Investment
Management
Corporation

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International Valuation Standards Council
41 Moorgate
London EC2R 6PP
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Dear Sirs;

International Valuation Standards Council - Investment Property Discussion Paper

Introduction

In December 2012, the IVSC published the above Discussion Paper, inviting comments before March 1, 2013. This letter constitutes a response from the British Columbia Investment Management Corporation (bcIMC) to the Discussion Paper.

About bcIMC

bcIMC is one of Canada's largest institutional fund managers, with assets under administration of $98 billion as of January 31, 2013. Our clients include public sector pension plans, public bodies, publicly administered trust funds, and government operating funds. bcIMC manages 65 pooled investment funds in all major asset classes with investments in domestic and international markets, with some $17.5 billion in real estate investments.

bcIMC is a long-hold investor that looks for quality investments that produce reliable long term cash flows and capital appreciation for our clients. Our investment activities help to finance the retirement benefits of more than 500,000 members of British Columbia public sector pension plans including university and college instructors and staff, municipal employees, healthcare workers, firefighters, police officers, public servants, teachers, and employees of other Crown entities. Our investment activities also help finance insurance and benefit funds that cover more than 2.3 million workers.

General Comments

bcIMC has extensive investment in many types of real estate, including office, commercial, industrial, retail, multi-family residential, hospitality, seniors care, agricultural, and mixed use. Many of the investments are held in one of bcIMC's investment funds, units of which can be bought or sold quarterly based on the fair value of the investments in the fund at the time the units transact. Accordingly, the consistent application of robust valuation methodologies is important to bcIMC and its clients. bcIMC is concerned that real estate valuation practices are creating volatility in the investment industry that is detrimental to investors and their clients.

The recent global financial crisis highlighted this issue. Following a lengthy period of rapid escalation in real estate values, the real estate market, almost overnight, became dysfunctional, with almost no transactions other than distress sales. The Canadian real estate market was not affected as dramatically as other real estate markets, however, the Canadian market did go through a significant period of lower activity as many buyers and sellers adopted a 'wait and see' strategy. Valuation professionals had very few 'normal' comparable transactions to work with and may have been overly influenced by a few distressed transactions that generated higher capitalization rates and lower prices than would otherwise be expected. It would also appear that valuators did not consider the increase in real estate capitalization rates in the context of capitalization rates in other asset classes - given all the liquidity governments were pouring in to their economies and the resulting decrease in already very low interest rates, what rationale was there for real estate capitalization rates to dramatically reverse course and move to levels well above previous trading ranges in a dysfunctional environmental where few transactions could support such a reversal?

In the Canadian market, a significant portion of investment grade real estate is held by large institutional investors (such as pension plans and REITs) that generally have the financial capacity to ride out market volatility without having to liquidate properties at distress values. In bcIMC's case, the net operating income of bcIMC's Canadian real estate portfolio remained consistent throughout the downturn - a strong indication that the intrinsic value of the portfolio had not been affected by the downturn. A further indication of the strength of the intrinsic values of Canadian investment grade real estate was the general lack of foreclosure activity on the part of lenders, and a minimal number of properties that were offered up for sale - both of which suggested that both lenders and owners viewed the decline in real estate values as a temporary phenomenon.

The reduced values during the downturn caused great concern amongst bcIMC's clients, many of whom are large pension funds that are subject to actuarial valuations every three years. For those pension funds whose actuarial valuation occurred at the bottom of the economic downturn, depending on how the actuary viewed the downturn (short or long-term), the pension funds could be faced with increasing contribution rates for employers and plan members and/or reducing pension benefits. These changes might have been reversed in the next actuarial valuation, as real estate values have largely recovered over the past three years. Similarly, clients that bought/sold units in bcIMC's real estate fund may have been unduly enriched or disadvantaged by the unrealistically low underlying real estate valuations.

These comments are offered as context for bcIMC's answers to the Discussion Paper questions below. Many of the issues we have raised could be addressed by adopting IVSC definitions of Fair Value or Investment Value, which, in some measure, consider the value of an investment property to the owner and/or prospective purchasers that have similar characteristics to the owner. There is a fundamental difference between long-hold institutional investors who truly have the capacity to withstand market volatility, and short term real estate speculators that look for short-term capital appreciation. It is not clear that both should be measured by the same fair value definition. For any given property, long-term investors such as bcIMC are generally looking for stable cash flow and capital appreciation over time, which in many cases can be achieved by selecting uses other than the “highest and best use”. For example, acquiring a vacant land site for a purpose-built rental apartment instead of building condominiums for immediate resale better aligns with long-term investors’ objectives, yet the highest and best use may be condominium development because of its short-term higher return (and higher risk) profile.

bcIMC recognizes that the definition of fair value for financial statement purposes lies more with the International Accounting Standards Board than with the IVSC and will, accordingly, also be writing to the International Accounting Standards Board to express our concerns.

