

# **ERES Bucharest 2014**

## **Commercial property valuations – Useful or useless?**

**Or “What have they ever done for us?”**

Neil Crosby

School of Real Estate and Planning

University of Reading, UK

# Introduction

- UK Commercial Property Crashes in 43 years from 1971 to 2012. 1973/4 – 1989/90 – 2007/8 – ???? (you can guess the next one for yourselves but is there anybody out there who believes there won't be another one?).
- All different – one rental value crash in nominal terms, one rental value crash in real terms and 3 asset price crashes.
- But one similarity with all of them. Property valuation underpinned substantial increases in bank lending in the boom
- Loans in actual and technical default during the crashes.

# Whose fault is it – valuers for over-valuation or banks for over-lending?

- 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 in current UK market. Negligence cases in the post 1974 and 1990 periods.
  - 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.
  - Academics – bend and shape valuations to clients' interests, inaccurate, anchor, lag, smooth, etc.

# Issues surrounding these questions

- The real questions are:
  - Is the valuation model, particularly the bank lending valuation model, fit for purpose?
  - Does it give clients what they want/ask for?
    - MV/ERP/MLV/ERRP/Future MV
  - Does it give them what they need?
    - Who knows best, the valuers or the clients? Are valuers scared of telling clients a few home truths? (Post crash 1990 in the UK). Do they undersell their capabilities (IPF Vision for Real Estate Finance seminar, London, June 2014)
- I think key is the different bases of valuation (market values, investment values and sustainable values) and their application to bank lending valuations (see also work by Lind and Norlund in Sweden)

# Setting the Context # 1

## Bases of valuation available to valuers

- Two main bases set out in the International Valuation Standards (IVS).
  - Market Value (MV) – exchange price (rational or not?)
  - 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)
- UK has resisted MLV but there are signs of backtracking in the UK. (IPF, “Vision for RE Finance in the UK” discussion paper, 2013), [www.ipf.org.uk](http://www.ipf.org.uk).

# What is Mortgage Lending Value?

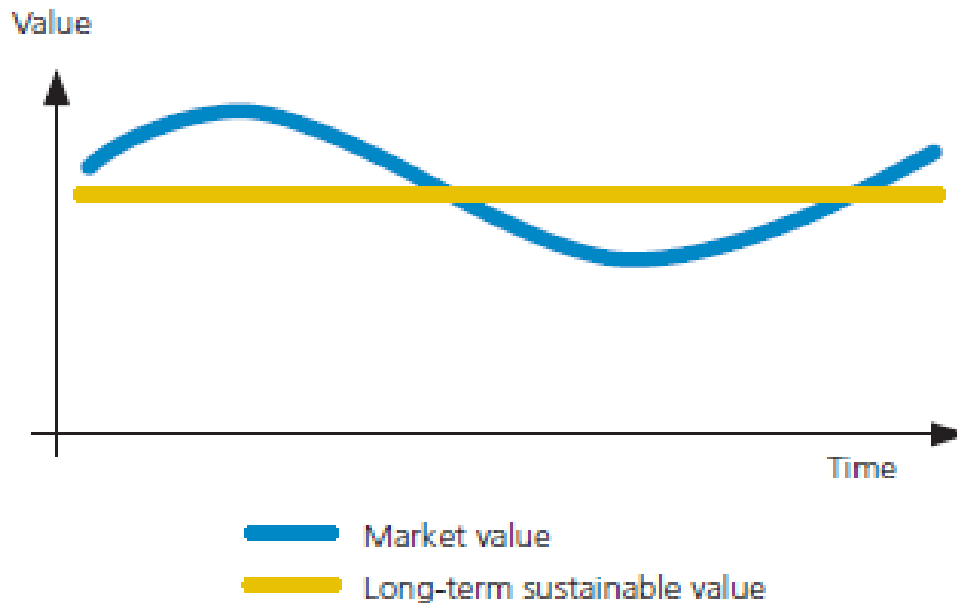
*“The mortgage lending value shall mean the value of the property ... making a prudent assessment of the future marketability of the property by taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses 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](http://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)

After consultation IPF, backtracked slightly in final report – *“should be linked to a long term measure of collateral value”* (IPF, 2014)

# IPF Vision For RE Finance

## Long-term sustainable value



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

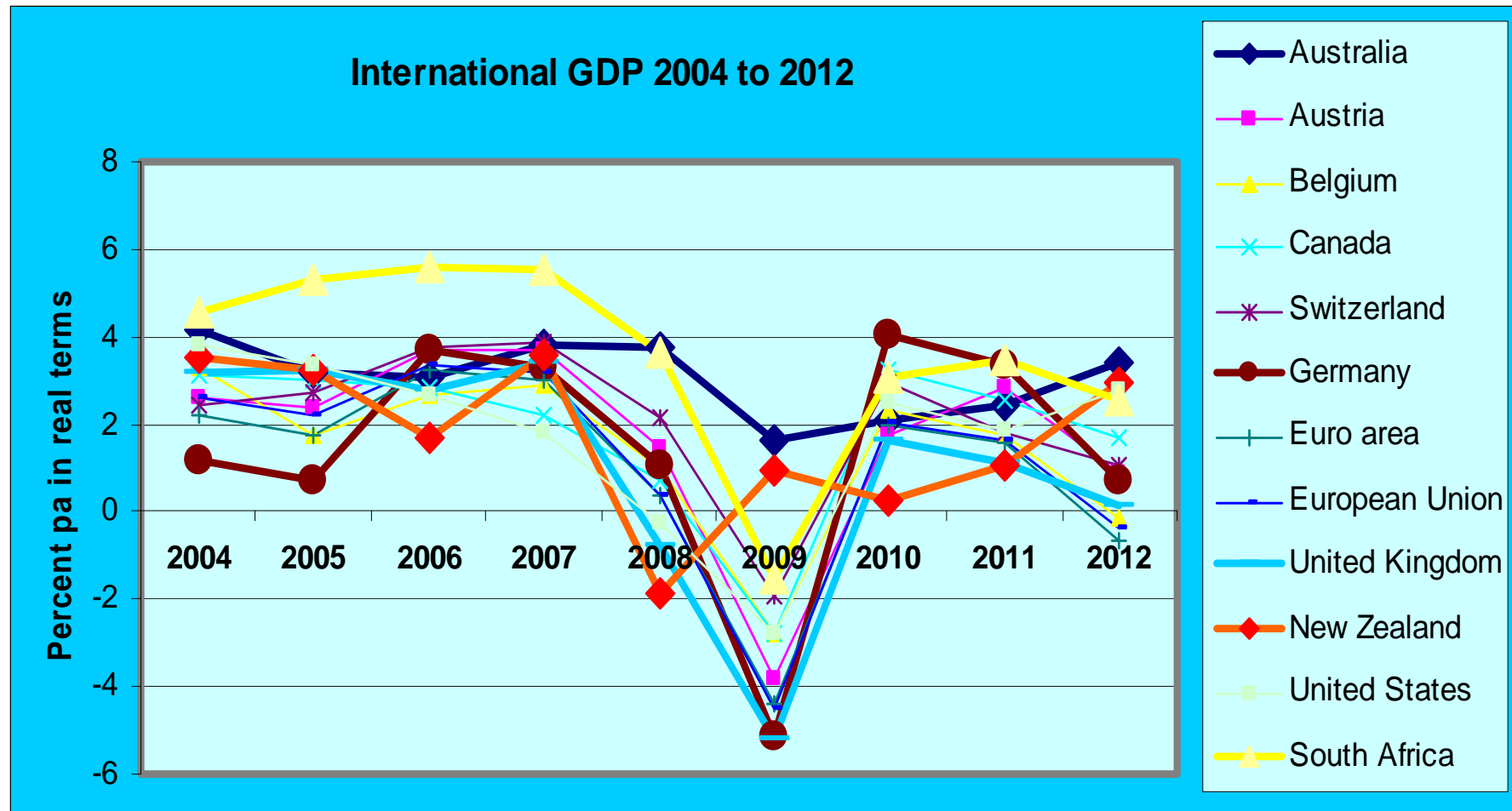
So should the yellow line be drawn below the blue line???

