INTERNATIONAL VALUATION STANDARDS COUNCIL

DEVELOPMENT PROPERTY

EXPOSURE DRAFT

Comments on this Exposure Draft are invited before 30 April 2014. All replies may be put on public record unless confidentiality is requested by the respondent. Comments may be sent as email attachments to:

commentletters@ivsc.org

Or by post to IVSC, 1 King Street, LONDON EC2V 8AU, United Kingdom.

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Introduction to Exposure Draft

In December 2012 the IVSC Standards Board issued a Discussion Paper on Investment Property, which examined various options for improving the way in which the standards relate to this class of real property. Views were sought on how various issues that had been raised with the Board concerning investment property should best be dealt with in the standards.

After analysis of the comments made by respondents on various issues raised in the Discussion Paper, the IVSC Standards Board tentatively agreed that the additional requirements for valuing investment property that had been identified as needing consideration would best be dealt with by making amendments to the existing IVS 230 *Real Property Interests* and by including a section on investment property in IVS 300 *Valuations for Financial Reporting*. These proposed changes are the subject of a separate Exposure Draft released in parallel with this document.

The Discussion Paper raised the view expressed by some Board members that the current IVS 233 *Investment Property under Construction* (IPUC) is an anomaly among the standards in the 200 series because it deals with a subset of an asset class (investment property as defined under IFRS) and then only to a specific type of valuation required under limited circumstances. The other "Asset Standards" all deal with generic asset classes. The Board has now agreed that consideration should be given to the retirement of the current IVS 233, and its replacement with more broadly based guidance on the valuation of any type of real property that is either in the course of construction or where construction is contemplated, ie "development property".

This Exposure Draft is of proposed new guidance to supersede IVS 233. It is based closely on the commentary in the current IVS 233 but has been broadened in its scope. It is intended to provide supporting information and guidance to assist the application of requirements elsewhere in the IVSs to development property.

Questions for Respondents

The IVSC Standards Board invites responses to the following questions. Not all questions need to be answered but to assist analysis of responses received please use the question numbers in this paper to indicate to which question your comments relate. Further comments on any aspect of the Exposure Draft are also welcome.

Notes for respondents:

In order for us to analyse and give due weight to your comments please observe the following:

1. Responses should be made in letter format, where appropriate on the organisation's letter heading.
2. Comments should not be submitted on an edited version of the Exposure Draft.
3. Unless anonymity is requested, all comments received may be displayed on the IVSC website.
4. Comments letters should be sent as an email attachment in either MS Word or an **unlocked** PDF format and no larger than 1mb. All documents will be converted to secured PDF files before being placed on the web site.
5. The e mail should be sent to commentletters@ivsc.org **with the words "Development Property" included in the subject line.**
6. Please be sure to submit comments before the 30 April 2014.

Questions

Respondents are welcome to comment on any aspect of the proposed guidance but the Board is particularly interested in receiving responses to the following questions:

It is proposed that the specific requirements for valuations of investment property under construction for financial reporting under IFRS be referenced in the guidance on IFRS requirements in IVS 300 *Valuations for Financial Reporting*, rather than being in a separate standard. The Board considers it more logical to include all the requirements in the IVSs for valuations used in financial reporting and guidance on the requirements under IFRS in the same standard. If this is done the current IVS 233 would be withdrawn.

1. Do you agree with the Board's proposal to move all material in the standards specific to financial reporting to IVS 300?

This Exposure Draft is of a proposed Technical Information Paper (TIP) that will retain the guidance in the current IVS 233 Investment Property under Construction if the latter is withdrawn. The guidance in this proposed TIP is designed to be more broadly applicable to all development property rather than to the specific case of valuations of investment property under construction under IAS 40. The Board considers that similar valuation considerations and methods are applicable to all types of real property under construction, not just investment property.

2. Do you agree with the Board's view that the valuation techniques described in the commentary to the current IVS 233 are applicable to all types of development property, not just investment property as defined in IFRS?

The intended purpose of the proposed new TIP will be to provide guidance to support the application of the principles in IVS 230 *Real Property Interests* to development property. Paragraphs 1-4 set out the scope of the proposed guidance.

3. Do you agree with the scope as described? If not, please explain any additional matters that you believe should be added to the scope or matters currently included that you believe should be excluded.

Paragraph 7 provides a non-exhaustive list of matters that typically need to be considered when undertaking a valuation of development property.

4. Please indicate if there are any items on this list with which you disagree or any additional matters you believe should be included.

