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TEGoVA
THE EUROPEAN GROUP OF VALUERS' ASSOCIATIONS

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European Valuer

In its most decisive win since the Mortgage Credit Directive, TEGoVA achieves insertion of a requirement for qualified valuers in the Covered Bonds Directive

Under the European Commission's proposed legislation, covered bond real estate collateral did not require a valuer for valuation of the property. Following TEGoVA's campaign, in the amendments by the Council of Ministers and the European Parliament, this has been reversed: the valuation must now be carried out by a valuer who is independent, qualified, able and experienced.

Covered bonds are financial instruments backed by a separate pool of assets – typically mortgages or public debt – to which investors have a preferential claim in case of failure of the issuer. The covered bonds market is very developed in the EU. In December 2015, the outstanding volume of covered bonds issued by EU-based institutions reached €2.1 trillion and constituted 84% of the total volume at global level. Covered bonds markets are particularly developed in Germany, Denmark, France, Spain, Italy, Luxembourg and Sweden, as those countries have longstanding national regimes in place.

The aim of the proposed EU regulatory framework is to set minimum harmonisation requirements that all covered bonds across Europe will have to meet. This will increase security for investors and open up new opportunities, in particular where markets are less developed.

The proposed framework:

- provides a common definition of covered bonds
- defines the structural features of the instrument
- defines the tasks and responsibilities for the supervision of covered bonds
- sets out the rules allowing the use of the **"European Covered Bonds"** label
- strengthens the conditions for granting preferential prudential treatment of covered bonds under the Capital Requirements Regulation (CRR).

Valuation is just one minor aspect of the Covered Bonds Proposal, where initially there was no more than a provision that covered bonds are collateralised by assets for which market value or mortgage lending value (MLV) can be determined, with the member states laying down rules on the valuation of assets.

The problem arose not from the Proposal for a Covered Bonds Directive, but from the changes that needed to be made to the CRR's covered bond provisions for it to be in sync with the Covered Bonds Directive. Certain powerful economic interests are displeased with the provision in CRR that empowers the European Banking Authority (EBA) to develop rigorous criteria for the assessment of MLV. They saw the chance to eliminate it, at least concerning covered bonds, by tinkering with the Covered Bonds Directive and the CRR. The (unintentional?) drafting fallout from that was that the

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Going beyond real estate valuation

Danijela Ilić bridges the gap with business valuation

At TEGoVA's General Assembly in Athens last October, the assembled delegates voted in favour of the development of European Business Valuation Standards (EBVS).

In fact this was not as revolutionary as it seemed, as some years ago the 5th edition of European Valuation Standards, EVS 2003, included guidance on business valuation and the valuation of intangible assets. At the time, the latter served as a professional framework for business and/or business and real estate valuers in Europe.

As TEGoVA must respond to the changing needs of its members, business valuation subsequently fell out of favour and out of subsequent editions of EVS – for almost 15 years.

Today, **TEGoVA boasts 71 member organisations** – valuation associations from 37 countries. A considerable number of them have individual members who practice both real estate and business valuation. Furthermore, new entrants to the valuation profession are young professionals who wish to specialise in more than one area of valuation and to develop additional (non-valuation) skills, in order to better adapt to

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requirement in the CRR to use a qualified, independent valuer for valuation disappeared concerning valuations linked to covered bonds. It would have been possible to use automated valuation models (AVMs) without a valuer.

TEGoVA:

- discovered the problem, found the drafting solution and explained both to the Commission
- got from the Commission, *in writing*, which is exceptional, acknowledgment of the problem and a commitment to solve it
- ensured that its efforts in the European Parliament met with the same success, and in the Council of Ministers its amendment was tabled by the Bulgarian government in the final week of its Presidency.

Parliament and Council will now negotiate a final text of the Covered Bonds Directive and amended CRR, based on their separate amendments, but this is immaterial to TEGoVA, as both sets of amendments are satisfactory. ●

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the rapid changes in the global market place and valuation world.

Today, business valuation is routinely undertaken by accountants, auditors, business advisors, financial analysts, business brokers, online business valuations, and merger and acquisition specialists. However, the business valuation community does not have an identity, and in each country the field has evolved from different professional backgrounds.

