

## Valuation Uncertainty - IVSC Discussion Paper - September 2010

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New Zealand Valuation Standards Board response to questions set down on page two of the discussion paper:

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***Question 1. Do you agree that it is only when material, or abnormal, uncertainty attaches to a valuation on a specific time or date that specific disclosure is necessary when the valuation is reported? If not please explain why you consider that an uncertainty statement should be provided in all cases.***

We consider that valuation uncertainty should be disclosed in every valuation. Valuers have a duty to implant in the mind of the report reader the level of market price uncertainty at the time so as to put any point valuation in context, and avoid the counter-productive results of including point values in valuations.

We acknowledge the need for a point valuation, particularly if the distribution of expected the range is asymmetric; for example, if there was a greater probability of the point estimate being lower than the expected value, or vice versa.

Our experience is that the general public, lenders, and deal-makers tend to place too much reliance on what are often totally arbitrary point estimates of value, and hence they tend to over-estimate the certainty of valuations. This is counter-productive and unhelpful to the market and the real estate industry as a whole. It would be more useful to most market participants to shift focus to value ranges instead of point values.

For example, valuations prepared by share market analysts usually provide a valuation range when evaluating proposals, and that suits their industry. Perhaps valuers should follow suit?

Consider an industrial land portfolio, with a valuation range of \$31 to \$35m prior to purchase, noting the midpoint of the valuation range was \$33 M. A sale was agreed at \$34 M. A client might request to have the valuation addressed to a bank to obtain mortgage finance. If the report had been prepared with an arbitrary \$33 M as a midpoint of the value range, the lender may then limit finance available to a ratio applied to the valuation and yet the parties agreed on a price at \$34 M, which is well within the standard market range and not at all contrary to the expected range. The deal could be frustrated by the bank's reliance on the valuation rather than the deal which is confirmed to have been at or around a market price, or at least within the accuracy the valuer could estimate at the time.

This type of influence can cause deals to fail, causing loss to possibly all three parties. Such a situation plays out commonly. Lenders may be placing too much weight on the

valuation amount without considering if the price was in a fair range as opposed to simply being above or below an artificial midpoint in a value range. Valuers that fail to express the standard market pricing uncertainty may result in parties not being able to evaluate transaction appropriately; the vendor may miss out on a sale which was to all parties a fair price, including to the purchaser.

Consider a simple residential real estate transaction. A buyer obtains a valuation at \$500,000, and then negotiates with a vendor, but refuses to agree to \$510,000 because “the valuer said it was only worth \$500,000”. The valuation should have said the valuation range is \$490,000 to \$520,000 because that is the general range of sales in the area involving similar properties. That value range was more helpful information than the point value because the buyer then knows where their price stands in relation to the market range – which is only ever one of the factors in a house purchase. Without the stated market range, the purchaser may be fooled into believing that \$510,000 was too much to pay, when it really was not excessive in context of ‘normal’ market uncertainty.

In the above cases, valuers are influencing market prices to an excessive degree, interfering in the workings of the very market they are seeking to assist to function efficiently.

Consider financial reporting valuations where revaluations are being considered for assets expected to have experienced a material change in value. A value range allows them to make the decision to retain the present point value they have if it remains in the market range, or alter it if the market range has moved. Comfort can be gained by the directors to see if the property’s book value (or an anticipated transaction value) is well within, at the top end of, or at the lower end of, the valuation range.

Consider market rental valuations. Those relying on rental reports may very well get more use out of such assessments if they included a range of values because they would realise where a particular assessment sat within the range and this would help them with their own negotiations. Their ability to seek a midpoint result is unaltered if a range is provided.

We are unable to think of a situation where a range (reasonably stated and soundly based) should not be provided.

We do acknowledge that providing ranges is not without its problems, particularly in terms of consistency in the range that valuers use for particular properties or property types. One valuer might choose a different range than another valuer for the same or similar property. There is no easy solution to this, but regardless, we support the use of value ranges.

We disagree strongly with the statements at para 5 of the discussion paper where ‘normal valuation uncertainty’ is excluded by the Board as being worthy of recognition. In our opinion, an expression of the valuation uncertainty should be provided as a matter course.

***Question 2: Do you believe that the Board has identified all major sources and types of material valuation uncertainty? If not please identify what additional causes of uncertainty exist and how often you encounter these in practice.***

The discussion at paragraphs 6 to 14 is generally complete in our view. We note however, that additional market uncertainty arises from changes in supply and demand which are less obvious and which might have an influence on values. For example, if valuing vacant factories in a market where sporadic sales occur, sometimes the sales are to investors at discounted values and sometimes sales are to owner occupiers and these may be at higher prices. Valuer should not assess one number alone, but should identify the range of values and point out the lack of price certainty in the market.

Another example is valuations of prime coastal properties here in New Zealand. The market is thinly traded and prices will depend on actual market demand at the time which is in a constantly changing swing from local purchasers to offshore purchasers, all depending on different exchange rate movements, individual preferences, and a large amount of guesswork on behalf of the valuer as to who might be active in the market.

Such situations can result in an apparent two tier market that alternates from one to the other apparently randomly and in keeping with changes outside the knowledge of the valuer. Neither extreme value (high or low) may be so infrequent as to be labeled a premium price or a discounted price if both groups remain active sporadically and seemingly randomly within a lightly traded market. Equally, if the participation of overseas buyers that pay the premium prices is uncertain, a valuer might be more confident about a value at the lower end of the range, implying an asymmetric value distribution (skewed probability curve).