Paragraph 15 suggests that all three valuation approaches identified in the IVS Framework can be applied to development property.

5. Do you agree? If not, please explain why.

Paragraph 20 introduces the "*Residual method*". Paragraphs 21 and 22 explain the sensitivity of the residual value due to small changes in the inputs.

6. Do you consider the caution provided here is sufficiently detailed or do you consider further guidance is required?

Paragraph 24 lists typical inputs into a cash flow forecast for a development property. This list is almost identical to that appearing in the current IVS 233.

7. Do you consider that there are any typical inputs that are not referenced but should be included or items included that would not typically be used? If yes, please identify the input and the reasons for inclusion or exclusion.

Paragraph 25 indicates common sources or methods for determining the appropriate discount rate. More detailed guidance is provided in TIP 1.

8. Do you consider that there are any other methods for determining the interest rate that should be included? If so, please explain these.

Paragraph 34 includes a list of recommended matters that should be included in a valuation report for development property where relevant and appropriate.

9. Do you agree with this list? If not, please identify any additional matters you would like to see included or matters that are included that you think should be excluded, with supporting reasons.

Paragraph 36 suggests that it may be advisable to include a sensitivity analysis if the valuation is very sensitive to changes in key inputs. This is in order to illustrate the risk of the value changing if, say, market conditions or construction costs were to change during the period required for completion.

10. Do you agree that this type of disclosure is helpful and should be encouraged wherever appropriate?

Exposure Draft

Development Property

Technical Information Papers

Technical Information Papers (TIPs) support the application of the requirements in other standards. A TIP will do one or more of the following:

- provide information on the characteristics of different types of asset that are relevant to value,
- provide information on appropriate valuation methods and their application,
- provide additional detail on matters identified in another standard,
- provide information to support the judgement required in reaching a valuation conclusion in different situations.

A TIP may provide guidance on approaches that may be suitable but will not prescribe or mandate the use of a particular approach in any specific situation. The intent is to provide information to assist an experienced valuer decide which is the most appropriate course of action to take.

A TIP is not intended to provide training or instruction for readers unfamiliar with the subject and will be primarily focussed on practical applications. A TIP is not a text book or an academic discussion on its subject, and neither will it endorse or reference such texts.

CONTENTS

Introduction and Scope

1. The objective of this TIP is to provide information and guidance on the valuation of real property interests where improvements are either being contemplated or are in progress at the valuation date. In the context of this TIP improvements include:

   - the construction of buildings on previously undeveloped land,
   - the provision of infrastructure,
   - the redevelopment or improvement of existing buildings or structures

   For the purposes of this TIP the term *development property* encompasses all of the above.

2. Valuations of *development property* may be required for different purposes including:

   - acquisitions, mergers and sales of businesses or parts of businesses,
   - loan security,
   - litigation,
   - financial reporting.

3. The guidance in this paper is intended to support the application of the principles in the International Valuation Standards (IVSs) to the valuation of real property that is in the course of development, including properties where development is contemplated but has not yet commenced. The following IVSs are of particular relevance to the valuations discussed in this TIP:

- The *IVS Framework*,
- IVS 101 *Scope of Work*
- IVS 102 *Implementation*
- IVS 103 *Reporting*
- IVS 230 *Real Property Interests*

4. This TIP provides guidance on appropriate valuation procedures, approaches and methods for the valuation of *development property* generally. It does not examine any specific statutory or regulatory requirements that may apply for particular purposes in specific jurisdictions, eg for taxation or financial reporting. Where a valuation is required for inclusion in a financial report the provisions of IVS 300*Valuations for Financial Reporting* apply. IVS 300 also contains guidance on the principal valuation requirements under the International Financial Reporting Standards (IFRSs).

Definitions

5. The following defined words and terms have particular relevance to the valuation of *development property* and appear in this TIP. Other words and terms that are also defined in the IVS Glossary may be used but are not listed below in the interests of brevity.

Cost Approach	A valuation approach based on the economic principle that a buyer will pay no more for an asset than the cost to obtain an asset of equal utility, whether by purchase or by construction.
Development Property	Any type of *real property* that is either in the course of construction or where construction is contemplated,
Income Approach	A valuation approach that provides an indication of value by converting future cash flows to a single current capital value.
Market Approach	A valuation approach which provides an indication of value by comparing the subject asset with identical or similar assets for which price information is available.
Residual Method	A method under the *income approach* that estimates the current value of a *development property* by reference to its anticipated value on completion minus the anticipated costs that will be incurred in order to achieve that value.

