



INTERNATIONAL VALUATION STANDARDS COUNCIL

IVS 400: REAL PROPERTY INTERESTS

EXPOSURE DRAFT

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Comments on this Exposure Draft are invited before 31 August 2016. All replies may be put on public record unless confidentiality is requested by the respondent. Comments may be sent as email attachments to:

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Introduction to Exposure Draft

Why is the International Valuation Standards Board (IVSB) issuing IVS 400 Real Property Interests?

In October 2015 the IVSC published its *Purpose and Strategy Document* which stated that the priority of the IVSC is to expand the quality and depth of International Valuations Standards (IVS) and ensure they are fit for purpose and provide much needed clarity and market efficiency.

What are the Main Provisions?

The main provisions of this chapter are:

- (a) an overview of real property interests and the circumstances in which they are valued,
- (b) a framework for the selection and application of approaches and methodologies for the valuation of real property interests, and
- (c) a discussion of special topics related to the valuation of real property interests including hierarchy of interests and rent.

How do the Proposed Provisions Compare with IVS 2013?

This chapter includes elements from IVS 2013 that were included in IVS 230 *Real Property Interests*. Some of the concepts from IVS 2013 have been clarified and/or expanded upon in this Exposure Draft, but the majority of the content has remained the same. Sections have been added related to selection and application of approaches and methodologies.

Questions for Respondents

The Board invites individuals and organisations to comment on all matters in this proposed update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

- (a) In IVS 2013, all substantive portions of IVS 230 *Real Property Interests* were labelled as “commentary” (except for scope and effective date). This label seems to have created some confusion amongst stakeholders as to whether the standard was mandatory. The Board’s position is that all aspects of IVS 2017 should be mandatory and this Exposure Draft has removed the “commentary” label for clarity. Do you agree with the removal of the commentary label?
- (b) Do you agree with Section 20.5, which states it is the valuers responsibility to state the extent of the investigation and source of the information to be relied on? If not, why not?
- (c) The Board believes that the standard presented in this Exposure Draft can be applied in the valuation of real property interests regardless of the purpose of the valuation (secured lending, sales of real property, taxation, litigation, insolvency proceedings and financial reporting. etc). Do you agree? If not, for what purpose(s) do you not believe this standard can be applied? Why?
- (d) Are there any further topics that you feel the Board should add or remove from IVS 400 *Real Property Interests*? If so, what are they and what is your rationale?

IVS 400 Real Property Interests

10. Requirements

- 10.1. The principles contained in the General Standards apply to valuations of real property interests. This standard contains additional requirements for valuations of real property interests.

20. Overview

- 20.1. A real property interest is a right of ownership, control, use or occupation of land and buildings. There are three basic types of interest:

- (a) the superior interest in any defined area of land. The owner of this interest has an absolute right of possession and control of the land and any buildings upon it in perpetuity subject only to any subordinate interests and any statutory constraints;
- (b) a subordinate interest that gives the holder rights of exclusive possession and control of a defined area of land or buildings for a defined period, eg under the terms of a lease contract;
- (c) a right to use land or buildings but without a right of exclusive possession or control, eg a right to pass over land or to use it only for a specified activity.

- 20.2. Interests in real property may be held jointly, where a number of parties have the right to share the whole interest, or severally, where each party has a defined proportion of the whole interest.

- 20.3. Although different words and terms are used to describe these types of real property interest in different states, the concepts of an unlimited absolute right of ownership, an exclusive interest for a limited period or a non-exclusive right for a specified purpose are common to most jurisdictions. The immovability of land and buildings means that it is the right that a party holds that is transferred in an exchange, not the physical land and buildings. The value, therefore, attaches to the property interest rather than to the physical land and buildings.

- 20.4. To comply with the requirement to identify the asset to be valued in IVS 101 *Scope of Work*, para 2(d) the following matters shall be included:

- (a) a description of the real property interest to be valued,
- (b) identification of any superior or subordinate interests that affect the interest to be valued.

