Israel IVS Forum

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International Views and Approaches

Cash flows or cap rates?

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Andrew Baum

The issue of valuation methods and techniques has once again become pertinent this year, due to the disruptions caused by Covid-19. The difficulty in valuing by use of direct capitalisation in periods of swift market transitions, be they temporary or permanent, recalls past criticisms by academics, which have been aired for twenty years. Andrew Baum authored with Neil Crosby a foundational text on the subject, the fourth edition of which has recently been published. We are delighted that he has agreed that we translate, with due changes, an excerpt from the first chapter of Property Investment Appraisal.

ANDREW BAUM

Andrew Baum is one of the most eminent and respected experts on property valuation and investments in the UK. He is Professor of Practice at Oxford University and also serves as Chairman of Newcore Capital Management, a property investment manager which specialises in alternative assets, and adviser to several property organisations. Andrew has authored some of the most highly regarded British texts on valuation and property investments, which have sold a total of over 60,000 copies. In 1987 he was the first head of real estate research at Prudential, the insurance company. Since then he has divided his time between academia and business. In 1990 he established RES, a research firm which was sold in 1997 to Henderson Global Investors, and became their CIO for Real Estate. In 2001 he established OPC, a property research and investment company which was sold to CBRE to create CBRE Global Investment Partners, which now manages 40 billion dollars in assets. During the period of 1989 - 2013 Andrew was Professor of Real Estate Management at Henley Business School at the University of Reading and established the Reading Real Estate Foundation, a charity that aims to advance real estate education. Andrew has received several prizes and awards from universities

and institutions around the world, including the Urban Land Institute in the US. During the period of 1989 - 2013 Andrew was Professor of Real Estate Management at Henley Business School at the University of Reading and established the Reading Real Estate Institute, a charity that aims to advance real estate education. Andrew has received several prizes and awards from universities and institutions around the world, including the Urban Land Institute in the US.

CASH FLOWS OR CAP RATES?

In choosing the term 'appraisal', we have two distinct applications in mind.

The first of these is Market Valuation; this means to fix a price for an asset, or to predict the most likely selling price of an asset.

The second is Investment Appraisal. This means to estimate the worth or value of an asset.

While a Market Valuation will tell us what a property asset is likely to sell for, an Investment Appraisal will tell us what the asset is worth to us. In a scenario where we wish to acquire a property, comparison of these appraisals can help us answer the following question: should we pay the market price - or not?

There is now widespread acceptance of the international definition of Market Value set out in the valuation standards of the International Valuation Standards Council (IVSC), which is commonly known as 'the White Book'. This definition is:

the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction after proper marketing and where the parties had each acted knowledgeably, prudently, and without compulsion. (IVSC 2019)

Many nations feel the need to have their own valuation standards, not least the UK, whose standards (maintained by the Royal Institution of Chartered Surveyors [RICS]) have been through a number of editions of what is commonly referred to as 'the Red Book'. The latest edition (RICS 2020a) adopts the aforementioned international definition of Market Value. There are also some regional standards such as the European 'Blue Book' published by TEGOVA, The European Group of Valuers Associations. This has in the past created some tension and rivalry between international, regional, and national bodies, particularly in Europe. Yet there is now

very little disagreement, if any, on the general wording of the market value definition.

Investment appraisal, or the estimation of worth or value, is not necessarily market-based. This concept developed and institutionalised, having entered UK valuation standards in the 1990s as the 'calculation of worth'. It was subsequently defined in International Valuation Standards under the term 'Investment Value'. Up until 2013, this was defined as:

the value of property to a particular investor or class of investors, for identified investment objectives. This subjective concept relates specific property to a specific investor, group of investors, or entity with identifiable investment objectives and/or criteria. (IVSC 2007)

This definition blurred a major issue, specifically whether worth or value is to an individual investor or to a group of investors. This question has significant implications about how value might be assessed in practice, as the value to an individual and the value to a group may not be the same. However, in the 2013 edition, the IVSC changed the definition and came down heavily on the side of Investment Value representing worth to the individual investor rather than to a group or the market. The latest definition is:

the value of an asset to a particular owner or prospective owner for individual investment or operational objectives. (IVSC 2020)

Individual investors are influenced by a set of criteria through which the value of an asset might be assessed. Their tax situation, the rate at which they can borrow, how much equity capital they have, what adjoining assets they own, and the strengths and weaknesses of their existing investment portfolio are all factors that may lead them to perceive value in a particular property.