***Question 3: Do you agree with the Board's conclusion that an explanation of any abnormal uncertainty identified and an explanation of the impact this has on the valuation (a qualitative statement) is more helpful to users in understanding the valuation than a purely numeric expression of the range of possible values created by the uncertainty (a quantitative statement)?***

We disagree with the board. In our view, qualitative statements of themselves are of little use and leave readers of reports wondering just how reliable the valuation is.

Quantitative expressions of uncertainty are useful if the valuer keeps these to a 'reasonable market range'. In our experience, clients find a valuation range more helpful in most cases than a point value, and this information is frequently an important input into their negotiations, adding value to the valuation report.

In our view it is erroneous for the Board to assume that there is a standard market level of uncertainty that is accepted or even known in the market. Some assets are more volatile than others and even the experienced market participants do not always appreciate that.

They need to be informed of this in every valuation in order to contextualize the valuation.

We agree that there are pitfalls in this such as correlation of variable inputs leading to unlikely ranges, etc as noted by the Board at para 19.

***Question 4: Do you think the IVSB should include an explicit requirement in the proposed IVS 105, Valuation Reporting, to disclose any material uncertainty or is the principle that requires valuation reports not to be ambiguous or misleading sufficient?***

We consider that all valuations which do not provide an indication of the uncertainty range are insufficient.

The terms “normal” uncertainty (paragraph 5) and material uncertainty would seem, however, to require discussion.

***Question 5a: Do you consider that there are cases where a qualitative statement of the causes and impact of uncertainty on the valuation is inadequate and should be either augmented or replaced by a quantitative statement? If so please state the circumstances and assets classes where you believe that quantitative statements are more helpful to users and,***

See our answers to Question 1.

***Question 5b: Provide a brief explanation or example of the type of quantitative statement that you believe would be useful.***

We suggest words to the effect of: “Transactions can be analysed to support a valuation in the current market within a reasonable range of between \$X and \$Y”, or similar.

Valuers are commonly instructed to provide a tabular display of value sensitivities. This can be frustrating and ultimately unhelpful to the parties because of the unreal assumptions that just one variable would change in a complex model when there are usually correlated changes that may even partially offset the first variable change.

The preference is to have a generic range such as might be approximated by (say) one standard deviation either up or down from a midpoint. That range would include 68% of prices, which could be fairly easily translated into meaningful words for lay people such as “We would not expect the property to sell for less than \$X or greater than \$Y under normal market conditions”.

In frequently traded markets this can be a statistical measurement. In markets with relatively low price variability the range may be very small indeed. In assets with significant uncertainty due to complexity, such as development projects, Montecarlo

Analysis can be used. This may be a step too far for the valuation profession at present, but ultimately Monte Carlo Simulation (and Options Valuation techniques) will become more prevalent, in our view.

In markets which are simply infrequently traded, a more subjective assessment of the range of likely prices may very well be the only determinant of the value range. Just as the law has a fairly clear definition of what the ‘reasonable person’ would say or do or conclude, it should not be difficult to refine a definition of the lower and upper bounds of values that the valuer can identify as moving from unlikely to be sold at a price of \$X, the fair value range, and then unlikely to achieve a price as high as \$Y, all within the constraints of standard market conditions.

***Question 6: Do you consider that it would be helpful if IVSC developed guidance on methods for making a quantitative disclosure of uncertainty under specific circumstances? If so please indicate the circumstances and any methods that you either use or encounter in your market.***

Yes we do think guidance on how to express uncertainty, even normal market uncertainty, would be beneficial to valuers. Clearly, there is reference to these issues at a high level in other guidance notes and standards, however, in our experience, the issue is not getting through to members and explicit guidance on this issue is therefore strongly supported.

Perhaps a definition of “fair value range” would be helpful for valuers to rely upon and quote in reports to educate their clients and the general public and to increase the value of the assessments we provide by placing them in a superior context.

As mentioned already, we do not consider there are any situations where valuers should not provide such information as a matter of course.

Ultimately, providing valuation ranges is more accurate than a point value. Value uncertainty has long been a feature in the world of financial analysts, and it is time real estate valuers caught up with what we consider is a more informative standard of value reporting.

#### **Further comment – paragraphs 4 and 6**

The reference to “most probable price” might need clarification. For example, if it is known that the probability distribution of price is 100 with probability 0.8 and 10 with probability 0.2. Is the valuation estimate then 100? Most people would not pay 100. They might pay the expected price 82 (=80+2) or some other number intermediate to 100 and 10. How does that relate to the statement in paragraph 6 that “valuation uncertainty relates to the probability that the valuation estimate would differ from the price in an actual transaction”? If the valuation estimate was a number intermediate to 100 and 10 would that indicate 100% valuation uncertainty?

**Further comment – paragraphs 6, 7, 8 and 19**

It is stated in paragraph 6 that “... market risk is the loss an asset can face ...” and in paragraph 7 it is stated that “... market risk ... is the maximum expected loss ...”. Are these statements intended to be different and what does “expected” mean? Is it a weighted probability estimate? It is claimed that market risk (as defined) is also known as “value at risk”. In fact value at risk (VaR) is a more specific concept. For example, a one month 5% VaR of \$100 for a traded asset means that there is a 5% probability that for the month the mark to market loss on the asset will be \$100 or more. The example in paragraph 8 is not consistent with this definition of value at risk. In paragraph 19 (fourth bullet) “market risk” appears to have a different meaning from that given in the earlier paragraphs.

**NZ Valuation Standards Board  
15 December 2010**