The Existing Asset

6. IVS 230 *Real Property Interests* sets out in para 3 a list of matters that are to be considered when settling the scope of work and then undertaking any valuation of a *real property* interest. These are all applicable to *development property*. Of particular importance in the valuation of *development property* is the need to establish the suitability of the real property in question for the proposed development. Some matters may be within the valuer's knowledge and experience but some may require information or reports from other specialists.

7. Matters that typically need to be considered for specific investigation when undertaking a valuation of a *development property* before a project commences include:

   - legal permissions or zoning, including any conditions or constraints on permitted development;
   - limitations or conditions imposed on the relevant interest by private contract;
   - rights of access to public highways or other public areas;
   - geotechnical conditions, including potential for existing contamination;
   - the availability of necessary services, eg water, drainage and power;
   - the need for any off site infrastructure improvements and the rights required to undertake this work;
   - any archaeological constraints or the need for archaeological investigations;
   - the availability and cost of funding.

8. Where a project is in progress, additional enquires or investigation will typically be needed into the contracts in place for the design of the project, for its construction and for supervision of the construction.

The Proposed Project

9. The value of an interest in a *development property* is closely correlated with the value of that interest at the end of the development period. In most cases it will therefore be necessary to establish the nature of the completed development. Where no construction work has started this will involve considering the type of development that would be contemplated by a market participant. Where work is in progress it will involve considering the value that a market participant would place on the actual development on completion.

10. In addition to the matters set out in para 3 of IVS 230 *Real Property Interests*, it is normally advisable to also consider and record the following:

    - the source of information on any proposed building or structure, eg any plans and specification that are to be relied on in the valuation and
    - any source of information on the construction and other costs that will be incurred in completing the project and which will be used in the valuation.

11. Because a valuation of a *development property* will often involve either a valuation or consideration of a building or other structure that either has not been built or is only partly

complete at the valuation date, it is frequently necessary to make assumptions or *special assumptions* about the condition or status of the building when complete. Frequently it will be either impracticable or impossible to verify every feature of a *development property* which could impact on potential future development, eg where ground conditions have yet to be investigated. Where this is the case it may be appropriate to make assumptions, eg that there are no abnormal ground conditions that would result in significantly increased costs. If this was an assumption that a market participant would not make, eg because there were actually strong grounds to suspect poor ground conditions, it would need to be presented as a *special assumption*.

12. All assumptions and *special assumptions* will need to be agreed and confirmed in the scope of work in order to comply with IVS 101 para 2(i).

Valuation Bases

13. The valuation basis will depend on the purpose of the valuation. The *IVS Framework* defines different bases. *Market value* is the most commonly used basis as it is normally suitable for both financial reporting and secured lending. However, an entity may also wish to establish the feasibility of a project having regard to its own criteria rather than those of the general body of market participants. Where this is required, *investment value* is the appropriate basis. For certain statutory purposes, eg taxation, statutory definitions of value may be required.

14. This TIP focuses on methods appropriate for estimating the market value of *development property*. If other bases are required, similar methods may be applied but with appropriate adjustments to the inputs, eg for *investment value* entity specific rather than market derived capitalisation rates may be appropriate.

Valuation Approaches

15. The three valuation approaches identified in the IVS Framework, the *market approach*, the *income approach* and the *cost approach* can all be applied to *development property*. Some specific applications of these approaches are discussed together with their limitations in the following sections.

Market Approach

16. Some types of *development property* can be sufficiently homogenous and frequently exchanged in an active market for there to be sufficient data from recent sales to use as a direct comparison where a valuation is required. An example could be relatively small plots of land suitable for similar types of building with all necessary off site infrastructure in place.

17. However, the *market approach* has limited application for larger or more complex properties, or smaller properties where the proposed improvements are heterogeneous. This is because the number and extent of the variables between different sites make comparisons unreliable. Examples of variables which can render the *market approach* unreliable for development properties that may appear superficially similar include differences in what may be legally built, different ground conditions, different on or offsite infrastructure requirements and differences in the availability of services.

18. For *development property* where work on the improvements has commenced but is incomplete, the application of the *market approach* is even more problematic. Such properties are rarely transferred between market participants in their 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 *development 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.

Income Approach

19. The market value of a *development property* will reflect the expectations of market participants of the value of the property when complete, less deductions for the costs that they will incur to complete the project with appropriate allowances for profit and risk. These expectations can be reflected in an *income approach* that allows the anticipated cash outflows and inflows over the duration of the project to be modelled in order to give an indication of the present value by applying an appropriate discount rate to reflect the anticipated timing of those cash flows in relation to the *valuation date*.

