

29 October 2009

The Property Institute of New Zealand (Valuation Standards Board) – Response to Exposure Draft

The Valuation of Investment Property under Construction

General comments

The Valuation and Property Standards Board has reviewed the proposed IVSB draft and makes this submission in response to the call for comments by 31 October 2009.

As an overview, we observe the valuation construct, or the steps in the valuation approach contained in Section 2, as follows:

- 2.1 Market Value – hypothetical exchange of partially completed building
- 2.2 Few transactions
- 2.3 The two frequently applied approaches (sales comparison and income based)
- 2.4 Cost approach not recommended as it may no longer be relevant in the current market,
- 2.5 Completed value, less cost to complete including profit and risk
- 2.6 Timing of cashflows important

We consider this to be an appropriate structure with a generally logical flow that can easily be followed.

Our general observations are summarized as follows:

Clause 2.3.3 – Even though this is only an example, we consider that the IVSB should consider also referring to income capitalization in this i.e. *“income capitalisation and/or discounted cash flow projections by comparable market data on construction costs.....capitalisation/discount rates and other key inputs”*.

Clause 2.5 4th line – “...adjustment for risk.” would more correctly read “...adjustment for *profit* and risk.”

We consider Section 2.4 should be put at the end of the section. Then valuers have 5 positive directive points and the last is an inappropriate approach. The importance of applying market reasoning to the whole valuation process is then strengthened.

Clause 3.1 Suggest the word “reliably” be deleted.

Clause 3.2.2 In a New Zealand context, and I understand an Australian context, our standards reference an “as if complete” concept which directs valuers not to make estimates of prospective values to the extent that they should value the property as if complete but relative to market conditions that apply as at the date of valuation. The framework for this is that no-one has a crystal ball and therefore can’t predict what will happen with values. As clause 3.2.2 currently reads (acknowledging that it is prefaced (in 3.2) that the “more appropriate of these alternatives will be the one prevailing in the

market for the class of property on the valuation date”), it could cause confusion for New Zealand valuers.

- Clause 3.3 We agree with the general thrust of this clause. However the use of the word “normally” provides uncertainty and is unnecessary. The word “should” already infers. We would recommend adding the words *“in the valuation.” to the last sentence, and the word “capital” in line three should possibly be “value”*.
- Clause 3.5 The cost of financing to the completion date is relevant as a completion cost. However the valuation approach when considering completed buildings would normally make an allowance for the time cost of achieving 100% occupancy and is reflected in either the discount rate, capitalisation rate, or as a separate one off adjustment.
- We agree they should be treated separately and that probably post development holding costs will be directly reflected in the valuation methodology for the completed property.
- The opening sentence to this section would benefit from the words “These represent the cost of providing finance to cover the remaining costs...”
- Clause 3.8 4th line – Should “capital appreciation” be “capital value”?
- Clause 3.9 A change of use to reflect a different highest and best use requires the valuer to consider the added value (if any – they could be a detriment) of the partially constructed building to the land. We consider that the last sentence be deleted as an alternative end use would have to be identified, at least in a generic sense, to establish there is a different highest and best use of the land. In our opinion, this sentence adds nothing and could be misleading.
- Clause 4.1 We support that a market approach is adopted and that the valuation is as at the date of inspection. A valuer may be subsequently asked to consider if there is any material market movement between valuation date and reporting date and, if so, the impact on the initial valuation. Alternatively, the valuer may advise that they consider the initial valuation where completed prior to the financial reporting date should still be applicable as at the financial reporting date as long as there are no material changes to the property or market conditions.
- Clause 5.1 **Special Considerations for Secured Lending**
The final sentence to this section is ambiguous. Is the hypothetical example that the borrower was also going to lease some of the investment property back? If so, then if there is default by the borrower, it is likely that there will also be default by the borrower as a lessee. I think the point here is that the value as vacant (once completed) is necessary when completing the valuation. It may be less than the cost to complete.
- Clause 6.1 In terms of the comments “and where possible quantify costs associated....”, it is hard to imagine a situation where the cost to complete is not critical to a valuation under these circumstances. We acknowledge that the IVSB may be referencing quantification of the “remaining risks” rather than the costs per se. Perhaps the words “and costs” be deleted from the 3rd to last line.

Response to Questions

1 Scope of Guidance

We acknowledge that the introduction references that the GN cannot provide specific guidance for every valuation situation. However, we foresee potential confusion in terms of the definition of Investment Property. The GN has been written around “investment property”. Corporate or owner occupier property could bring in a whole lot of specialised property types for which the guidance as currently written, would not be applicable.

One of the issues that the GN doesn’t address is how to you determine if a property is an “investment property” or not, when it is not be valued for IFRS purposes.

We therefore consider that consideration should be given to defining “Investment Property” in the context of this GN.

2 Valuation Approaches

We prefer the less prescriptive model which requires valuation best practice be the general guidance. This then allows the valuer to select the approaches currently prevalent in the market place considering the type of the property and the specific circumstances of any valuation.

3 Current versus Prospective Values

We reference our earlier comment regarding Section 3.2. In a New Zealand context, and I understand an Australian context, our standards reference an “as if complete” concept which directs valuers not to make estimates of prospective values to the extent that they should value the property as if complete but relative to market conditions that apply as at the date of valuation. The framework for this is that no-one has a crystal ball and therefore can’t predict what will happen with values. As clause 3.2.2 currently reads (acknowledging that it is prefaced (in 3.2) that the “more appropriate of these alternatives will be the one prevailing in the market for the class of property on the valuation date”), it could cause confusion for New Zealand valuers.

We seek to establish market value “as if complete” at the date of valuation. In the context of a DCF, this should be reconciled (via discount rate) with the projected future markets (rents, costs, rates of return (terminal value)).

4 Finance Costs and Risks

- a. The valuer considers the valuation of the completed development and the time it will take to completion.
 - i. The valuer also considers the cost to complete, the timing of the cash out flows and the associated development and investment risks.
 - ii. The valuation of a partially completed investment is largely viewed as the residual (ie what is the highest and best end use value, from that deduct the development costs and risk allowance to achieve that end use). The resulting value represents the added value of the partially completed project and will include all sunken costs including finance costs and profit and risk allowances to valuation date.

For large projects, profit and risk and projected values can change significantly over time. Where there is a soft market the estimated completed value will likely be lower and the profit and risk allowance higher which generally results in the value to date being lower than the capital cost to date.

In our opinion the financing costs require no further explanation.

- b. The cost of finance will be market based so as to avoid an entity specific value (value in use) calculation. We consider that members undertaking valuation for financial reporting should be constantly reminded that they are operating within market model and should be applying market derived data.

To address your specific question, the board considers it appropriate to appropriate to comment that the applicable interest rate may change as the risk profile of the project changes, to the extent that this is observable and appropriate in a market context.

5 Valuation Reliability

We concur with the IVSC position