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GUIDANCE NOTE 17

The Valuation of Investment Property under Construction



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GUIDANCE NOTE

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Valuation of Investment Property under Construction

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1. Introduction and scope

- 1.1. The International Valuation Standards currently include “Guidance Notes” and this is the latest in the series. These deal with the application of the principles in IVS to specific asset types or for a specific valuation purpose. The standards set out the principles and objectives to be followed in a specific situation but do not provide instruction on how to value nor detailed discussion on the merits of different valuation techniques. The Board has embarked on a project to rewrite the current standards, with an Exposure Draft expected in the second quarter of 2010. In implementing this project, the Board has agreed to accept many of the recommendations made in the 2007 report of the Critical Review Group. Among these was that the current distinction between “Standards”, “Applications” and “Guidance Notes” will disappear and in the next edition all documents will be called “Standards”.
- 1.2. The objective of this Guidance Note (GN) is to provide guidance on internationally recognised principles that should be applied when the objective is to estimate the market value of investment property that is under construction on the valuation date. While the valuation of other types of property under construction is not specifically included in the scope of this GN, the same principles will be applicable if the objective is to estimate market value. Many of these principles are similar to those that apply to the valuation of other types of asset; this guidance should therefore be read in conjunction with the International Valuation Standards, and in particular IVS 1 *Market Value Basis of Valuation*, IVS 2 *Bases other than Market Value*, and IVS 3 *Valuation Reporting*.
- 1.3. Valuations of partially completed investment property are required for different purposes including:
- acquisitions, mergers and sales of businesses or parts of businesses;
 - loan security;
 - litigation; and
 - financial reporting.

2. Definition

2.1. *Investment property*. Property (land or building, or part of a building, or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation, or both, rather than for:

2.1.1. use in the production or supply of goods or services or for administrative purposes; or

2.1.2. sale in the ordinary course of business.

3. Valuation approach

3.1. This Guidance Note examines the principles that should be observed in estimating the market value of investment property under construction. Market value is discussed in detail in IVS 1 but in summary the objective is to estimate the price that would be paid and received in a hypothetical exchange of the partially completed property in the market as of the date of valuation.

3.2. In practice, few investment properties are transferred between market participants in a partially completed state, except as either part of a transfer of the owning entity or where the seller is either insolvent or facing insolvency and therefore unable to complete the project. Even in the unlikely event of there being evidence of a transfer of another partially completed investment property close to the valuation date, the degree to which work has been completed would almost certainly differ, even if the properties were otherwise similar.

3.3. In the absence of directly comparable sales evidence, the value has to be estimated using one or more market-based valuation approaches. Such approaches may use information from a variety of sources, including:

3.3.1. sales evidence of comparable properties in different locations or in a different condition with adjustments made to account for such differences;

3.3.2. sales evidence of comparable properties transacted in different economic conditions with adjustments made to account for such differences;

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- 3.3.3. discounted cash flow projections or income capitalisation supported by comparable market data on construction costs, lease terms, operating costs, growth assumptions, discount and capitalisation rates and other key inputs.
- 3.4. The market value of a partially completed investment property will reflect the expectations of market participants of the value of the property when complete, less deductions for the costs required to complete the project and appropriate adjustments for profit and risk. The valuation and all key assumptions used in the valuation should reflect market conditions at the valuation date.
- 3.5. It is inappropriate to estimate the market value of a partially completed investment property solely by reference to the project plan or feasibility study produced at the commencement of the project. Once the project has commenced, this is not a reliable tool for measuring value as the inputs will be historic. An approach based on estimating the percentage of the project that has been completed prior to the valuation date is therefore unlikely to be relevant in determining the current market value.
- 3.6. If the time required from the valuation date to complete construction of a new investment property is such that the anticipated cash flows will occur over a period of time, and if the time cost of money is likely to be a significant factor, it would be appropriate to use a valuation method that reflects the probable timing of those cash flows.
- 3.7. A valuation of investment property under construction may be undertaken using either a growth-implicit model, which uses current cost and value inputs, or a growth-explicit model which uses estimated future cost and value inputs. In either model, the objective is to estimate the value on the assumption that the property is complete, from which appropriate deductions are then made in order to estimate the value of the property in its present condition. The more appropriate of these alternatives will be the one prevailing in the market for the class of property on the valuation date. However, inputs from one model should not be used in the other, and the report should make clear which approach is being adopted.

4. Valuation inputs

The exact valuation inputs used will vary with the valuation model being used but will normally include those listed in this section. The inputs will also vary depending on whether a growth implicit or growth explicit valuation model is being used, see para 3.7. The primary inputs used, together with any assumptions made, should be disclosed in the valuation report.