- 20.5. To comply with the requirements to state the extent of the investigation and the nature and source of the information to be relied upon in IVS 101 *Scope of Work*, para 20.3(j) the following matters shall be considered:

- (a) the evidence required to verify the real property interest and any relevant related interests,
- (b) the extent of any inspection,
- (c) responsibility for information on the site area and any building floor areas,

- (d) responsibility for confirming the specification and condition of any building,
- (e) the extent of investigation into the nature, specification and adequacy of services,
- (f) the existence of any information on ground and foundation conditions,
- (g) responsibility for the identification of actual or potential environmental risks,
- (h) legal permissions or restrictions on the use of the property and any buildings as well as any expected or potential changes to legal permissions and restrictions.

20.6. Typical examples of *special assumptions* that may need to be agreed and confirmed in order to comply with IVS 101 *Scope of Work*, para 20.3(k) include:

- (a) that a defined physical change had occurred, eg a proposed building is valued as if complete at the *valuation date*,
- (b) that there had been a change in the status of the property, eg a vacant building had been leased or a leased building had become vacant at the *valuation date*.

20.7. Valuations of real property interests are often required for different purposes including secured lending, sales of real property, taxation, litigation, insolvency proceedings and financial reporting.

30. Basis of Value

30.1. In accordance with IVS 104 *Bases of Value*, a valuer must select the appropriate basis(es) of value when valuing real property interests.

30.2. Understanding the purpose of a real property interest valuation and the appropriate basis(es) of value is critical to the identification of the specific asset(s) that need to be valued. For example, for many purposes and bases of value, a piece of real property may be valued and reported as a single unit of account including land, buildings, and leases in place, net of any associated liabilities (such as environmental liabilities). However, for other purposes and bases of value, a valuer may be required to separately identify and value such items (for example, when the value of a building is needed for depreciation purposes or when liabilities need to be recorded separately).

30.3. Under most bases of value, a valuer must consider the highest and best use of the real property, which may differ from its current use (see IVS 104 *Bases of Value*, para 30.3). This assessment is particularly important to real property interests which can be transitioned from one use to another or that have development potential.

40. Valuation Approaches

40.1. The three principal valuation approaches described in the IVS 105 *Valuation Approaches and Methods* can all be applicable for the valuation of a real property interest.

40.2. When selecting an approach and method, in addition to the requirements of this chapter, a valuer must follow the requirements of IVS 105 *Valuation Approaches and Methods*, including para 10.3.

50. Market Approaches

- 50.1. Property interests are heterogeneous (ie with different characteristics). Even if the land and buildings have identical physical characteristics to others being exchanged in the market, the location will be different. Notwithstanding these dissimilarities, the market approach is commonly applied for the valuation of real property interests.
- 50.2. In order to compare the subject of the valuation with the price of other real property interests that have been recently exchanged or that may be currently available in the market, it is usual to adopt a suitable unit of comparison. Units of comparison that are commonly used include:
- (a) price per square metre (or per square foot) of a building or per hectare for land,
 - (b) price per room,
 - (c) price per unit of output, eg crop yields.
- 50.3. A unit of comparison is only useful when it is consistently selected and applied to the subject property and the comparable properties in each analysis. To the extent possible, any unit of comparison used should be one commonly used by participants in the relevant market.
- 50.4. The reliance that can be applied to any comparable price data in the valuation process is determined by comparing various characteristics of the property and transaction from which the data was derived with the property being valued. Differences between the following should be considered in accordance with IVS 105 *Valuation Approaches and Methods*, para 30.8. Specific differences that may need to be considered in valuing real property interests include:
- (a) the type of interest providing the price evidence and the type of interest being valued,
 - (b) the respective locations,
 - (c) the respective quality of the land or the age and specification of the buildings,
 - (d) the permitted use or zoning at each property,
 - (e) the circumstances under which the price was determined and the basis of value required,
 - (f) the effective date of the price evidence and the valuation date.

60. Income Approaches

- 60.1. Various methods are used to indicate value under the general heading of the income approach, all of which share the common characteristic that the value is based upon an actual or estimated income that either is or could be generated by an owner of the interest. In the case of an investment property, that income could be in the form of rent (see paras 90.1 through 90.3); in an owner-occupied building, it could be an assumed rent (or rent saved) based on what it would cost the owner to lease equivalent space.