"The business valuation community does not have an identity, and in each country the field has evolved from different professional backgrounds."

By setting European Business Valuation Standards, TEGoVA will be taking the first step towards shaping this side of the profession and giving it true **European identity**. Real estate and business valuers share certain common abilities:

- ability to follow a code of ethics and professional conduct
- ability to listen to the client and understand instructions
- ability to research and analyse market data and various other sources of valuation input, to systemise collected information and draw conclusions, with an ability to apply statistical tools where necessary
- ability to analyse economic cycles and industry-specific behaviour
- ability to follow professional valuation standards, and where appropriate the legal framework for certain purposes of valuation and/or other standards, such as accounting standards and financial reporting standards
- ability to differentiate between various bases of value, their key premises and assumptions
- ability to apply the three generally accepted valuation approaches
- ability to reconcile different indications of value resulting from more than one valuation approach
- ability to prepare a full valuation report and communicate the result to the client.

So, what is the knowledge and skills gap between these two fields of valuation, particularly from the point of view of the real estate valuer? TEGoVA is currently undertaking such a gap analysis with the help of the most authoritative business valuation educators, but it is already clear that experienced real estate valuers can easily capitalise on their existing knowledge and skills. The **"gap"** is relatively small.

New generations of real estate valuers are already seeking to practice in more than one field of valuation. They want to better understand businesses by developing their analytical skills, leading to a stronger awareness of the economy and specific industry cycles. They want to develop an ability to forecast trends and undertake **"big data"** analysis (data sourcing, data handling, data manipulation and data presentation) and learn to work with mobile software. Furthermore, important to their business development, they want to improve their communication, marketing and networking skills. They also need to learn to defend their opinions when challenged.

All valuers, young and old, are acutely aware that the future of the valuation profession lies in the flexibility of educational programs which produce the multidimensional valuer. Also, the future of small valuation firms lies in widening their services and embracing new skills.

Business valuation is a natural offshoot for valuers proficient with the complexities of real estate. In addition, the modern day holistic approach to real estate education provides an excellent technical and analytical foundation for approaching the valuation of businesses in general. ●

Danijela Ilić FRICS REV is the Chair of the European Business Valuation Standards Committee (EBVSC).

Professor Ewa Kucharska-Stasiak highlights the doubtful application of explicit cash flow models in property valuation

Introduction

Real estate valuation methodology is rooted in economics. The need for valuations had already been noted by Adam Smith who, when describing the behaviour of markets in **"The Wealth of Nations"**, stated that no markets could function in an effective manner without thorough valuations.

On the other hand, A. Marshall made a distinction between the theory of value and theory of valuation, thus contributing to the development of valuation methodology. Marshall identified the three approaches to valuation – namely the comparative, income and cost approaches. His contribution to the foundation of income methodology is unquestionable. He defined value as the present value of future income (*Marshall, 1925*). That said, no unified valuation methodology has ever been established.

A mosaic of various national valuation methodologies has developed under the influence of local conditions. The difference in valuation methodologies is visible not only in detailed solutions, but also in terminology, the classification of valuation methods, and the definition and interpretation of basic categories such as market value.

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The development of the income approach to property valuation

The income approach is based on the relationship between income and value, the latter being understood as the present value of future income. The approach is considered to be the most controversial of the three approaches because of the different ways of representing income in the valuation process, as follows:

***Concept 1 (Direct Capitalisation)*:** the value represents only the current state of a given property, and it is assumed that there is a stable income stream. It is also assumed that there is a defined balance between demand and supply in the tenants' market, and that the ratio between the identified demand and the existing supply will not change.

"The income approach is based on the relationship between income and value, the latter being understood as the present value of future income. The approach is considered to be the most controversial of the three approaches because of the different ways of representing income in the valuation process …"

Assuming a stable stream of income, the valuer sets the capitalisation rate, which takes into account all kinds of risks. The valuer adjusts this rate to represent the differences between the property constituting the subject of valuation and similar properties. As emphasized by N. French, this adjustment is subjective (*French, 2006, p. 88*). If it is expected that rental rates or property values on the market will change, the adopted rate must imply market expectations of growth or decline. It will be disclosed in the rate, rather than in the income stream. An expected future increase in the market rental rate is reflected by the adoption of a lower rate of return, whereas a decrease of the rental rate is expressed by adoption of a higher rate of return. Such a method can only apply when there is an appropriate number of transactions on the market.