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- 4.1. **Completed property:** If a growth implicit model is used this will reflect the value of the investment property as if complete, ie its value on the assumption that on the date of valuation it had already been completed in accordance with the current specification. If a growth explicit model is used this will reflect the value of the property upon completion, ie the value of the property as of the date it is anticipated to be completed.
- 4.2. **Leasing:** If lessees for the property after completion have still to be identified, allowance will need to be taken of the time and costs (inclusive of incentives and fees) that it would be realistic to allow for stabilised occupancy to be reached, ie the period required to reach realistic long term occupancy levels. The income from anticipated future leases may be based on current market rents if a growth implicit model is used or anticipated future rents if a growth explicit model is used. If there are leasing agreements in place that are conditional on the project, or a relevant part, being completed, these should be reflected in the valuation.
- 4.3. **Construction costs:** The benefit of any work carried out prior to the valuation date will be reflected in the current value, but will not determine that value. Similarly, previous payments under the actual building contract prior to the valuation date are not relevant to current value. In contrast, the sums remaining to be paid under any binding construction contract in existence at the valuation date are often the best evidence of the construction costs required to complete. However, if there is a material risk that the contract may not be fulfilled, for example due to a dispute or insolvency of one of the parties, it may be more appropriate to reflect the cost of engaging a new contractor to complete the outstanding work. If there is no fixed price contract in place and a growth explicit model is being used then it may be appropriate to use prospective cost, ie reflecting the reasonable expectation of market participants on the valuation date of costs on the dates when they are likely to be incurred.
- 4.4. **Finance costs:** These represent the cost of finance for the project from acquisition through to the anticipated repayment of the loan. As the lender may perceive the risks during construction to differ substantially from the risks following completion of construction, the finance cost during each period should be considered separately. Even if the entity is self funding the project, appropriate market rates of interest should be allowed to reflect those which would be obtainable by a typical buyer of the property in the market at the date of valuation.

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- 4.5. **Other costs:** These will include legal and professional costs that would be reasonably incurred by a buyer in completing the construction and in letting the investment property. Except where there are leasing agreements in place, allowance will also need to be made for the reasonable costs of marketing. However, any costs that would be incurred in an actual transfer of the property on the date of valuation should be ignored.
- 4.6. **Risk:** All significant risks should be identified and evaluated. Typical risks associated with any partially completed construction project will include variations in construction cost, finance costs and the construction programme. Additional risks associated with investment property under construction include fluctuations in the value of the completed project between inception and completion, and the time that will be required to secure lessees and a stabilised income. The risks associated with generating income from the property after completion should be identified and evaluated separately from the risks associated with completing construction. If a growth implicit model is used, the valuation inputs will reflect current values and costs so the risk of these changing between the valuation date and the anticipated completion date should be evaluated. If a growth explicit model has been used based on prospective values and costs, the risk of those projections proving to be inaccurate should be evaluated.
- 4.7. **Investor's return:** Allowance should be made for the return that would be required by a buyer of the partially completed investment project in the market place. This should reflect the risks associated with the completion of the construction programme and in achieving the anticipated income or capital value on the date of valuation. The buyer's return can be expressed as a target profit, either a lump sum or a percentage return on cost or value. Alternatively, if a discounted cash flow approach is used to produce the valuation it may be the minimum rate of return that would be required by a typical buyer in the market. The profit anticipated by the entity at the commencement of the development project is irrelevant to the valuation of its interest in the project once construction has commenced. The valuation should reflect those risks remaining at the valuation date and the discount or return that a buyer of the partially completed project would require for bringing it to a successful conclusion.
- 4.8. **Other considerations:** In situations where there has been a change in the market since a project was originally conceived, the project under construction may no longer represent the highest and best use of the land. In such cases the costs to complete the project originally proposed may be irrelevant as a buyer in the market would either demolish any partially completed structures or adapt them for an alternative project.

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In such cases, the value of the investment property under construction would need to reflect the current value of the alternative project and the costs and risks associated with completing that project.

5. Special considerations under IAS 40

- 5.1. IAS 40 (paragraph 38) provides that the fair value of investment property shall reflect market conditions at the end of the reporting period. Paragraph 39 further provides that the value is time-specific as of a given date. As indicated in IVA 1 *Valuations for Financial Reporting*, the IVSB considers that the explanatory provisions in IAS 40 on the application of fair value¹ mean that, for financial reporting purposes, it is indistinguishable from Market Value.
- 5.2. Financial statements are produced on the assumption that the entity is an ongoing concern unless management either intends to liquidate the entity or cease trading, or has no realistic alternative but to do so (IAS 1 paragraph 25). It is therefore normally appropriate to assume that any contracts, for example for the construction or letting of the property on completion, would pass to the buyer in the hypothetical exchange, even if those contracts may not be assignable in an actual exchange. An exception would be if there was evidence of a higher than normal risk of default by a contracted party on the date of valuation.

6. Special considerations for secured lending valuations

- 6.1. A valuation of a partially completed investment property for secured lending produced in accordance with these standards (IVA 2 *Valuations for Secured Lending Purposes*) will have Market Value as its objective. However, many contracts are either void or voidable in the event of one of the parties becoming subject to formal insolvency proceedings. Therefore, an assumption that a buyer of the partially completed project may have the benefit of existing building contracts and any associated warranties and guarantees may be inappropriate in valuations for this purpose. Likewise, care should be taken in assuming that any agreement for lease entered into by the borrower acting as lessor would be transferable to a buyer.

¹ The provisions in IAS 40 cited in this draft may be superseded by the IASB's proposed new Fair Value standard after the publication of this IVSB Guidance Note. However, the IASB Exposure Draft Fair Value Measurement published in May 2009 reinforces the need for fair value measurements generally under IFRS to be based on the same objectives and principles as Market Value as defined in IVS.

7. Reporting

- 7.1. In addition to the provisions of IVS 3 Valuation Reporting the valuation report should state clearly in a heading that the project is under construction, include a description of the project, the stage of development reached, the valuation method or methods used, the key inputs to the valuation and the assumptions made in determining those inputs, including a summary of the status of any outstanding, major contracts, if relevant. In particular, the report should identify and where possible quantify the remaining risks associated with the project and how these have been reflected in the valuation. In quantifying such risks, distinction should be made between risks in respect of generating rental income and construction risks.

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