- 60.2. As noted in IVS 105 *Valuation Approaches and Methods* all income approach methods are essentially a discounted cash flow, but for real estate the two most common income approach methods are described in IVS 105 *Valuation Approaches and Methods*:
- (a) Income capitalisation method.
 - (b) Traditional discounted cash flow method.
- 60.3. For some real property interests, the income-generating ability of the property is closely tied to a particular use or business/trading activity (for example, hotels, golf courses, etc.). When the income used in the income approach represents cash flow from a business/trading activity (rather than cash flow related to rent, maintenance and other real property-specific costs), the valuer should also comply with the requirements of IVS 200 on the Valuation of Business and Business Interests and, where applicable, IVS 210 on Intangible Assets.
- 60.4. The use of a property's trading potential to indicate its value is often referred to as the "profits method".
- 60.5. The income capitalisation method (profits method) referred to in IVS 105 *Valuation Approaches and Methods*, section 50.10 cannot be reliably used where the income is expected to change in future periods to an extent greater than that generally expected in the market or where a more sophisticated analysis of risk is required.
- 60.6. For real property interests, various forms of discounted cash flow models can be used. These vary significantly in detail but share the basic characteristic that the cash flow for a defined future period is adjusted to a present day value using a discount rate. The sum of the present day values for the individual periods represents the capital value. As in the case of the all risks yield method, the discount rate in a discounted cash flow model will be based on the time cost of money and the risks and rewards attaching to the income stream in question.
- 60.7. Further information on the derivation of discount rates is included in IVS 105 *Valuation Approaches and Methods*, paras 60.09 to 60.11. The development of a yield or discount rate will be influenced by the objective of the valuation. For example:
- (a) If the objective of the valuation is to establish the value to a particular owner or potential owner based on their own investment criteria, the rate used may reflect their required rate of return or their weighted average cost of capital.
 - (b) If the objective of the valuation is to establish the market value, the discount rate may be derived from observation of the returns implicit in the price paid for real property interests traded in the market between market participants or from hypothetical market participants' required rates or return or weighted average cost of capital.
- 60.8. For real estate the appropriate discount rate can be determined from analysis of the rates implicit in transactions in the market. When a discount rate is based on an analysis of market transactions, valuers should also follow the guidance contained in IVS 105 *Valuation Approaches and Methods*, paras 30.7 and 30.8.
- 60.9. An appropriate discount rate may also be built up from a typical "risk free" return adjusted for the additional risks and opportunities specific to the particular real property interest.

60.10. The appropriate yield or discount rate will also depend on whether the income inputs or cash flows used are based on current levels or whether projections have been made to reflect anticipated future inflation or deflation.

70. Cost Approach

70.1. In applying the cost approach, valuers should follow the guidance contained in IVS 105 *Valuation Approaches and Methods*, paras 80.1 to 80.9.

70.2. This approach is generally applied to the valuation of real property interests through the depreciated replacement cost method.

70.3. It is normally used as the primary approach when there is either no evidence of transaction prices for similar property or no identifiable actual or notional income stream that would accrue to the owner of the relevant interest.

70.4. In some cases, even when evidence of market transaction prices or an identifiable income stream is available, the cost approach may be used as a secondary or corroborating approach.

70.5. The cost approach is commonly used for the valuation of specialised property, which is property that is rarely if ever sold in the market, except by way of sale of the business or entity of which it is part.

70.6. The first step requires a replacement cost to be calculated. This is normally the cost of replacing the property with a modern equivalent at the relevant valuation date. An exception is where an equivalent property would need to be a replica of the subject property in order to provide a market participant with the same utility, in which case the replacement cost would be that of reproducing or replicating the subject building rather than replacing it with a modern equivalent. The replacement cost needs to reflect all incidental costs such as the value of the land, infrastructure, design fees and finance costs that would be incurred by a market participant in creating an equivalent asset.

70.7. The cost of the modern equivalent is then subject to adjustment for physical, functional, and economic obsolescence (see IVS 105 *Valuation Approaches and Methods*, section 90). The objective of the adjustment for obsolescence is to estimate how much less valuable the subject property would be to a potential buyer than the modern equivalent. Obsolescence considers the physical condition, functionality and economic utility of the subject property compared to the modern equivalent.

80. Special Considerations for Real Property Interests

80.1. The following sections address a non-exhaustive list of topics relevant to the valuation of real property interests.

