TEGoVA Spring General Meeting, Dubrovnik, Croatia, 16th-18th. May, 2019. Go to tegova.org

TEGoVA
THE EUROPEAN GROUP OF VALUERS' ASSOCIATIONS

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European Valuer

Welcome

Dear friends and colleagues,

On behalf of the Croatian Association of Court Expert Witnesses and Valuers (HDSViP), I have great pleasure in welcoming delegates representing 70 valuer associations from 36 countries to the Spring Meetings and Assembly of TEGoVA at the Hotel Lacroma in Dubrovnik on 16th to 18th May, coinciding with a European Valuation Conference titled **"The Role of the Expert Witness in the Valuation of Property and Businesses"** on 17th May. I am sure that these events will contribute to the growing unity and harmonisation of practice within the European valuation profession, with substantial progress being made on updating TEGoVA's flagship European Valuation Standards, and the drafting of the 1st edition of the European Business Valuation Standards.

I hope you will enjoy your stay in Dubrovnik and please ensure that you also find some time to explore this beautiful city and savour its unique atmosphere.

With kind regards,

Melita Bestvina MSc REV
President HDSViP

To contribute an article or to send a letter to the editor commenting on one, contact jcroberts54@hotmail.com

TEGoVA extends Highest and Best Use value to encompass Hope Value

TEGoVA's European Valuation Standards Board (EVSB), in drafting updated **European Valuation Standards** (EVS) for publication next year, has taken the revolutionary step of jettisoning those familiar yet often misunderstood words ***"Hope Value"*** by incorporating their meaning in an extended concept of **Highest and Best Use**.

Hope Value is often mistaken for a value in the future, which it is not. It is always a part of the market value of the property at the date of valuation, being an element of that value and lying somewhere between the value of a property in its "Highest and Best Use" as commonly defined, at the date of valuation, and its value assuming that an even more valuable use which (whilst at the date of valuation was not legally permissible or reasonably probable) was assumed to have become so. The actual amount of hope value is a matter of valuation judgement, depending largely on the extent of the perceived likelihood of a non-permitted use or development becoming reality in the future.

To understand this fully, one needs to start with the concept of "Highest and Best Use."

Highest and Best Use

TEGoVA's EVS 2009 stated that Market Value is "*… in principle based on the highest and best use of the property*", defined as "*The most probable use of the property which is physically possible, appropriately justified,* ***legally permissible****, financially feasible, and which results in the highest value of the property being valued*". The latter definition was taken from IVS 2007 (8th Edition) published by the IVSC.

However, the words *"legally permissible"* gave rise to problems of interpretation. In particular, valuers in countries with local master plans and formal zoning systems became uncertain about the assumption to be made about the value of a use which, whilst not legally permissible through lack of zoning, at the date of valuation, was likely to be become legally permissible sometime in the future. For example, in the case of a site suitable for office development but zoned residential, or land zoned agricultural but suitable for warehousing or retail development.

In response TEGoVA in its 7th (2012) and 8th (2016) editions of EVS moved away from endorsing the concept of Highest and Best Use in favour of a less restrictive interpretation of the definition of market value which could reflect so called Hope Value.

"Hope Value is often mistaken for a value in the future, which it is not. It is always a part of the market value of the property at the date of valuation …"

Indeed EVS 2016 considers that the market value of a property reflects its full potential in so far as it is recognised by the market place. As stated in paragraph 5.3.4, "*… it may reflect any "Hope Value" that the market may place on such prospects and as such, should be distinguished from an*

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assessment of market value limited by the "highest and best use" assumption."

EVS 2016 paragraph 5.3.5 continues: *"**Hope value** is used to describe an uplift in value which the market is willing to pay in the hope of a higher value use or development opportunity being achievable than is currently permitted under development control, existing infrastructure constraints or other limitations currently in place. It is an element within the Market Value of the property being considered … It will reflect an appraisal of the probability that the market places on that higher value use or development being achieved, the costs likely to be incurred in doing so, the timescale and any other associated factors in bringing it about. Fundamentally, it will allow for the possibility that the envisaged use may not be achieved. While descriptive of that uplift, it does not exist as a separate value but helps explain the Market Value of the property which must be judged from the available evidence just as much as any other part of the valuation. Hope value is not a special value as it represents the market place's reasonable expectations as to the opportunities offered by the property."*

And so in recent years EVS and IVS have been at odds in their interpretation of market value until the publication of IVS 2017, in which the IVSC's concept of highest and best use was extended with the following words:

*"To reflect the requirement to be legally permissible, any legal restrictions on the use of the asset, eg. zoning designations, need to be taken into account **as well as the likelihood that these restrictions will change.**"*

With the addition of the above highlighted words, IVS now recognises that market value may include in part what TEGoVA calls Hope Value. The IVS interpretation, however, falls short in omitting to allow consideration of uses thought likely to become possible, where existing infrastructure constraints or other physical limitations are likely to be eased in the future.