Specific Questions

1 **Do you think that the current definition should be retained in full or that an amendment to the definition in IVS 233 is required?**

We believe it would be appropriate to amend the current definition of investment property in IVS 233. See comments in 3.

2 **If you believe it should be retained in full, what guidance should be given to valuers when valuing for the non-financial reporting purposes referred to above?**

N/A

3 **If you believe an alternative definition is warranted, please give reasons and suggest appropriate wording.**

Many institutional real estate investors have significant investments in the healthcare, hospitality and seniors care sectors. We would agree with the board that the exclusions in a) and b) should be removed so that these types of properties can be regularly valued under the same investment property premise as other investment properties.

4 **Have you encountered valuations that explicitly refer to intangible assets associated with either the property interest or the business in occupation? If so, were these separately valued or not? For what purpose was the valuation required?**

Yes, bcIMC has encountered valuations that explicitly refer to intangible assets associated with the property interest or the business. The intangible assets are valued as part of the property valuation. These property valuations are used to determine the net asset value for the investment fund, as well as financial reporting of the fund and the legal entities that hold the investment properties.

5 **Have you encountered valuations of investment property where you believe that the value of an intangible asset has been included in the value of the property interest but has not been expressly identified?**

Generally, we have not seen this situation. We provide specific instruction to our appraisers to have these components detailed in the valuation report.

6 **Do you consider that the IVSC needs to provide guidance on this issue?**

Yes. Although this has not been an issue for bcIMC it would be helpful to have guidance that would ensure consistent valuation approaches; and would confirm that properties such as hotels and restaurants are investment properties.

7 **Which of these options do you favour or is there another option that you would suggest?**

bcIMC would favour a new IVS on Investment Property incorporating IVS 233. The interests of long hold property investors, particularly institutional investor such as pension plans, were not well served during the recent economic downturn, when real estate markets were not functioning normally and there were very few property transactions that were not of a distressed nature. In bcIMC's experience, the net operating income and intrinsic value of investment properties were unaffected by the downturn and there were minimal foreclosures on investment grade properties in Canada, yet there was a significant decline in property values because appraisers were overly influenced by a small number of distressed transactions.

8 Do you consider the provisions of IVS 230 and IVS 233 in relation to valuation methods to be sufficient?

The provisions of IVS 230 and IVS 233 are generally sufficient when real estate markets are functioning normally and there are many relevant comparable transactions. More guidance is needed to provide a consistent approach to valuation methodologies when markets are not functioning normally, or when a transaction is unique. For instance, when markets are not functioning properly, guidelines might allow a temporary pause in the valuation process and/or the use of average historical metrics anchored to a normal market to determine fair values. Guidance of this nature may have significantly mitigated the considerable stress on the markets from late 2008 to 2010. Similarly, it would be useful to provide some guidance on valuation methodologies when markets seem over heated and prices may not be sustainable.

It would be beneficial to have a separate standard for Investment Properties to address issues that are currently not covered in IVS 230 and IVS 233.

9 If not, what specific aspects of valuation methodology for investment property do you think should be addressed in any future TIP?

Future TIP should provide further guidance on the issues raised in our response to question 8. It would also be useful to provide further guidance on ensuring that comparable transactions used for valuations do not overly lag the market. In thin markets comparable transactions may significantly predate a valuation and therefore may not be reliable indicators of current values.

10 Do you consider that the additional guidance to that provided in the IVS Framework (paras 33 – 35) is needed to apply the highest and best use concept to investment property?

It would be beneficial to have further guidance on the valuation of properties that are destined for development or re-development at other than the market's perception of highest and best use. As we have referenced in our opening comments, long-hold investors are looking for stable long term cash flows and capital appreciation that may well be delivered by uses other than what the general market determines to be 'highest and best use'. For example, quality residential rental housing may be of little interest to most developers, who may prefer short term condominium development and sales, however, for long-hold investors quality residential housing may be a much better option, as noted above.