20. The adaptation of the *income approach* that uses forecasted cash flows to estimate the current value of a *development property* is frequently known as the *residual method*. While the *residual method* can be used to indicate the current value of a *development property*, it can also be adapted to estimate other elements of the project, for example the estimated profit that a project will return for a given land cost or construction cost, and therefore it is commonly used to examine the feasibility of a proposed project.

21. The advantages of using the *residual method* are that it allows the costs and income that are specific to the particular project to be reflected and therefore it avoids many of the shortcomings of the *market approach* described above. However, caution is required in the use of this method because of the sensitivity of the result to changes in many of the inputs, which may not be precisely known on the *valuation date*, and therefore have to be estimated and may be based on assumptions.

22. The residual value can be highly sensitive to relatively small changes in the forecast cash flows. For example, a relatively minor change in either the anticipated value on completion or the costs of completing the project has a much greater relative impact as a percentage of the current value. The reliability of this method is therefore dependent upon the quality of the information available on the costs that are anticipated and the accuracy with which the value of the completed project can be estimated. It is often useful for land values derived by this method to be checked against a *market approach*, where comparable data is available.

23. A valuation of *development property* may be undertaken using either a nominal or a real cash flow model[1.] In either model, the objective is to estimate the value on the special 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

[1] See TIP1 *Discounted Cash Flow* TIP 1 – published by IVSC IBSN 978-0-9569313-4-4

date. Inputs from one model should not be used in the other, and the report should make clear which approach is being adopted.

Residual Method – Cash Flows

24. 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 nominal or real cash flow inputs are being used, see para 20 above. Typical inputs include:

(a) Completed property

The value of the completed project may be based on current values on the *special assumption* that on the *valuation date* it had already been completed in accordance with the current specification or the projected value of the property upon completion, ie the expected value of the property on the date when it is anticipated to be complete. Care must be taken to ensure that the discount rate used is commensurate with the valuation approach and assumptions used.

(b) Lease agreements

If the property is to be held for investment after completion there may be leasing agreements in place that are conditional on the project, or a relevant part, being completed, which can be reflected in the valuation of the completed property.

(c) Stabilised occupancy

If the property is to be held for investment after completion and there are no pre-leasing agreements in place at the *valuation date*, see para 24(b) above, allowance will also be needed for both the time and the costs involved in reaching stabilised occupancy, ie the period required to reach a realistic long term occupancy level. For a project where there are many individual letting units the stabilised occupancy level may be less than 100%. The costs incurred during this period could include fees, marketing, incentives, maintenance and unrecoverable service charges.

(d) Construction costs

The benefit of any work carried out prior to the *valuation date* will be reflected in the 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, eg 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 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.

(e) Finance costs

These represent the cost of finance for the project from acquisition through to the anticipated repayment of the loan. As the funder 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 an entity is intending to self-fund the project, to estimate the market value an allowance should be made for interest at a rate which would be obtainable by a market participant on the *valuation date*.

(f) Consultants' fees

These will include legal and professional costs that would be reasonably incurred by a market participant in order to complete project.

(g) Buyers profit and risk

Allowance should be made for the return that would be required by a buyer of the *development property* in the market place for taking on the risks associated with the completion of the project. This will include the risks involved in achieving the anticipated income or capital value following physical completion of the project. However, the risks involved in holding the completed property once stabilised occupancy has been reached should be reflected in the anticipated value of the completed property, see para 24(a) above. The buyer's return can be expressed as a target profit, either a lump sum or a percentage return on the costs incurred or of the anticipated value of the project on completion.

Typical risks associated with the completion of a development project include unforeseen complications that increase construction costs, contract delays, supplier failures, regulatory changes, changes in supply and demand and the time that will be required to secure lessees and a stabilised income or a sale to an owner occupier after physical completion.

In the case of a *development property* where construction has commenced but is not yet complete, 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.

Residual Method – Discount Rate

25. In order to arrive at an indication of the value of the *development property* on the valuation date a discount rate will be applied to all future cash flows in order arrive at a net present value, ie the value of all anticipated cash inflows less the present value of all anticipated cash outflows. This discount rate may be based on an analysis of the rate implied by transactions for similar

development properties in the market or by using the weighted average cost of capital (WACC) that is typical for participants in the relevant market.[2]

26. If the cash flows are based on values and costs that are current on the *valuation date* the risk of these changing between the valuation date and the anticipated completion date should be considered and reflected in the discount rate used to determine the present value. If the cash flows are based on prospective values and costs, the risk of those projections proving to be inaccurate should be considered and reflected in the discount rate.