(a) Hierarchy of Interests (Section 90)

(b) Rent (Section 100)

90. Hierarchy of Interests

90.1. The different types of real property interest are not mutually exclusive. A superior interest may be subject to one or more subordinate interests. The owner of the absolute interest may grant a lease interest in respect of part or all of his interest. Lease interests granted directly by the owner of the absolute interest are “head lease” interests. Unless prohibited by the terms of the lease contract, the holder of a head lease interest can grant a lease of

part or all of that interest to a third party, which is known as a sub-lease interest. A sub-lease interest will always be shorter than the head lease out of which it is created, even if only by one day.

90.2. These property interests will have their own characteristics, as illustrated in the following examples:

- (a) Although an absolute interest provides outright ownership in perpetuity, it may be subject to the effect of subordinate interests. These subordinate interests could include leases, restrictions imposed by a previous owner or restriction imposed by statute.
- (b) A lease interest will be for a defined period, at the end of which the property reverts to the holder of the superior interest out of which it was created. The lease contract will normally impose obligations on the lessee, eg the payment of rent and other expenses. It may also impose conditions or restrictions, such as in the way the property may be used or on any transfer of the interest to a third party.
- (c) A right of use may be held in perpetuity or may be for a defined period. The right may be dependent on the holder making payments or complying with certain other conditions.

90.3. When valuing a real property interest it is therefore necessary to identify the nature of the rights accruing to the holder of that interest and reflect any constraints or encumbrances imposed by the existence of other interests in the same property. The sum of the individual values of various different interests in the same property will frequently differ from the value of the unencumbered superior interest.

90.4. Property interests are normally defined by state law and are often regulated by national or local legislation. Before undertaking a valuation of a real property interest, an understanding of the relevant legal framework that affects the interest being valued is essential.

100. **Rent**

100.1. Market rent is addressed as a basis of value in IVS 104 *Bases of Value*.

100.2. When valuing either a superior interest that is subject to a lease or an interest created by a lease, it is necessary to consider the contract rent and, in cases where it is different, the market rent.

100.3. The contract rent is the rent payable under the terms of an actual lease. It may be fixed for the duration of the lease or variable. The frequency and basis of calculating variations in the rent will be set out in the lease and must be identified and understood in order to establish the total benefits accruing to the lessor and the liability of the lessee.

IVS 400 Real Property Interests: Basis for Conclusions

The basis for conclusions do not form part of IVS 2017 and will not be included in the finalised document, but have been drafted to provide the reader with the rationale behind certain changes made within this Exposure Draft. The Board feels that the inclusion of this section is a necessary part of the consultative process and is in line with the recommendation contained within the IVS Purpose and Strategy Document requirement that “standards need sufficient consultation” and that the IVSC should be “operating in an open and transparent way”.

In October 2015 IVSC published their *Purpose and Strategy Document* which stated that the priority of the IVSC is to expand the quality and depth of IVS and ensure they are fit for purpose and provide much needed clarity and market efficiency.

The Board has changed the numbering of many of the asset standards to allow for more flexibility in future standard-setting activities. As a result, this chapter, which was IVS 230 in IVS 2013 has been re-numbered to IVS 400. Furthermore, the numbering within the chapter has been revised so that there is more consistency in the format of standards between the various asset standards. The new format for the various asset standards will be as follows:

- Section 10: Overview
- Section 20: Introduction
- Section 30: Bases of Value
- Section 40: Valuation Approaches and Methods
- Section 50: Market Approach
- Section 60: Income Approach
- Section 70: Cost Approach
- Section 80 (and thereafter): Special Considerations

Discussions with stakeholders indicated that there was a significant amount of confusion related to what content represented mandatory standards versus what content represented non-mandatory commentary. The Board notes that in IVS 230 (like many other IVS 2013 standards), all substantive portions of the standard were labelled as “commentary” with the exception of the scope and effective date sections. This Exposure Draft has eliminated the “commentary” label to make it clear that the contents are mandatory for compliance with IVS.

The Board believes that one of the primary purposes of standards is to reduce diversity in practice. The IVSC performed outreach to stakeholders and identified several areas of diversity in practice related to the valuation of real property interests. As a result of that outreach, this Exposure Draft includes new requirements related to:

- an overview of real property interests and the circumstances in which they are valued,
- the selection of valuation approaches and methodologies.