"With work now in progress to update European Valuation Standards, TEGoVA's European Valuation Standards Board has taken the opportunity of simplifying, streamlining and combining its own wording of Highest and Best Use and Hope Value …"

With work now in progress to update European Valuation Standards, TEGoVA's European Valuation Standards Board has taken the opportunity of simplifying, streamlining and combining its own wording of Highest and Best Use and Hope Value as follows:

5.3.4 *The concept of **'highest and best use' (HABU)** is integral to Market Value and is characterised as the use of a property that is physically possible, reasonably probable, legal or likely to become so, and that results in the highest value of the property at the date of valuation.*

- *"physically possible"*: there can be a reasonably probable and legal use which offers the highest value for the property, but is inoperable if, for instance, poor soil quality means that the foundations could not bear the size of the construction envisaged
- *"reasonably probable"*: disregarding specialist uses that might occur to a single bidder. It also allows consideration of uses thought likely to become possible, as for example, where existing infrastructure constraints or other physical limitations are currently in place but are likely to be eased in the future (for example by the building of a new road or a flood alleviation scheme)
- *"legal or likely to become so"*: potential buyers perceive that a planning authority is likely to allow a change of use or permit a proposed development in the foreseeable future, or legislation is likely to change to render a currently illegal use or development legal. Other situations might concern a use thought likely to be decriminalised or where a licensing regime is considered likely to become more or less stringent
- *"the highest value"*: it will reflect an appraisal of the probability that the market places on the highest value use or development being achieved, the costs likely to be incurred and, where relevant, the return on investment likely to be earned in doing so, the timescale and any other associated factors in bringing it about.

A valuation taking into account a "likely" or "reasonably probable" use will only reflect an element of the uplift in value that is expected to result once such use is fully permitted or where relevant, other constraints have been lifted.

5.3.5 *In most cases valuers will quickly ascertain that HABU is the same as existing use. Sometimes they may identify a more valuable use but conclude that the costs of such change of use would be too great and therefore HABU would still equal value in existing use at the date of valuation.*

The above definition and interpretation of Highest and Best Use, subject to the acceptance of TEGoVA's General Assembly, will be incorporated in EVS 2020. The latter will be launched in Brussels in May 2020. ●

Krzysztof Grzesik REV is Chairman of TEGoVA

Investment Screening Regulation – final text covers property and valuation

"Europe that protects has become a reality. This mechanism is a concrete step against threats to our industries, technologies and strategic interests. We have succeeded in setting up this mechanism quickly, despite the sensitivity of the subject, some reticence and unprecedented pressure. Europe is taking control of its destiny, while staying open for foreign investment."

Franck Proust, Rapporteur, European Parliament

The *ratio legis* for this Regulation was a collective political will that the Union, the top world destination for foreign* direct investment (FDI; €6.3 trillion at end 2017) stop being the "useful idiot" and start protecting its strategic assets. On 14th February, Parliament approved the final text by 500 votes for, 49 against and 56 abstentions, which says a lot about the supposed "divide" between "nationalists" and "Europeans". Council approved on 5th March and the Regulation entered into force on 10th April.

* *very politically-charged recent evolution in EU vocabulary: "foreign" means non-EU.*

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In the Commission Proposal, there was nothing property-specific. In the final Regulation, concerning the factors that must be taken into consideration when a member state or the Commission is determining whether an FDI is likely to affect security or public order (the trigger for the Regulation's mechanism):

- "critical infrastructure"* now includes "land and real estate crucial for the use of such infrastructure" (Art. 4(a)); and
- "supply of critical inputs" includes "food security" (Art. 4(c)).