And what if the slope is upwards?

# Setting the Context #2

## The Market Context

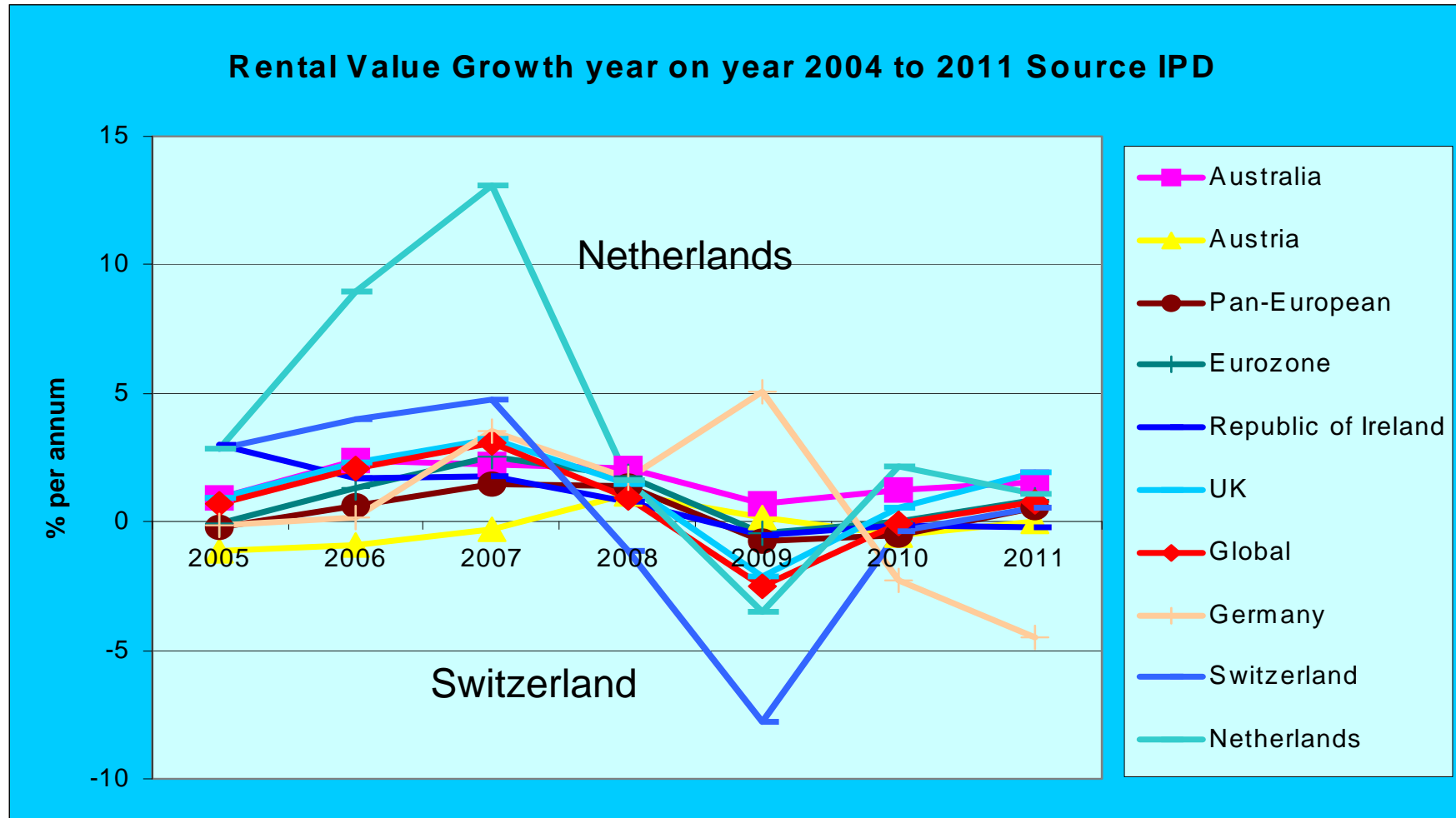
Source World Bank





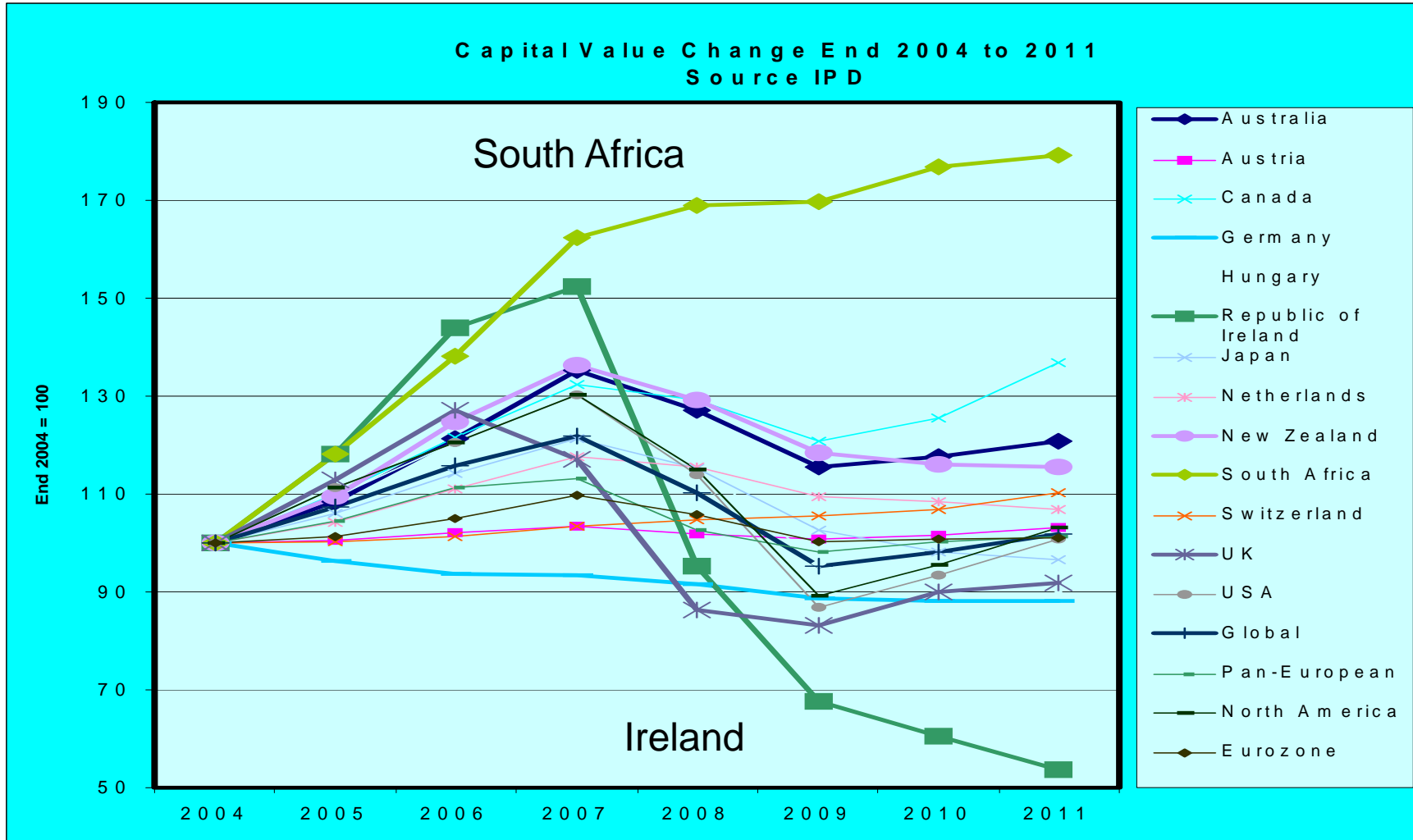
# IPD Rental Value Growth 2004 to 2011

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

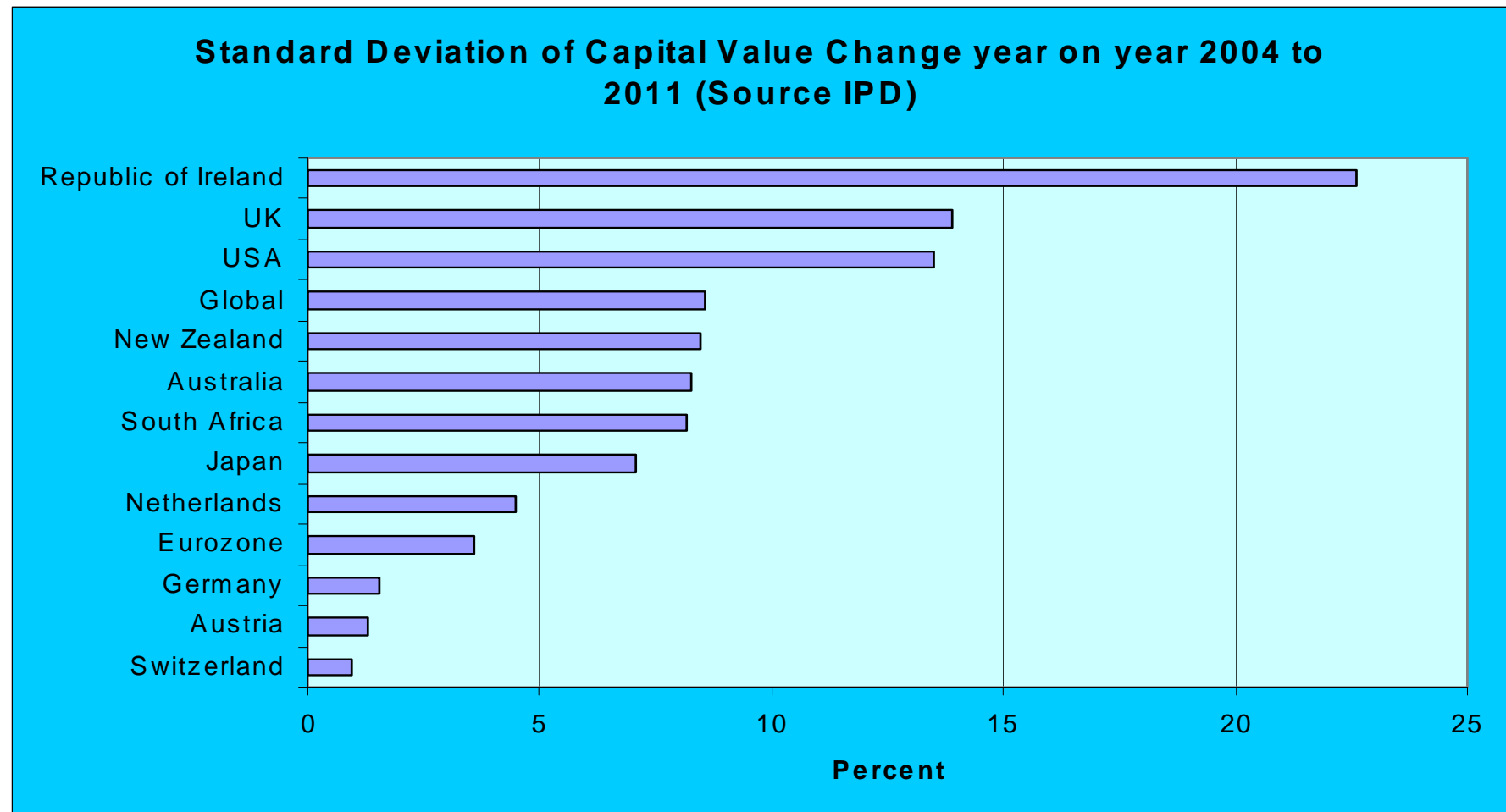


# Market Capital Values

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



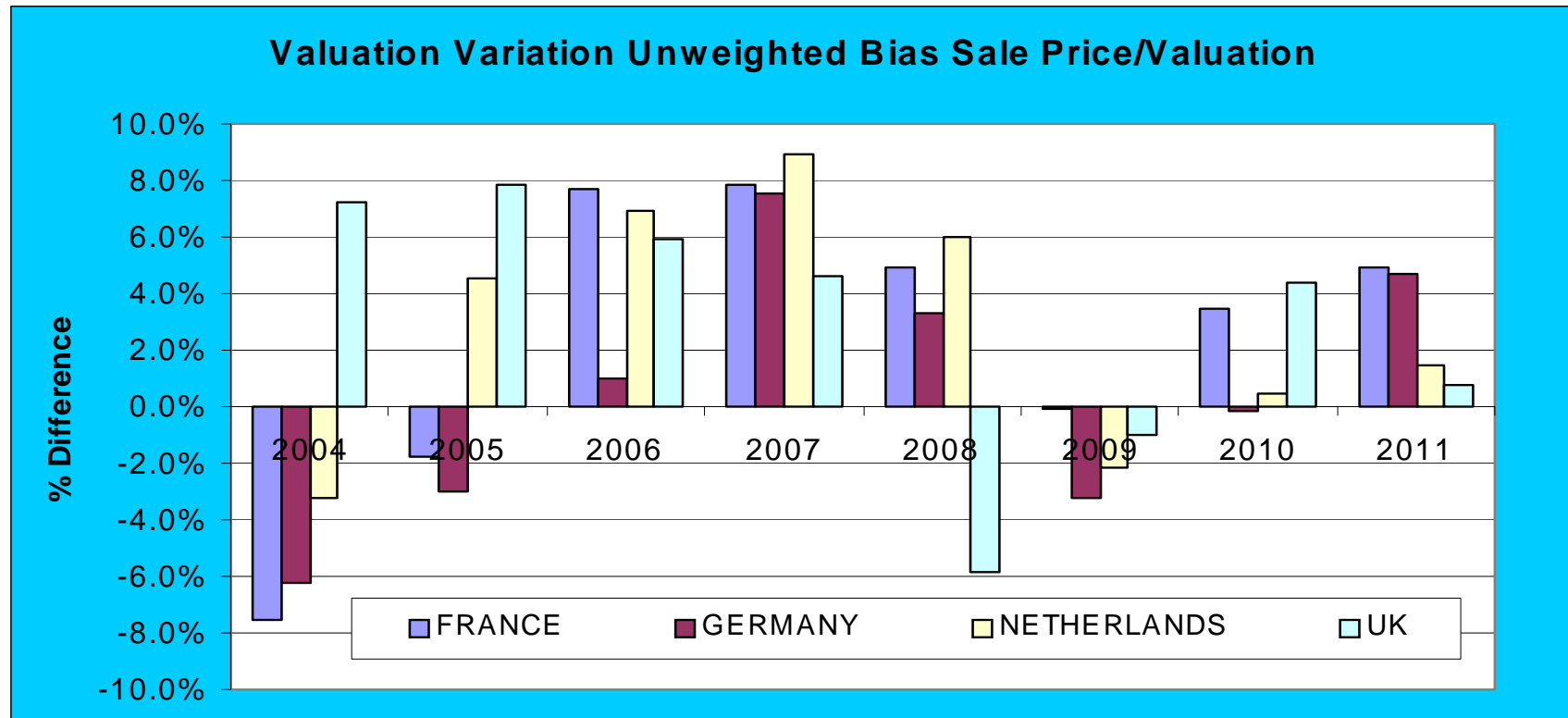
Volatile v stable markets?  