Concept 2 (Implicit Cash Flow): abandons the idea of a stable income stream, and recognises the likelihood of a variable income during a forecast period. The assumed fluctuation of the income stream is not caused by expected changes in the property market (demand and/or supply), but by the expected volatility of the income stream generated by the subject property as a result of built-in assumptions, such as the need to carry out future renovation, modernisation, partial or total change of use and changes in rents paid on rent review, and the way the property is leased after termination of existing leases – although this **"implicit cash flow"** concept is mainly focused on demand. Supply is also relevant, insofar as it may affect the yield adopted in the valuation. If, at the time of the valuation, there are grounds to conclude that the supply of similar properties will increase in the market, the risk related to the income, as calculated by potential buyers, will increase, and so will the rates of return they require.

Concept 3 (Explicit Cash Flow): the value represents not only changes to the subject property taking place during the forecast period, but also any income growth (or decline) caused by changes to the market environment as a result of shifts in the interplay between demand and supply. Such an income stream is called **"explicit cash flow."** This approach entails the forecasting of revenue and expenditure. The months during which no revenues are generated due to a gap between the expiration of one lease agreement and the beginning of the next one are also included in the revenue forecast. The expenditure forecast estimates reasonable levels of operating costs and property taxes in successive years. The forecast requires adoption of macro- and meso-level predictions, which are known as at the day of the valuation, as well as changes at the micro level, i.e. in the vicinity of the property. The assumed inflation rate is also reflected in the cash flow. Assumptions concerning market dynamics have influence not only on the volatility of the income stream, but also the rate of return. The volatility of income after the forecast period means that, at the stage of determining the residual (exit) value, the capitalisation rate and the discount rate are different.

Directions of changes in the income approach

Historically-shaped valuation methodologies have been constantly evolving. In the UK, for example, conventional methods (Concepts 1 and 2 above) were criticised for not directly reflecting with any precision expected annual income growth. The latter was only reflected indirectly in the adopted capitalisation rate or yield.

The weaknesses of these methods resulted in the growing interest in the application of explicit cash flow models. The Mallinson Report, which was prepared for the RICS in 1994, contributed a lot to the changes in valuation methodology, as it recommended the creation of new valuation methods to reduce the scope of direct capitalisation methods. The report did not disqualify traditional valuation techniques, but merely highlighted their shortcomings (*The Mallinson … 1994*).

Reservations concerning explicit cash flow models

Notwithstanding the identified weaknesses in traditional methods of valuation, many methodologists, when describing explicit cash flows, point to the dangers of their use. For example, Rattermann, the author of the popular American property valuation text book states, "*As with every forecast, but especially in the case of the DCF analysis, these predictions are different for different valuers. (...) the fact that it is necessary to anticipate changes in income and expenditures, leads to discrepancies in opinions*" (*Ratterman... ch.24*).

Similarly, the authors of another American textbook point to the fact that valuers do not have a crystal ball to provide a precise picture of future events (*Friedman, Ordway 1992, ch.8*). They indicate that the application of these income streams requires analysis of demand and supply as an *ex ante* category. The authors point to the difficulties in estimating demand resulting from the fact that estimating the future income stream is affected by the systematic risk dependent on macro- and meso-economic conditions, which are hard to predict. In short, the adoption of explicit cash flows increases the valuation risk understood as the difference between different valuations of the same property.

The introduction of explicit cash flow models has also been met with some resistance from property valuers, despite strong pressure from a part of the academic community, their inclusion in curricula and pressure from clients, including institutional investors and their advisors. This was not only because valuers have become used to traditional valuation methods but also because of their belief that the valuations so achieved are more accurate, and that the less input data used for the valuation, the lower the uncertainty of the valuation.

