore does not meet the definition of market value. This is simply not true. Market value is a dynamic concept which seeks to respond to changes in market conditions. An excess of demand over supply causes an upward trend in market values, and during times like now an excess of sellers over buyers will result in a fall in asset values.

His article continues -

“So having applied their market knowledge, resisted any external pressure and correctly applied the basis of market value, the valuer faces one further task; communicating the valuation. Traditionally, valuation reports for use in financial statements have been minimalist in style, with little more than an address, a valuation figure and a signature. Some valuers have even liked to refer to their reports as certificates, which implies that the valuation figure itself gains additional credibility and weight by being ‘certified’. Perhaps the intention was that it be framed and hung on the finance director’s wall! However, client needs and expectations are changing. IAS 40, para 75, requires the entity to make various disclosures, including the methods and significant assumptions applied in determining fair value, and whether it was based on market evidence. It is therefore reasonable to expect valuation reports commissioned for this purpose to provide parallel disclosures, and indeed this is required under International Valuation Standards.”

For copy of Chris Thorne article and other current activities in relation to valuing in the current GFC see www.ivsc.org/pubs

As the National Professional Board stated in the January 2009 Edition of the API e-news –

“With respect to the commercial market and looking forward in 2009, we consider the momentum in property yields remains upwards, despite the recent and further potential interest rate cuts by the RBA. This yield softening is likely to be a result of further downgrading of cash flow fundamentals including, but not limited to, declining rental growth and increased incentives, as a result of the weakening occupier / tenant market.”

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In buoyant active markets the price sits within a narrow band of sellers and buyers expectations as there are many competing participants. However, in a market like today the value has to be set in a wider band of expectation between the meeting place of buyers and sellers in a value sense. The very nature of those selling and those in a position to buy is rapidly changing ie markets have new players with a new basis of price justification.

The ability and skill to be able to arrive at a market value at a point in time, adopting appropriate valuation methodology, is only part of the process and responsibility of the valuer. In the market that we are currently operating, communication with your client is paramount.

Valuers need to provide adequate explanation in support of their valuation and as necessary liaise with clients and/or their auditors to ensure the process from instruction stage to handing over the valuation report is undertaken in a professional manner.

Valuers should also re-acquaint themselves with long established court precedent relating specifically to valuing properties in markets where there is limited transaction evidence. (See *The Law Affecting Valuation of Land in Australia* by Alan Hyam, Fourth Edition – Part II, Chapter 3, page 124 – Absence of comparable sales.)

As has been widely published, Australia's office markets have corrected in a capital value sense by yields or capitalization rates moving out, given the onset of the credit crisis and its flow on effects in the economy and commercial office real estate markets. In the current economic cycle, wherein there is growing evidence of tenant stress, the difference between face rentals and effective rentals properly analysed for the impact of tenant incentives and inducements is widening. In such circumstances where face rents are capitalized, as opposed to properly analysed effective rentals, capital values of office properties could be significantly overstated.

Members utilizing proprietary software to undertake discounted cash flow analyses need to fully understand the effect of any inputs into the model. International Valuation Guidance Note No.9 – Discounted Cash Flow Analysis for Market Valuations and Investment Analyses is also relevant.

API members are the most highly qualified and best placed property professionals to provide expert valuation advice in the current market. ■

Cameron Harris
Chairman
National Professional Board

ATTACHMENT:

EXTRACT FROM AUSTRALIA AND NEW ZEALAND VALUATION AND PROPERTY STANDARDS MANUAL

International Valuation Standards I – Market Value Basis of Valuation

6.0 Discussion

6.1 The *Market Value* concept and definition are fundamental to all valuation practice. A brief summary of essential economic and procedural foundations is presented in Concepts Fundamental to Generally Accepted Valuation Principles and Code of Conduct, the documents upon which these Standards are predicated.

6.2 The concept of *Market Value* is not dependent on an actual transaction taking place on the date of valuation. Rather, *Market Value* is an estimate of the price that should be realised in a sale at the valuation date under conditions of the *Market Value* definition. *Market Value* is a representation of the price to which a buyer and seller would agree at that time under the *Market Value*

definition, each previously having had time for investigation of other market opportunities and alternatives, and notwithstanding the fact that it may take some time to prepare formal contracts and related closing documentation.

6.3 The concept of *Market Value* presumes a price negotiated in an open and competitive market, a circumstance that occasionally gives rise to the use

of the adjective open before the words *Market Value*. The words *open* and *competitive* have no absolute meaning. The market for one property could be an international market or a local market. The market could consist of numerous buyers and sellers, or could be one characterised by a limited number of participants. The market in which the property is exposed for sale is not a definitionally restrictive or constricted market. Stated conversely, the omission of the word open does not indicate that a transaction would be private or closed.