Or are they? Are the differences part  
*valuation* induced or just *value* induced?



# Is there any evidence of how valuations differ from prices?

- Does this suggest **over valuation in the boom**, (bankers charge) or does it suggest **undervaluation** and lagging markets – a more rational hypothesis?
- Does it suggest **overvaluation in the recession** (open-ended, PUTs charge of not following the market down quickly enough - lagging) or **undervaluation in the recession** (Property companies/REITs suggestion can't reduce valuations until there is "evidence" of falls – i.e. no transactions taking place)

# Over and under valuation at various stages in the cycle?



Source IPD 2012

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 period (which is what you would hypothesize suggesting that valuers lag the market).

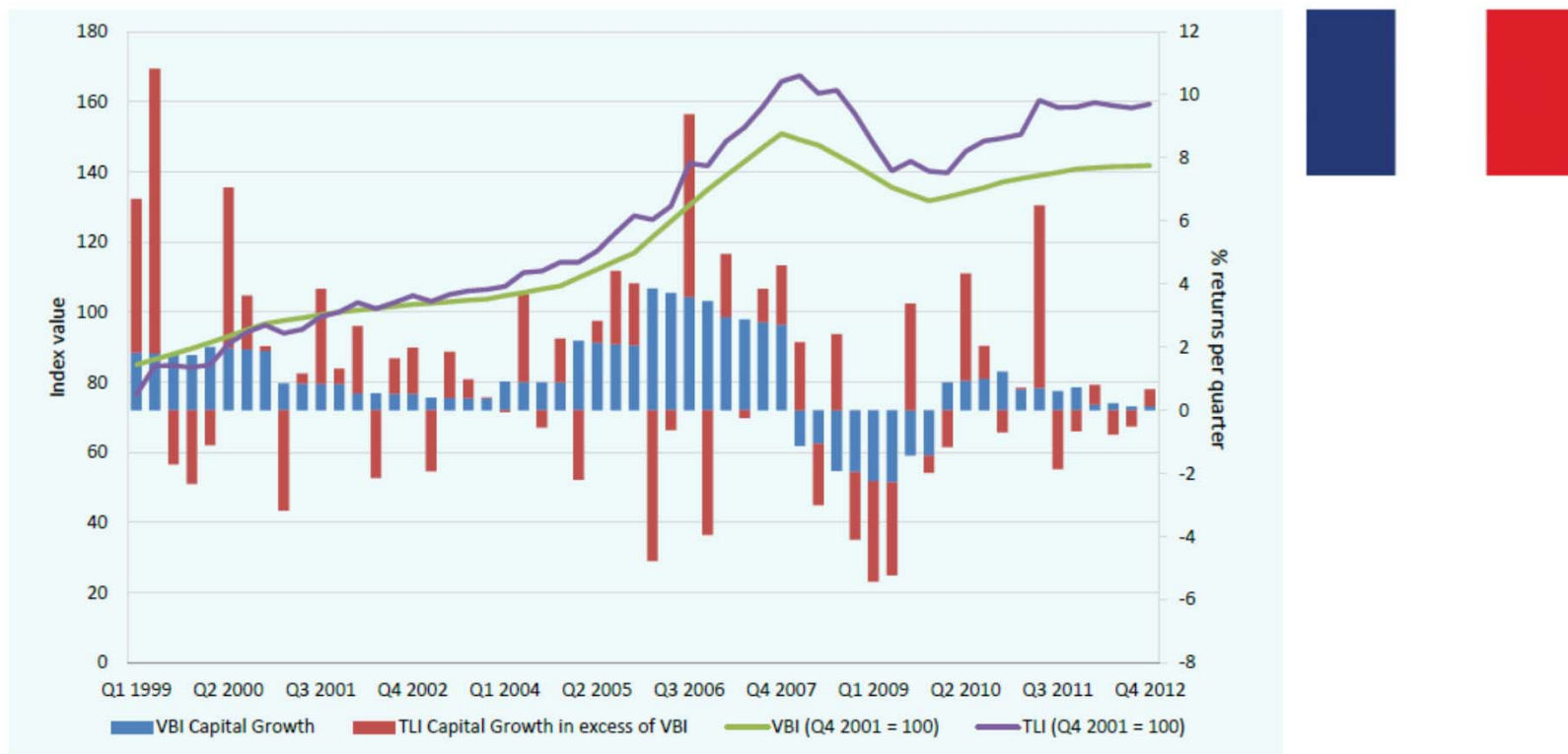
**Does the IPD transactions based indices support that hypothesis**