For development or redevelopment properties held by long term investors, it may be more relevant to determine fair value based on intended long term use. Guidance might allow long term investors to declare the intended use for a property at acquisition, or when a significant redevelopment is planned for an existing property, and rely on that intended use for valuation purposes over the holding period. The guidance would also need to provide for the ability to change the intended use for valid reasons. We recognize that this concept is not without its challenges, however, with pragmatic definitions and constraints it should be workable.

11 Please indicate which of the above most frequently presents a problem in the valuations that you encounter and the most common methods you see being used to address the issue.

a), d) and e) are at the root of most valuation issues that we encounter, however, when markets are functioning normally, and there are good comparable transactions available, there generally are not significant issues with our valuations. When issues do arise they typically involve a), d), and e), and they arise because markets are not functioning normally, there are very few comparable transactions, or a transaction is unique. The resolution of issues typically involves discussion with the valuator on the reasonableness of assumptions, and identification of circumstances that might support a different valuation. At the end of the day it is the valuator that has the final say on the valuation.

12 If you are a valuation provider, please indicate why you prefer these methods. If you are a valuation user, please indicate if you are confident in the result obtained by these methods.

bcIMC is a valuation user. When markets are functioning normally, current methods generally arrive at a conclusion that works for both parties. When markets are not functioning normally, and in particular during the recent economic crisis, the methods were limited in being able to describe the potential volatility of the markets and their impact on the valuations. Both valuation providers and users acknowledged that valuations were overly conservative, however, the valuators were cautious of making assumptions that couldn't be substantiated by the few available data points. Accordingly, bcIMC struggled to reconcile the valuations received with the inherent long term value of its real estate portfolio as evidenced by the portfolio's continued strong net operating income throughout the downturn.

13 Have you encountered material inconsistency in the approach adapted to the treatment of costs or tax in valuations of investment property? If so please indicate the nature of the inconsistency and its consequences.

We have not encountered material inconsistency on the tax side - our valuations typically are done on a pre-tax basis.

With respect to costs, we have seen some inconsistency in the treatment of capital expenditures on existing Income Producing Property. In some cases valuators recognize a capital improvement plan and incorporate the costs and the anticipated revenue bump into the valuation once the capital project has started; in other cases valuators only recognize costs as they are incurred, and revenue bumps as they are realized. The difference in methodologies results in a timing difference in recognizing the valuation benefit of capital spending between properties, and that can translate into differences in investment returns for very similar properties. Additional guidance related to dealing with capital expenditures would be beneficial.

14 Do you consider that the IVSC should attempt to set benchmarks that indicate whether inputs and valuations should include or exclude different types of tax or other costs? If so, which specific benchmarks would you consider appropriate?

Yes, bcIMC would encourage benchmarks on whether certain types of taxes or costs are to be taken into account in the inputs to a valuation. Of particular concern is how differing tax rates among key market participants should be incorporated into the required rate of return and the discount rate. Benchmarks are useful in ensuring consistency and comparability of property values, however, they should be flexible enough to accommodate the multitude of different circumstances valuators face. Added consistency would be a benefit and would ideally reduce methodological differences between appraisers.

15 Do you consider that an opinion on where the inputs used in a valuation of investment property fall within the input hierarchy under IFRS (or any other accounting standard that contains a similar hierarchy of inputs) should be provided as part of the valuation report?

Yes. Enhanced disclosure would better enable users of valuations to understand and assess the inputs used and the judgments applied by the valuers in arriving at the market value. The enhanced disclosure would also assist preparers of fair value based financial statements with their disclosure requirements.

16 If so what guidance should the IVSC be providing to enable valuers to comply with the requirements of IFRS 13 in relation to disclosures on inputs?

The provision of information on the inputs related to the IFRS 13 hierarchy should include reference for each of the primary inputs as to whether the inputs are from observable market data, property specific data, or are based on assumptions.

17 Do you agree that not all investment property is capable of reliable valuation? If so please give any additional examples to those above.

bcIMC agrees with the factors listed in paragraph 4.2 and would add 'when markets are not functioning normally' to the list.

18 Please indicate the nature of guidance that you believe IVSC could usefully provide to help determine when a valuation cannot be reliably provided.

The IVSC could provide further examples of situations that could imply that a valuation cannot be reliably provided. The guidance could also identify possible alternatives that might be used to determine a valuation in circumstances that might otherwise suggest a valuation could not be reliably provided.

Sincerely,

David Woodward
Vice President, Finance