6.4 Market valuations are generally based on information regarding comparable properties. The Valuation Process requires a Valuer to conduct adequate and relevant research, to perform competent analyses, and to draw informed and supportable judgements. In this process, Valuers do not accept data without question but should consider all pertinent market evidence, trends, comparable transactions, and other information. Where market data are limited, or essentially non-existent (as for example with certain specialised properties), the Valuer must make proper disclosure of the situation and must state whether the estimate is in any way limited by the inadequacy of data. All valuations require exercise of a Valuer's judgment, but reports should disclose whether the Valuer bases the *Market Value* estimate on market evidence, or whether the estimate is more heavily based upon the Valuer's judgement because of the nature of the property and lack of comparable market data.

6.5 Because changing conditions are characteristic of markets, Valuers must consider whether available data reflect and meet the criteria for *Market Value*.

6.5.1 Periods of rapid changes in market condition are typified by rapidly changing prices, a condition commonly referred to as disequilibrium. A period of *disequilibrium* may continue over a period of years and can constitute the current and expected future market condition. In other circumstances, rapid economic change may give rise to erratic market data. If some sales are out of line with the market, the Valuer will generally give them less weight. It may still be possible for the Valuer to judge from available data where the realistic level of the market is. Individual transaction prices may not be evidence of *Market Value*, but analysis of such market data should be taken into consideration in the Valuation Process.

6.5.2 In poor or falling markets there may or may not be a large number of "willing sellers." Some, but not necessarily all, transactions may involve elements of financial (or other) duress or conditions that reduce or eliminate the practical willingness of certain owners to sell. Valuers must take into account all pertinent factors in such market conditions and attach such weight to individual transactions that they believe proper to reflect the market. Liquidators and receivers are normally under a duty to obtain the best price in asset disposals. Sales, however, may take place without proper marketing or a reasonable marketing period. The Valuer must judge such transactions to determine the degree to which they meet the requirements of the *Market Value* definition and the weight that such data should be given.

6.5.3 During periods of market transition characterised by rapidly rising or falling prices, there is a risk of over- or under-valuation if undue

weight is given to historic information or if unwarranted assumptions are made regarding future markets. In these circumstances Valuers must carefully analyse and reflect the actions and attitudes of the market and take care that they fully disclose the results of their investigations and findings in their reports.

6.6 The concept of *Market Value* also presumes that in a market value transaction a property will be freely and adequately exposed on the (open) market for a reasonable period of time and with reasonable publicity. This exposure is presumed to occur prior to the effective date of value. Markets for fixed assets typically differ from those available for stocks/shares, bonds, and other current assets. Fixed assets tend to be unique. They are usually sold less frequently and in markets which are less formal and more inefficient than, for example, markets for listed securities. Further, fixed assets are less liquid. For these reasons, and because fixed assets do not commonly trade on a public exchange, the application of the concept of *Market Value* requires the use of assumptions such as adequate market exposure over a reasonable time period to allow for proper marketing, and completion of negotiations.

6.7 Revenue producing properties held as long-term investments by a property company, pension (or superannuation fund), property trust, or similar type of owner are typically valued on the basis of individual asset disposal pursuant to an orderly plan. The aggregate value of such assets viewed or treated as a portfolio or as an assembled group of properties could exceed or could be less than the sum of the *Market Value* of each asset individually.



6.8 All valuations should refer to the purpose and intended use of the valuation. In addition to other reporting requirements, the Valuer should make it abundantly clear into which class each asset has been placed if the function of the valuation is related to the preparation of financial statements.

6.9 In exceptional circumstances *Market Value* may be expressed as a negative amount. Situations include certain leasehold properties, some specialised properties, obsolete properties with demolition costs exceeding land value, some properties affected by environmental contamination, and others. ■

API member survey

A nation-wide survey of members was launched by the National President, David Moore, on Thursday 9 July.

National Council commissioned the study in consultation with API Divisions. Member feedback will guide the Institute's development and transition to new technologies that will improve service delivery to members.

In distributing the survey forms to all API members last week, Mr Moore said "I do not recall, at any time in the recent history of the Institute, when such an extensive study has been commissioned, nor has the importance of technological change and reform meant so much to Institute members".

"This is an extremely important member opportunity to contribute to the Institute's future development and I cannot stress enough, the crucial nature of your response." Mr Moore added.

The survey is currently in the hands of members. It is vital to have as many

responses as possible and the Institute needs your input. If you did not receive the survey that was emailed to you on Thursday 9 July, please **click this link** to fill out the electronic form and email it directly to the research company:

Mr David Collins
Market Attitude Research
Services
research.mars@ozemail.com.au

This survey will provide the Institute with valuable data. There are also 12 focus group discussions being conducted around Australia which will further explore service delivery expectations amongst members and potential members.

The findings from the analysis of combined results will be presented to National Council at the end of September and it is expected that the member feedback will help shape the future of the Institute over the next 3 years. ■

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