# Valuation v Transaction based indices France

## IPD France Quarterly Property Price Indicator Q4 2012 Consultative Release



An MSCI Brand

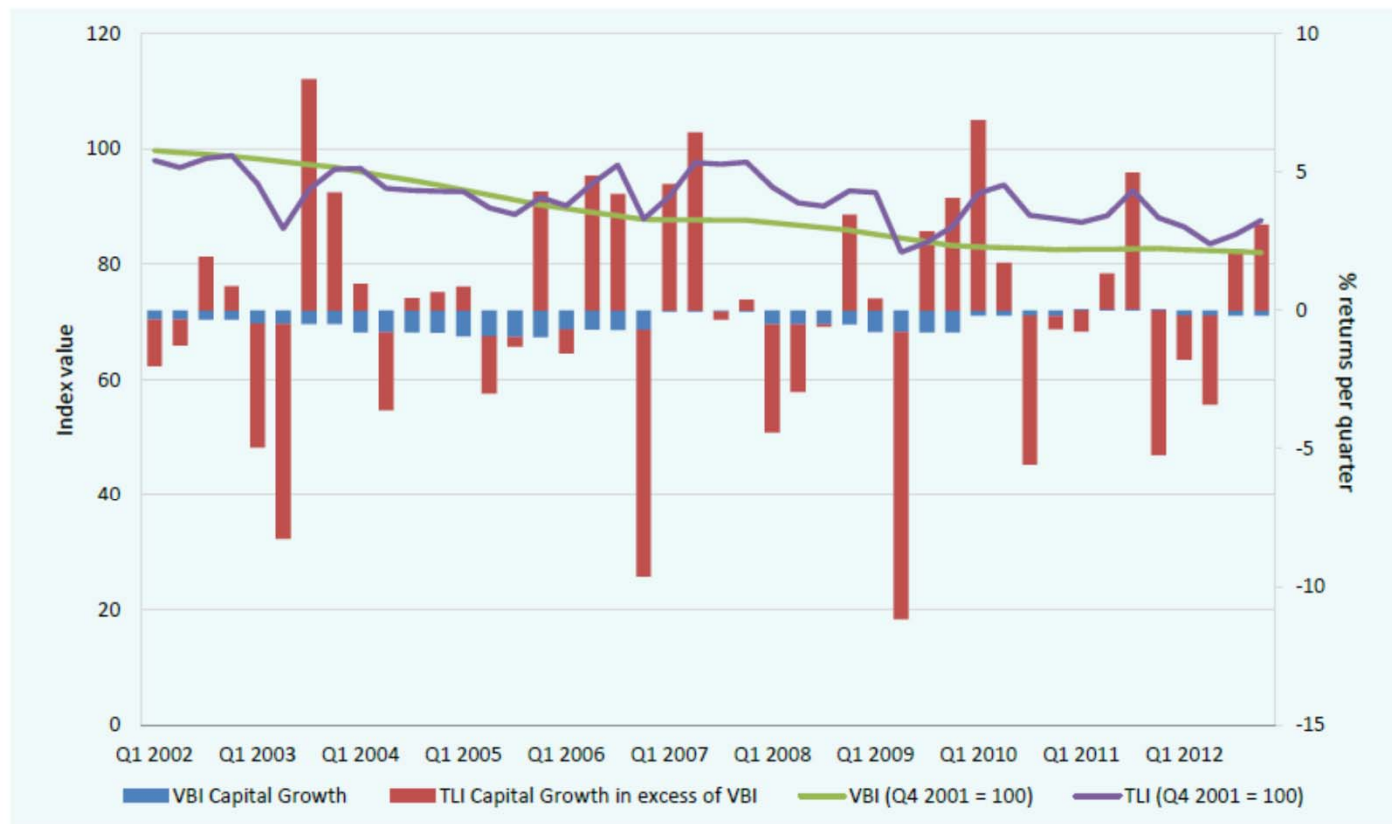


# Valuation v Transaction based indices Germany

## IPD Germany Quarterly Property Price Indicator Q4 2012 Consultative Release



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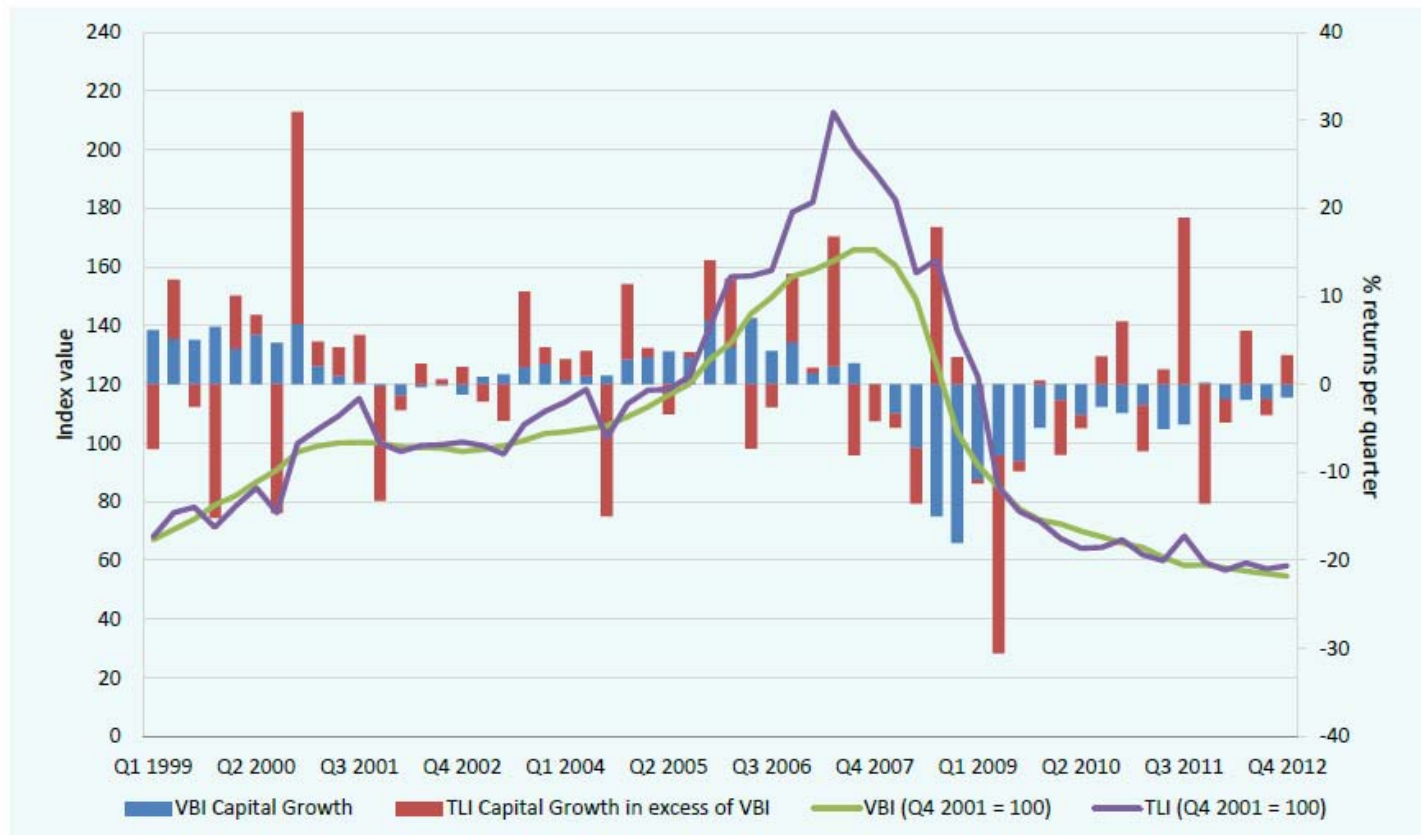


