Comments on the IVSC Consultation IVS410 'Development Property'

RICS – Working Group on 'Valuation of Development Land' Professional Statement.

Submission 1

There is a danger of significant overlap between IVS410 and VIP12. The bulk of IVS410 relates to method and I am not sure this is a good idea. In fact the IVSC standards seem to be a mixture of standards that relate to valuation purposes (financial reporting, lending) and valuation subjects (p&m, intangibles, real property interests). IVS410 sits uncomfortably between the two, valuing 'development' property for 'development' purposes.

The problem is illustrated by the definition of 'development property' in section 20.1; any property that has development potential (every property has development potential), and where EUV < MV (there is no EUV basis any more, and why does EUV have to be < MV? Why can't a property be valued to see if it has development potential or not, i.e. the EUV may be > MV but it was worth checking). This is stated as a general definition so the section then provides another definition for the purposes of the chapter (surely IVS?), which is stated as improvements contemplated or in progress (but the list of inclusions covers new development and redevelopments as well as improvements).

In my view, what is being described in this IVS is development valuation; the estimation of MV of (any) property assuming that it is to be (or being) developed, redeveloped or otherwise improved. The definition of 'development property' is unnecessary. This means that the IVS itself might also be unnecessary since it is describing a method of valuing real estate assets under certain assumptions. By extension, there should be IVSs for each valuation method. Is this something that the ISVC is planning?

If the IVSC is planning to publish standards that prescribe method, there needs to be some thought about the level at which they are pitched; broad or detailed. IVS410 is pretty detailed in places and broad in others. Section 40 begins by stating that there are two primary methods of valuing development properties; comparison and residual. Oddly, subsequent sections then describe the application of income and cost approaches to valuing development properties. It gets confusing because the income approach really only feeds in to the residual method (to estimate development value) and that method hasn't been described yet. The cost approach isn't really relevant at all.

Section 80 is very odd. It provides a 'non-exhaustive' list of topics relevant to the valuation of development property. This list includes the residual method, which was previously billed as a

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primary method of valuing development property. I am not sure I understand section 100 ‘existing asset’. It seems to be an investigation checklist.

Section 90 describes the residual method and there are debateable points throughout. For example, section 90.29 states that finance costs must be taken into account, and should be done so assuming the development is 100% debt financed. Section 90.31 states that profit can be expressed as a lump sum, a % of costs or a % of value. There is no mention of expressing profit as a rate of return. Section 90.36 states that a discount rate must be applied. This combination of financing, developer’s profit and discount rate is confusing and can easily lead to misapplication of method unless the guidance is clear about how profit is to be handled and how financing is to be handled. Section 90.37 relates to forecasting, a really important issue in development valuation and worthy of more discussion. I think there is a typo in the last sentence.

Fundamentally, I think the premise of the IVS (development property) is questionable. The draft as it stands focuses on method and is detailed in places and broad in others. If the aim is to publish a detailed standard on development valuation there needs to be a lot more consideration of cash flow approaches to development valuation and a lot more clarity over discount rates, profit/return assumptions, handling of finance, forecasting and, to be thorough, option pricing.

Submission 2

Conflict between RICS and IVSC, in producing Guidance Notes that would be very similar and potentially at odds on this or any other subject.

However in response to the request:

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100.1 rights of light should be specifically mentioned
120.1 "normally" market value?

Submission 3

We have reviewed the document IVS104 and believe that it is more guidance than standard and should therefore be deleted in its entirety. We would prefer to see guidance through the RICS that focusses on local market practices.
When the document is reviewed in the context of our local market, there are a number of confusing aspects. For example, it is market practice in Australia to only provide As Is/ As If Complete assessments, future value assessments are not permitted, and the standard assumption for debt funding is to assume 100% debt. The cost approach is not utilised at all.

Submission 4

1. Paragraph 20.6 on Page 10: Normally, the "Acquisition Cost (including the associated Legal Fees)" would be included in the Residual Valuation as well. Please refer to *Valuation and Development Appraisal (2nd Edition) edited by Clive Darlow, 2nd edition 1990*. This is not included in this paragraph of the Exposure Draft!!
2. Paragraph 20.25 on Page 12: I presume "para 20.23" on the third line of the paragraph should read "para 20.24".