The consequences of applying an explicit cash flow model in the assessment of market value and the end result

The conventional valuation model, based on direct capitalisation and/or implicit cash

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flows is a demand-based model. Market analysis as at the valuation date assumes that supply is constant, while demand is variable. Valuers do not analyse the demand *sensu stricto*, i.e. as an *ex ante* category. They analyse the realised demand, i.e. *ex post* demand. The assessment of value is based on market evidence. Identification of the most common behaviour of market participants allows for an objective treatment of the valuation input data, including rental rates, vacancy rates, operating expenses, and market rates of return. Such objective treatment of input data makes it possible to assess market value as defined. The adoption of an explicit cash flow model on the other hand requires not only an analysis of the market as at the valuation date, but also a forecast of changes in rental rates, vacancy levels and operating expenses driven by future changes in demand and supply. Thus the application of an explicit cash flow model requires a wide scope of market forecasting, i.e. *ex ante* analysis.

In terms of the assessed value itself, there are several consequences of the application of an explicit cash flow model, as follows:

- the application of an explicit cash flow model reduces the objective nature of the valuation, taking it closer to the **"investment value"** of the subject property, which may meet the expectations of just a few of the potential market participants
- forecasting future demand and supply increases the risk relating to the accuracy of input data. Under an implicit cash flow model, the risk of achieving the projected income is influenced by factors associated with the subject property, such as solvency of the main tenant or unfavourable changes in the property's neighbourhood (*Friedman, Ordway, 1992, ch.8*), whereas in the case of an explicit cash flow model the risk is also systemic, being dependent on macro- and meso-economic conditions, which are more difficult to predict (*IBID, ch. 8*)
- the increased number of variables, their hypothetical nature and reduced objectivity translate into a higher level of valuation uncertainty
- such valuation uncertainty leads to an increase in discrepancies between valuations.

The essence of changes in the concept of determining income streams

The discussion on the application of the income approach to property valuation has much deeper roots than apparent at the first glance – it concerns the role of market value in the real estate economy. Is it supposed to be a value which objectivises the market or something closer to **"investment"** value? Where should the process of valuation be embedded? Should the primacy of economics be preserved in such a process or should we adopt concepts borrowed from the theory of measuring financial investments, including valuation methods based on investment portfolio theory? Unfortunately, the traditional approach to valuation is increasingly undermined by the influence of financial theory.

The essence of the market value as an economic category is an attempt to objectivise the market by reflecting the most common behaviour of its participants. Although market participants have their own subjective expectations and perceive the utility of given assets differently, through the market's collective impact, the value ceases to be subjective and becomes objective. It is objectivity which determines the function of value on the market. Only the value determined on the basis of economics, whose task is to objectivise market phenomena, makes it possible for it to perform the informative decision-making and negotiation functions in the real estate economy. The question arises as to whether it is appropriate to borrow the concept of financial asset valuation for the valuation of real estate.

Although both kinds of income streams (explicit and implicit) are derived from the financial concept of calculating the present value of future income, there is a significant difference between them. The implicit cash flow model is based on a comparative analysis, where the units of comparison include the rental rate, expenses, and the rate of return. Explicit cash flow models are based on financial models (*Henneberry, Crosby, 2015*). The application of explicit cash flow models is a consequence of including real estate in portfolio theory.

In the 1960s, when properties started to be included in investment portfolios, at the request of investment advisors, the valuation of properties in the USA was based on the concept of financial investment valuation. Such a valuation model assumes that market information covers all the qualitative expectations of market participants (the market is effective), assets are liquid, investment decisions are driven by rational economic behaviour, and investors always strive for maximisation of profit and minimisation of risk. Such assumptions can be considered realistic only in markets where financial instruments are traded and the assets are homogeneous and liquid.

The property market does not meet these conditions. This makes it difficult to set the rates of return for properties as components of the portfolio. The features of real property, such as a fixed location, capital-intensive nature, low liquidity, dependence on local regulations (e.g. spatial planning requirements or tax rates), make it difficult to treat as legitimate any attempts to apply financial theory to property valuation. On the one hand, such attempts can be considered the result of the ambitions of academics seeking to be innovative in preparing scientific dissertations. On the other, they are the result of expectations of investors who are often accustomed to complex financial market analyses and do not understand, or are unwilling to recognise, the shortcomings involved in applying the same methods to property valuation.