# Valuation v Transaction based indices Ireland

## IPD Ireland Quarterly Property Price Indicator Q4 2012 Consultative Release



An MSCI Brand



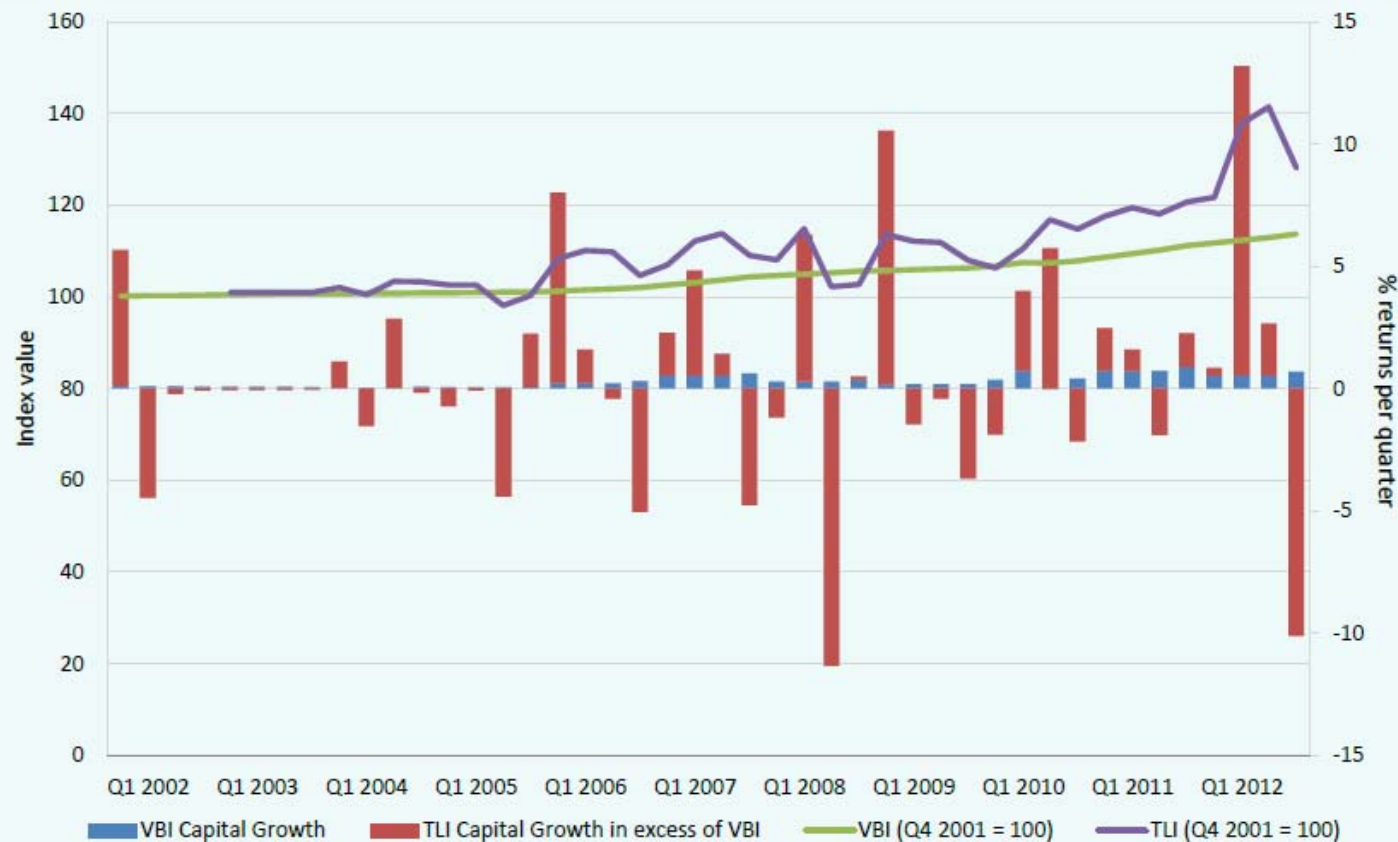


# Valuation v Transaction based indices Switzerland

## IPD Switzerland Quarterly Property Price Indicator Q4 2012 Consultative Release



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# Valuation v Transaction based indices