Submission 5

With a Risk Management hat on this is a key topic and one that both regulators and Risk communities spend time considering given the enhanced level of risk associated with such projects and of course the heightened volatility that is brings

Should the first sentence be more explicit ….." where its existing use value is below the market value, reflecting the development potential" – perhaps it has been left suitably wide.

The definition of “development”. Differentiation between a refurbishment and a development is sometimes a grey area but can be critical from a Risk Classification perspective. In Real Estate financing we typically have to Classify our Risk Accounts on a quarterly basis and where cashflows are not stable or there is an enhanced risk (aka development) these would need to be reported on. However assets that are subject to some form of refurbishment/ongoing works associated with repair and maintenance could potentially be treated in a different way. Many banks will absolutely not lend on development projects at all so this differentiation could be even more important.

From an accounting perspective the importance around the definition of development may I suspect impact on depreciation treatment. Historically we have had “value add” projects – some of which would really constitute development but others not.

20.4 (d) I would add “planning, and financing” to the key risks to be identified in addition to “construction”.

On 20.7 – it reads that “it may be appropriate to highlight the potential disproportional effect of possible changes…..” Personally I think that should be “…it SHOULD be appropriate………” The heightened risk around development appraisals should be clearly communicated by professional valuers.

The report outlines “special assumption” and the importance to specify and I think this is a positive, consistent with what I would expect to see from a Risk Management perspective. This aligns with the Red Book provisions on valuations. The outline of the valuation approaches is clear and well written.

In regard to the Residual Approach clearly the question will be how much detail really needs to go into a paper like this. In regard to 90.6 the key elements are highlighted – which could be expanded or contracted depending on requirements. However key pieces such a planning, leasing, sale should perhaps be specifically spiked out from the “construction costs” / “timetable”. One area of dispute is always the calculation of the GDV and to what degree the valuer has assessed based on a rental growth and/or cap rate compression/expansion. This can have a material impact obviously but I do feel that this needs to be clearly outlined in the special assumptions. The Market Value at the end of the day depends upon expectations around such elements as these and the anticipated development profit but from a Bank’s perspective this would be challenged as “speculation” – most prudent banks will sensortize the value based on another set of assumptions or size their loan according to the risk but perhaps an opportunity here to reinforce the importance of detailed special assumptions and a rationale.

90.26 – again on timetable “physical completion of the project” any merit again stating the key components of the phased project – site assembly, planning, construction, leasing, sale……

90.28 – thinking about this piece here around building to hold as investment. Fundamentally the approach and market value must be the same but there are a few areas in particular attitudes to development profit and the opportunity cost of finance (rather than perhaps an explicit provision from a 3rd party) that could impact the project value. It is more than potentially transaction costs that an investor could benefit from a hold scenario, which could impact value, but a prudent valuer should again reconcile to the Market Value and be clear on any special assumptions again.

90.29 – "These represent the cost (OR OPPORTUNITY COST) of finance for the project…….."

90.31 – target profit criteria is important and reflects the risk associated with the project and timeframe as outlined but I do feel that the addition of "Prevailing Market Conditions" is a criteria worthy on note. Financing and returns associated with other forms of investment both Real Estate and not will impact the level of target profit. Expectations around rental growth can be explicitly provided for in a cash flow and views on cap rate should align to where the broader capital markets sit however often the profit piece is neglected or treated in a very broad manner.

Interesting Question in 110.2 – in regard to Financial Reporting – at what point in a project does the asset value move from adopting a residual valuation approach (reflecting profit, costs, finance) plus costs incurred across to an approach of perhaps "Completed Value less costs to complete"? I believe accepting a point at which costs are substantially baked and a timeline has more limited risks associated with it this could be an appropriate juncture to make this switch – again it seems to me a bit of a grey area and I would need to understand better what the current accounting standards say in this regard as I am perhaps behind on latest guidance.

120.1 On Secured lending assumptions – I come back to my initial comments on Risk Classification. Important to highlight the excess of Market value (reflecting development potential) over the Existing Use Value. Banks will want to allocate risk and size loans/price pieces accordingly. Vanilla stabilized property with a cash flow is ideal but as soon as we layer in risk associated with development the leverage calculations in regard to the amount of capital they will need to put against a loan will increase significantly.

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