* *energy, transport, water, health, communications, media, data processing or storage, aerospace, defence, electoral or financial infrastructure and sensitive facilities.*

"Food security" is particularly interesting. Even though the rising political pressure to limit the freedom to invest in farmland concerns mainly EU institutional investors – Rabobank in Poland and Romania, Generali in Western Romania, Allianz in Bulgaria, KBC (Flemish banking group) in East Germany and Lithuania, etc. – characterised as "speculators" because the extreme mechanical increase in farmland prices outperforms returns in their "normal" business, the Treaty provision ensuring free movement of capital is so ironclad that it seemed likely that only non-Europeans would be targeted in the end.

And now here it is. How could this play out? It depends. The fact that the Chinese have bought a hundred vineyards in the Bordeaux region may be enervating for some, but it's not "critical". On the other hand, Romania is increasingly the bread basket of the Union and 40% of its farmland is no longer Romanian-owned. Today, it's 30% non-Romanian EU and 10% foreign, but what if the Chinese start buying up big-time? That could become a strategic European interest concerning the most critical infrastructure of all.

Valuation

There may be a high paying new source of work here.

The centrepiece of the Regulation is a European cooperation mechanism in which both the Commission and one or more member states can jointly or separately require that a member state provide information on the candidate foreign investor's (natural person or undertaking) ownership structure, the *approximate* value of the investment, the member states where the foreigner has conducted business operations and the source of the funding (Art. 9) under a secure and encrypted system provided by the Commission (Art. 11(2)) and can then engage with the member state considering the investment in good time before a decision is made.

"Approximate" was not in the Commission Proposal. Parliament or Council added it. That may seem unfortunate, making it easier to avoid a proper valuation, but in practice probably not. This is not a field for AVMs; rather, the "land and real estate crucial for the use of infrastructure such as energy, transport, water, health, communications, media, data processing or storage, aerospace, defence, electoral or financial infrastructure and sensitive facilities" sounds like DRC material for which doubtless the "approximate" qualification is quite germane.

NB: The Regulation does not oblige member states to have a screening mechanism*, and the final decision on foreign investment remains in the hands of each member state, *but not until it has braved the European agora*.

* *only 14 have one: Austria, Denmark, Finland, France, Germany, Hungary, Italy, Latvia, Lithuania, Netherlands, Poland, Portugal, Spain, UK.*

The agreement between Council and Parliament was followed by a Commission Report on FDI in the EU. It helps to get a handle on what is happening in general and for real estate.

On the one hand, the traditional investors in the EU remain the same (U.S., Switzerland, Norway, Canada, Australia, Japan) and still hold 80% of all foreign-owned assets (the latter amounting to 35% of total EU assets, a world record; 16 million direct jobs). On the other hand, Russia, China and the United Arab Emirates are rising quickly, and that is the reason for the Regulation. China went from €2.5 to €42 billion in six years, 60% of which was state-owned capital and 9% of the investment was in real estate (box 3, p. 60).

Real estate is a leading foreign investment except in terms of employment generated (Table 5.1, p. 66), which makes it easy to crack down on.

"Real estate" as we understand it is probably underestimated, because you would probably need to add at least a portion of separate categories like residential care activities, construction of buildings, specialised construction activities, retail trade, warehousing, rental and leasing activities, services to buildings and landscape activities and accommodation.

This Commission research will certainly influence EU FDI policy going forward, but for the moment, as explained above, under the Investment Screening Regulation, the real estate screening focus will be land and real estate crucial for the use of critical infrastructure and supply of critical food security inputs (farming land). ●

Michael MacBrien is an adviser to TEGoVA

The Importance of High-Quality Business Valuation Professional Education

The International Institute of Business Valuers (iiBV) is a not-for-profit organisation made up of eight business valuation professional organisations from across the globe, including the National Association of Valuers of Serbia (NAVS) and the National Association of Authorized Romanian Valuers (ANEVAR), both of whom are working with TEGoVA on a project to develop business valuation standards.

iiBV's mission is to provide the highest quality professional business valuation education. Professional education goes beyond academic knowledge to provide the practical application of such knowledge and research in serving clients. A cornerstone of being a professional is the love of lifelong learning.

The iiBV is governed by a fourteen member board of directors with the mission to lead the business valuation profession globally by (i) providing high standards of education, (ii) promoting principles-based ethics and standards to serve the public interest, and (iii) facilitating the exchange of information and ideas and encouraging international co-operation and communication. The iiBV provides in-class

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and online business valuation courses and exams delivered by experienced instructors that address core professional education and continuing professional education. The core professional courses include (i) the principles of business valuation, (ii) the income approach to valuation and cost of capital, and (iii) a capstone course that applies the valuation knowledge to a case study, an advanced topics course and a course specifically designed to address the issues of valuing intangible assets.