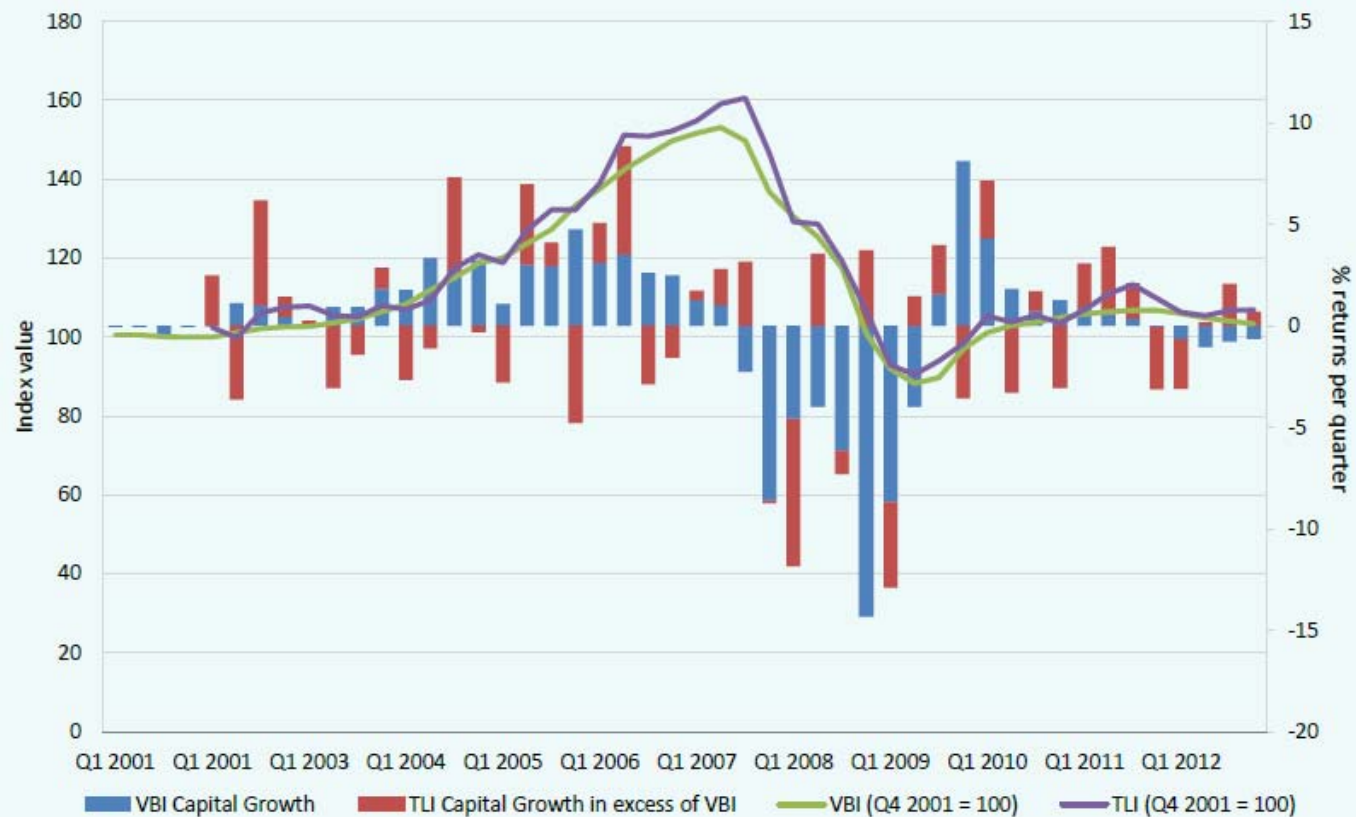
## UK

### IPD UK Quarterly Property Price Indicator Q4 2012

Consultative Release



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# 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 on over-valuations in the boom –
  - 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 the smaller claims rather than fighting the cases.
  - Getting the money back by increasing valuer premiums.
  - Small valuation firms are giving up their valuation business as too risky a past-time
  - So some might say the banks are doing their best to kill the local smaller scale valuation industry in the UK.

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

- Are party to manipulation of the valuation procurement process in the boom
  - 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. Are these the valuations that are now being targeted for negligence claims?
  - 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 Independent 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)

# Does the UK regulators' response include property valuation?

- Have few responses on the property valuation process
- 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)
- The Question - Could a different valuation regime have a role in changing pro-cyclical to counter-cyclical behaviour? What is that behaviour?
- Huge literature on Bubbles and Crashes

# Bubbles and Crashes

- 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 in 2007 (Bank of England).



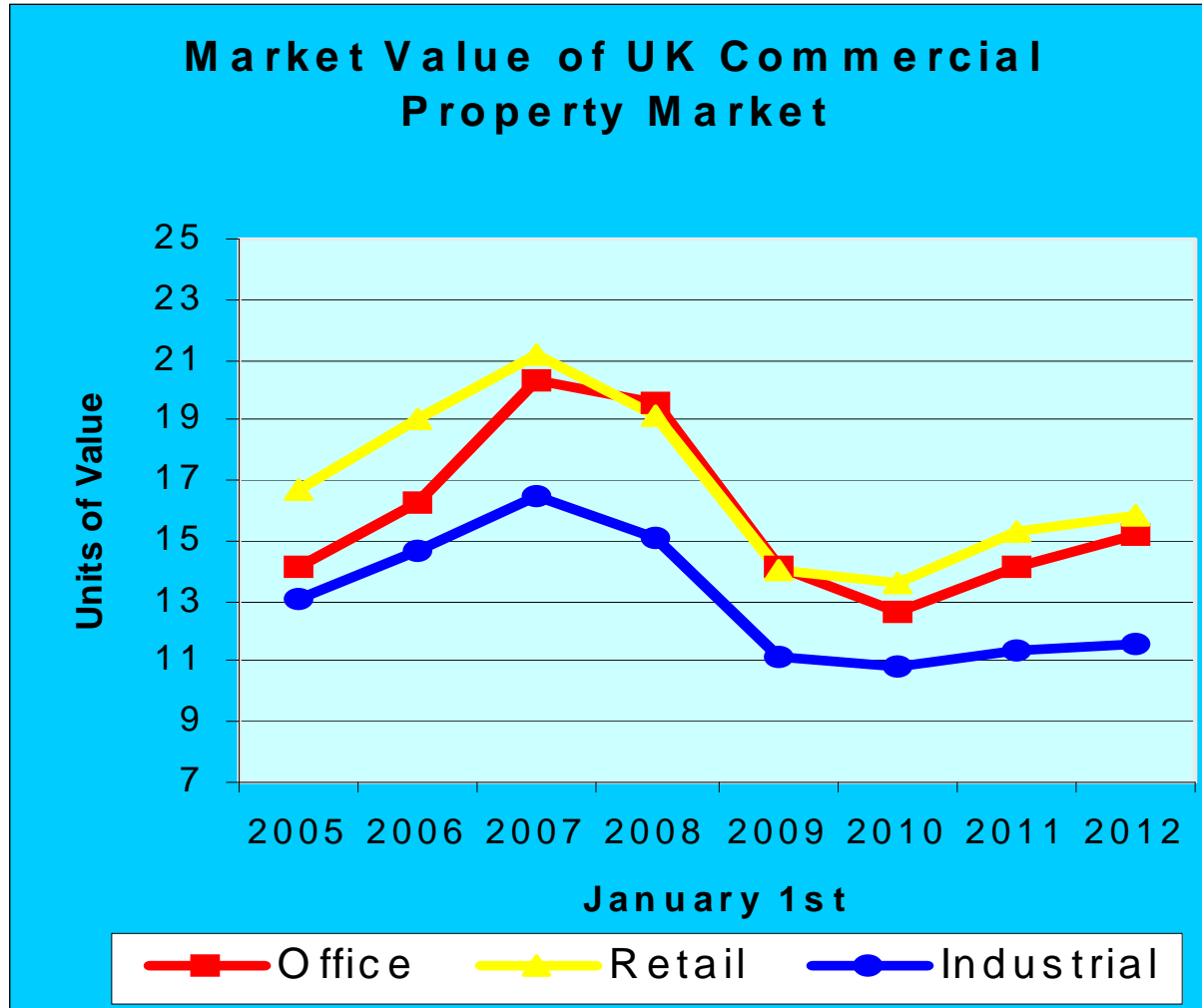
# Modelling valuations through the cycle

- 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 beginning 2012.
- 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