Conclusion

The specific features of property, as well as the property market itself, mean that the theory of market value assessment should be developed independently of the theories focused on the valuation of financial instruments. Property valuation should develop independently of modern day portfolio theory, remaining firmly rooted in economics. This means the continuing application of implicit cash flow models. They allow valuers to represent the state of the market as at the day of valuation. ●

This article is a short extract from an academic paper delivered by Professor Ewa Kucharska-Stasiak at a conference of the Polish Federation of Valuers' Associations. Ewa Kucharska-Stasiak professes at the Faculty of Economics and Sociology of the University of Łódz.

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TEGoVA to set European Business Valuation Standards. Krzysztof Grzesik reports on this key development

For many years TEGoVA has resisted calls for the addition of guidance on business valuation to its European Valuation Standards. This is because the TEGoVA membership has been made up of associations whose members specialise in real estate valuation. Amongst them are many individuals who can be described as top experts in real estate valuation. TEGoVA could not claim to speak authoritatively about business valuation nor could it point to any top business valuation experts within its ranks.

"The exponential growth of TEGoVA over the last decade has transformed its membership to 71 associations across 37 countries. Whilst most still focus on real estate valuation, some 15 have a significant number of members who specialise in business valuation or undertake both real estate and business valuations."

All that has now changed. The exponential growth of TEGoVA over the last decade has transformed its membership to 71 associations across 37 countries. Whilst most still focus on real estate valuation, some 15 have a significant number of members who specialise in business valuation or undertake both real estate and business valuations. Most of those associations are based in Central and South-Eastern Europe, where the separation of real estate and business valuation is not as marked as in Western Europe. Furthermore, a desire to diversify into business valuation has become noticeable amongst the younger generation of real estate valuers in particular.

And yet, on a continent where real estate valuation is highly regulated at both EU and national level, business valuation is a "free for all", with little in the way of on the ground guidance to independent valuers. Also, the public interest in Europe is not being well served by an industry with ill-defined methodology and qualifications. Top end business valuation activity in Europe has been largely the preserve of the big accountancy firms, who have primarily promoted the principles-based International Valuation Standards, which do have a section on business valuation. These firms no doubt fill in the detail with excellent in-house training, experience and guidelines. But where does that leave the more modest real estate valuation firms and self-employed independent valuers who wish to become proficient in business valuation? After all, you don't need an accountancy qualification to become a business valuer.

These days, many valuers have gained real estate related degrees which have followed a modern day holistic approach,

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Jeremy Moody provides a bag of current topics of note for the New Year

This note reviews some of the issues for valuers across Europe from changing markets and legislation.

Some residential valuation points

As well as working on general support for residential property valuation, the EVSB has been looking at more detailed issues which might be found by valuers, whether for transactions, taxation, compulsory purchase, development assessments, lending or other needs. Three are raised here. Comments and experiences from TEGoVA members would be welcome.

- **Rented property –** with current market pressure in many areas on rents, there is a swelling tide of regulation on let housing. Berlin and Dublin have introduced rent control policies that then bear on valuations. Issues for the valuer include the potential to achieve vacant possession and how far the rent is depressed below market levels. Other regulation may add to costs or restrictions.
- **Multiple and assignable interests –** a valuer might not only have to value a simple owner-occupied property but a variety of situations, such as:
  - the interest of one of two or more joint owners – how is that assessed?
  - the effect of matrimonial interests
  - collective ownership
  - usufruct
  - where there is a longer lease, the interest of the landlord or of the tenant
  - the value of an assignable lease
  - different shareholdings in a company owning a property.

Each may raise issues about access to value, risk, return, cost and improvements to be assessed on their own facts.

- **Equity release –** valuations where an owner grants a mortgage to release value as retirement income from housing, with the

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including the teaching principles of accounting and financial analysis – and many Recognised European Valuers (REVs) already have the skills required for business valuation.

"The pressure on TEGoVA to fill the "European" void on business valuation had become too great to ignore and in response to the clear demand, the TEGoVA General Assembly at its meeting in Athens last October, with near unanimity, approved the development of European Business Valuation Standards (EBVS)."