Residual Method – Other Considerations

27. In situations where there has been a change in the market since a project was originally conceived, a 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. 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.

28. When valuing a partly completed *development property* it is not appropriate to rely solely on projected costs and income contained in any 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. Likewise 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.

Cost Approach

29. The *cost approach* is based on the economic principle that a buyer will pay no more for an asset than the cost of it obtaining an asset of equal utility. To apply this principle to *development property* it would be necessary to consider the cost that a prospective buyer would incur in acquiring a similar asset with the potential to earn a similar profit from development as could be obtained from development of the subject property. However, unless there are unusual circumstances affecting the subject *development property*, the process of analysing a proposed development and determining the anticipated costs for a hypothetical alternative would effectively replicate either the *market approach* or the *residual method* as described above, which can be applied directly to the subject property.

30. Another difficulty in applying the *cost approach* to *development property* is in determining the profit level, which is its “utility” to a prospective buyer. Although a developer may have a target profit at the commencement of a project, the actual profit is normally determined by the value of the property at completion. Unless a fixed price has been agreed, profit is not determined by the costs incurred in acquiring the land and undertaking the improvements. Consequently, unless the property interest being valued is subject to a sale agreement on completion that guarantees a return on cost that is either fixed or defined within specified limits, an approach that relies only on the cost of completing the development plus a target profit is unlikely to give

2 See TIP 1 *Discounted Cash Flow* – published by IVSC IBSN 978-0-9569313-4-4

as reliable an indication of the present value of that interest as the residual approach described above.

31. The *cost approach* may be more relevant than other approaches as a means of indicating the value of *development property* where the proposed development is of a building or other structure for which there is no active market on completion or which will generate no income or benefits in lieu of income.

Special Considerations for Financial Reporting

32. Financial statements are normally produced on the assumption that the entity is a going concern, see IVS 300 *Valuations for Financial Reporting* para 4. It is therefore normally appropriate to assume that any contracts, eg for the construction of a *development property* or for its sale or leasing 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 an abnormal risk of default by a contracted party on the valuation date.

Special Considerations for Secured Lending Valuations

33. As indicated in IVS 310 *Valuations of Property Interests for Secured Lending*, the appropriate basis of valuation for secured lending is normally market value. However, in considering the value of a *development property* where the project is in progress but not completed, regard should be had to the probability that many contracts will become void or voidable in the event of one of the parties being the subject of formal insolvency proceedings. Therefore, it may be appropriate to highlight the risk to a lender caused by a prospective buyer of the partially completed project not having the benefit of existing building contracts and any associated warrantees and guarantees in the event of a default by the borrower. Similarly with an agreement to lease, care should be taken in assuming that the benefit of any agreement entered into by the borrower would be transferable to a buyer in the event of a default.

Reporting

34. IVS 103 *Reporting* and IVS 230 *Real Property Interests* set out general requirements for reporting the value of real property interests which are all applicable to *development property*. It is recommended that a valuation report on a *development property* also contain the following where relevant and appropriate:

- confirmation of the current status of the *development property*, eg its physical properties and current use or description of the stage of development reached,
- a description of the project,
- the estimated cost to complete and the source of that estimate,
- identification of and, where possible, quantification of the remaining risks associated with the project, distinguishing construction risks from risks associated with ownership of the completed project,
- the key inputs to the valuation and the assumptions made in determining those inputs.

35. As indicated in paras 21 – 22, the value of a *development property* can be very sensitive to changes in either the value of the completed project or in any of the costs that will be incurred

in completing the project. This remains the case regardless of the method or methods used or however diligently the various inputs are researched on the *valuation date*. Depending on the purpose for which the valuation is required it may be necessary to highlight any material uncertainty in the valuation.[3]

36. This sensitivity also applies to the impact of future changes in either the costs of the project or the value on completion on the current value. If the valuation is required for a purpose where future changes in value over the duration of a construction project may be of concern to the user, eg where the valuation is for loan security or to establish a project's viability, it may be appropriate to highlight the potentially disproportionate effect of possible changes in either the construction costs or end value on the profitability of the project and the value of the part completed property. A sensitivity analysis is sometimes useful for this purpose.

[3] See TIP 4 *Valuation Uncertainty* – published by IVSC ISBN 978-0-9569313-8