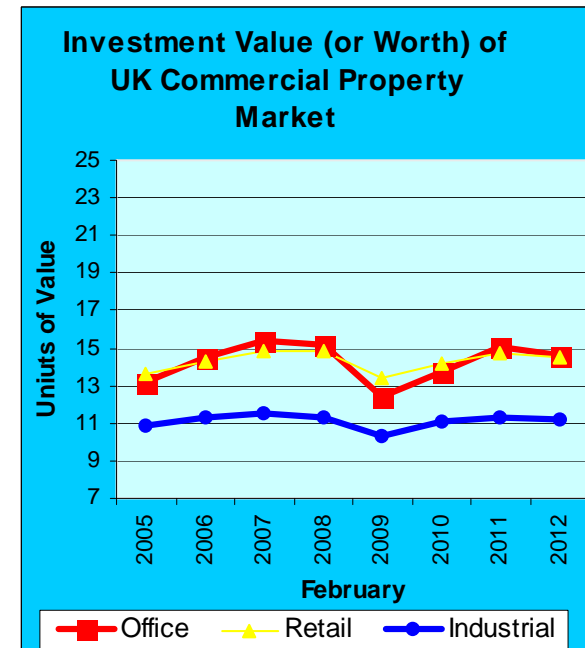
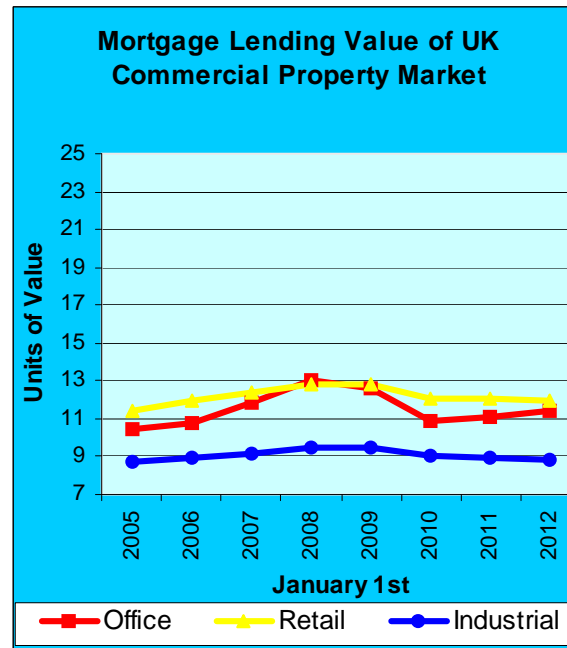
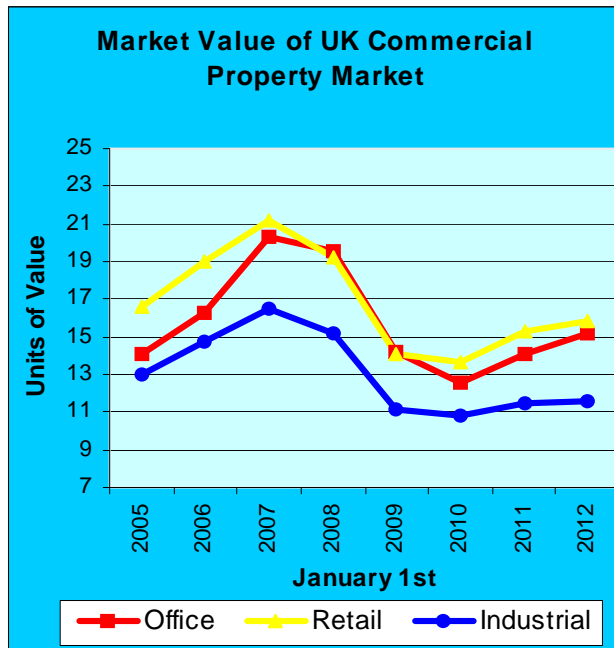
- MV - comparison based using current cap rates (IPD) and current rental values grown at IPD CRV index each year
- For IV - target rate (source mid term bond yield plus DTZ and IPF survey evidence for Risk Premium), forecast of growth (IPF consensus), holding period (5 years) and exit yield (Long term 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 inclusive).
- 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”. Real cook book routine.
- Shape of results not sensitive to input uncertainty.

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



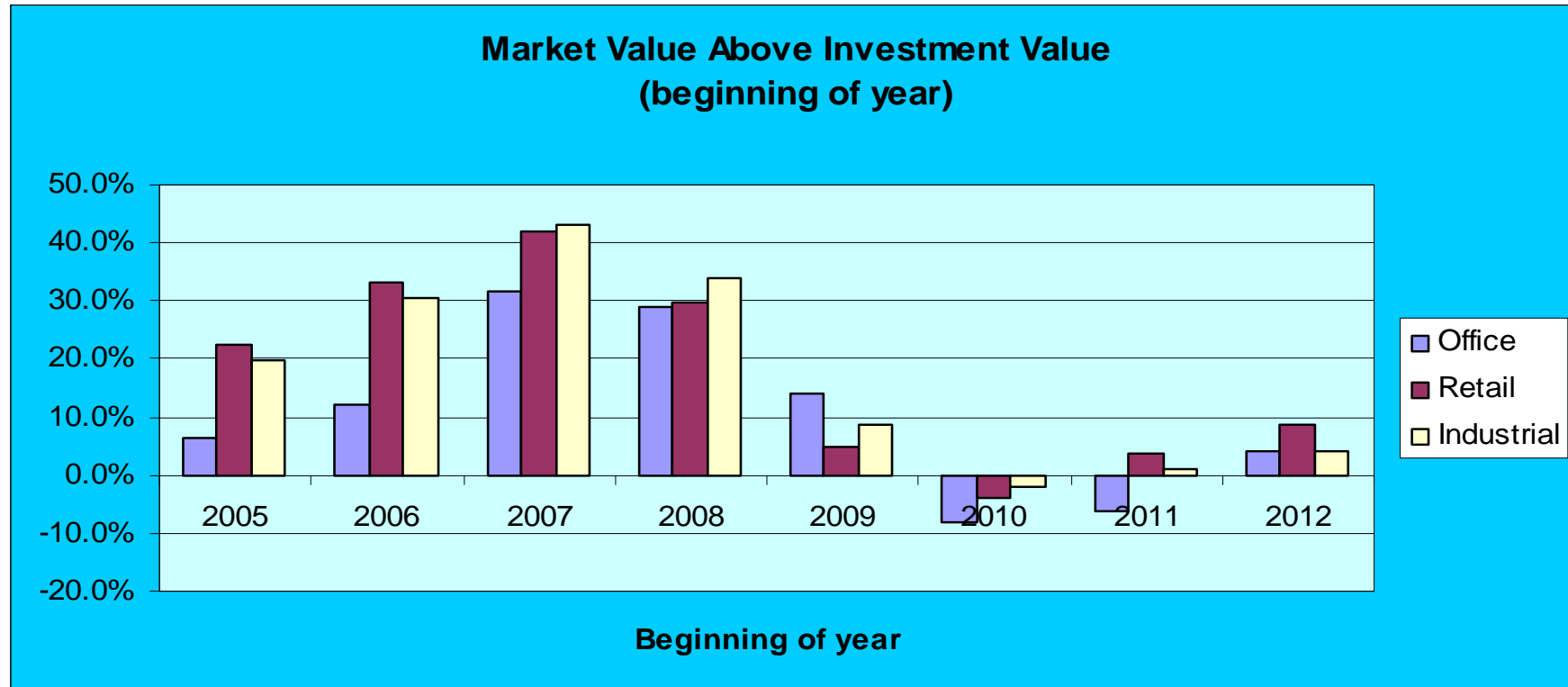
From the end of 2004 to the end of 2006 values rose by 40% for offices and 25% for retail and industrial. They fell by around 40% in all three sectors over the following 3 years

# 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 no conceptual base, an incomprehensible definition and cook book routines.
- Can we apply IV in markets that are data deficient regarding forecasting and longer term cap rate/exit yield trends?