The pressure on TEGoVA to fill the "European" void on business valuation had become too great to ignore and in response to the clear demand, the TEGoVA General Assembly at its meeting in Athens last October, with near unanimity, approved the development of European Business Valuation Standards (EBVS). In this connection, a 12-person EBVS Committee, chaired by TEGoVA Board Member Danijela Ilić REV, has been established. The Committee members are top business valuation experts drawn from Austria, Bosnia and Herzegovina, Bulgaria, Germany, Ireland, Latvia, Lithuania, Netherlands, North Macedonia, Poland, Romania, Serbia, Ukraine and the United Kingdom.

It should be made clear, however, that despite this new initiative, TEGoVA still considers the disciplines of real estate valuation and business valuation to be quite separate, requiring different knowledge, training and skills, albeit in many respects related. The stand-alone publication of EBVS will provide the opportunity for our members with a business valuation interest to contribute to and develop the standards over the coming years. In the meantime, TEGoVA will seek to develop educational programmes aimed at REVs who wish to fill the knowledge gap which would enable them to diversify their professional activities. ●

Krzysztof Grzesik REV is Chairman of TEGoVA.

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lender taking the secured value from the property on death ("equity release"; viager in France) is now of concern to these lenders (often insurers) and regulators. While the property can be valued as it stands, equity release mortgages have their own risks. How might the value vary in future with the issues (such as the property's condition) and conflicts (for example where the house is worth less than the loan) that might arise? How are these handled between lender, owner and valuer? Regular revaluation might be required.

Housing land valuations

With the strong sense of too little housing for a growing population, the UK is debating not only how to bring more land forward faster but also valuation issues. How might the value of land with permission be used to fund affordable housing, other infrastructure and works? This bears directly on the value that can be achieved by the landowner. While the costs of housing land to a developer with all those charges could be 40% of the final sale value, the original landowner might not see a third of that. The irony is that policy makers see land as expensive but the residual return to the landowner is limited.

"This exposes the difference between market value, with all its hopes of possible uses, and an approach founded on existing use value – or highest and best use, as traditionally defined."

Most shades of political opinion are now intent on reducing that return to the landowner and so are reopening a debate last seen in the UK in the 1950s about the basis for valuation (especially where there might be compulsory purchase). This exposes the difference between market value, with all its hopes of possible uses, and an approach founded on existing use value – or highest and best use, as traditionally defined. In the early days of the UK's comprehensive planning in the 1950s, that difference led to such distortions in behaviour that the law affirmed a market value basis in 1959. That is now under challenge, with the risk of repeating past problems.

Agriculture and business valuations

TEGoVA is now discussing business valuations, but aspects of this have long been part of the work of agricultural valuers. Land is a factor of production worked by the farmer, not just the premises where business is conducted.

With French regulation controlling its farmland market, the CEF has developed a valuation model which includes the economics of the farming business as a weighting factor in valuation.

"In the UK, there is a long history of valuing the improvements and fertility created by one user of the land and available to the next."

In the UK, there is a long history of valuing the improvements and fertility created by one user of the land and available to the next. We have had to understand and value the assets created by policies, such as the European Union's Common Agricultural Policy, including transferrable rights to support payments and the former milk quotas, each with their effects on markets. We are now looking at the valuation aspects of the increasing focus on environmental issues, with new legislation, charges, opportunities and markets.

A wider range of possible business structures, whether partnerships or joint ventures between owners and farmers, all require valuations. Where a company, rather than individuals, owns a farm, it has to be valued, as do the shareholdings in that business, whether they give control or not.

Retail property valuations

The retail sector is seeing great pressures for change, with rising internet sales (now over 20% of UK non-food sales; prospectively 40%) and changing consumer behaviour. That may change the markets for different types of retail property with valuation consequences, as for transactions advice, lease terms, investors or lending. As in most periods of financial change, this will test valuers, especially where there may be less current market evidence. Depending on the circumstances, the EVSB's work on Valuation Certainty and Market Risk in EVS 2016 (EVIP 2) may be relevant. ●

Jeremy Moody Hon REV is Secretary and Adviser with the Central Association of Agricultural Valuers (CAAV).