"The complexity of these issues, combined with the globalisation of businesses, requires advanced professional knowledge and experience on top of the core program of education."

In recent years the gaps between the value of the hard or tangible assets of a business (including real and personal property) and its overall market value have been increasing. The price to tangible book value compares the market value of a company to its tangible assets. In the case of the S&P 500, i.e., the largest capitalised companies traded on the US exchanges, the price to tangible book value ratio has increased from 4.0x in 2008 to now almost 10.9x. Over this period other intangible assets defined as marketing, customer relationships, technology, contract and artistic related are proving more influential to a company's business value than their tangible assets. The complexity of these issues, combined with the globalisation of businesses, requires advanced professional knowledge and experience on top of the core program of education.

The iiBV's professional education courses build on the prerequisite financial and accounting knowledge to provide practitioners with the state-of-the-profession approaches to complex issues. This professional education is what clients and regulators rely on to establish their trust of our members.

Although business and real estate valuers often use similar terms, such as discount and capitalisation rates, to arrive at their valuation conclusions, approaches used to determine business valuation and real estate appraisals are very different. In a business valuation, the determination of an appropriate discount/capitalisation rate is an essential and challenging component of an income-based approach. The total discount rate is derived through determining a reasonable rate of return on riskless investments and adding a premium that accounts for both external (expectations for the economy, industry, competitive environment) and internal (quality of management, financial status, reliability of business cash flows) factors. In addition, leverage or debt capacity may be incorporated into a business valuation discount rate to calculate a weighted average cost of capital. While consistent approaches to develop business valuation discount rates have emerged, regional circumstances may cause professionals to tackle these issues differently. The iiBV recently highlighted this by bringing together experienced business valuation professionals from North and South America, India, the UK and Central Europe in a panel discussion to review how each would approach the determination of a discount rate for a company in their local market. A video of this panel discussion can be viewed on the iiBV's website at ***www.iibv.org*** along with additional webinars discussing current trends and issues affecting the business valuation community worldwide.

"While consistent approaches to develop business valuation discount rates have emerged, regional circumstances may cause professionals to tackle these issues differently."

Market-based approaches in business valuation are also inherently challenging because available market data of two comparable businesses are not only difficult to come by, but businesses that are of different size, growth prospects, diversity of operation and liquidity are just difficult to compare. Market-based valuation approaches in the context of business valuation may, as a result, be used as a secondary approach to value or as a test of reasonability.

Professional standards and practices continue to evolve on topics where a diversity of practice may have existed. For example, business valuers in the United States are in the final stages of publishing ***Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies***. This multi-year project provides comprehensive guidance to investment companies and their advisors on key aspects of valuing investments in both equity and debt instruments of privately-held enterprises. As well, bridging documents between the Uniform Standards of Professional Appraisal Practice and the International Valuation Standards offer an example that help valuers improve consistency worldwide on behalf of users of financial reporting statements.

"At their Autumn 2018 Athens meeting, TEGoVA member delegates voted overwhelmingly in favour of the development of European Business Valuation Standards (EBVS)."

The iiBV mission is founded on building the stature, respect and public trust of its members. The iiBV endeavours to provide its members with communities of practice and awareness of emerging issues in business valuation best practices through a series of webinars. Increased public trust of the profession will ultimately lead to higher fees for the work of professional business valuers.

At their Autumn 2018 Athens meeting, TEGoVA member delegates voted overwhelmingly in favour of the development of European Business Valuation Standards (EBVS). Board member Danijela Ilić is charged with leading a technical committee to propose a stand-alone publication (separate from TEGoVA's Blue Book) to support their business valuation community.

The iiBV will be holding an important in-person meeting of our Board of Directors in Dubrovnik on May 16th, 2019. We look forward to continuing our discussions with all European business valuation professionals at the Spring General Meeting of TEGoVA (May 17th) and working closely with our organisation's members (NAVS and ANEVAR) to bring together European business valuers and build on the professionalism and trust of the business valuation professional ecosystem in Europe. ●

Peter Ott is a board member of the International Institute of Business Valuers (iiBV)