Hence, while all investors may agree upon such important variables as the size of the asset being appraised and the cash flow implications of the lease, individual investors will often be subject to different motivations, The distinction between the estimated price (Market Value) and worth (Investment Value) can be significant.

Further, it is possible that a group of investors (for example, tax exempt domestic pension funds with balanced portfolios) will share the same characteristics and use similar criteria, the result being that they attach a similar investment value to a particular property asset. Ascertaining the possible buyer group is very relevant to

appraisal; the appraisal process includes identifying objectively measured market variables and the prospective owner's (or group of owners') subjective estimates of other relevant factors.

Assets can be mis-priced, not just because a specific investor has particular characteristics relating to tax, debt, or other reasons; there are plenty of examples of where the market as a whole did not recognise certain characteristics concerning the asset causing them to under- or over-price properties as a consequence.

It is a shame that the possibility of confusion exists within these definitions, largely because the development of property terminology has been influenced by the isolation of the property world from other financial markets. There is no doubt regarding the meaning of valuation in the securities markets: it means the estimation of worth. Market valuation (or pricing) is a function that is carried out by buyers, sellers, and market makers. The price of a particular company in the stock market is publicly quoted, and large numbers of identical shares in that company can be bought and sold at that price. There is no need to employ a valuer to estimate the market value (or most likely selling) price of a publicly listed share - that price is available on a screen in real time.

In property, however, prices are not available, because each property is unique, the market is private, and there are no market makers. The price at which a transaction will take place will be influenced by an expert opinion - a 'valuation' - because there is insufficient market evidence and insufficient homogeneity of product for traders to be able to fix prices. While there may be some consensus regarding the most likely selling price or market value, it is to be expected that, at any one time, different views of worth will be held by different individuals and groups. These differences will fuel market turnover: those who believe that the market value is higher than the worth of the asset to them will sell; those who believe that the worth to them is higher than market value will buy.

The early 1990s occupier market crash led directly to an increased interest in valuation techniques from UK clients and valuers, and from those whose role it is to comment on valuation practice. Conventional approaches still dominated the UK market valuation practice in the pre-GFC period. This was in increasing contrast to some other mature real estate markets in which discounted-cash-flow (DCF) valuations dominated (for example, Sweden). Despite the GFC, nothing seems to

have changed in this regard and UK market valuation by conventional techniques still dominates practice, albeit often checked by DCF-based Investment Valuations.

Why is the UK more wedded to comparative conventional techniques than some other markets? Despite some high-rise development and the increasing importance of multi-let large-scale shopping centres, the UK still has much - albeit a decreasing amount of - prime property investment stock let on long leases to single occupiers. The typical institutional UK lease was traditionally the longest in the world and, despite major changes since 1990, has had the added benefit of upward-only rent reviews and 'triple net' rents. This has produced simple, low-risk investments with limited variability of cash flow. In these circumstances, the initial rent can explain a large proportion of the value of the asset and so the development of a comparative valuation method based on capitalising the initial rent can be understood. Given these physical and leasing characteristics, it is no great surprise that UK valuations persist in adopting simple comparison-based valuation methods rather than DCF-based approaches to appraisal. This is increasingly dangerous; leases have become much shorter; and cash flow are less predictable, exemplified by the unsustainability of retail rents, set in sharp focus by the COVID-19 crisis. To repeat: conventional valuation methods become very troublesome when the current rental income is no longer to be relied upon as a good indicator of future cash flows.

The cash flow approach has significant advantages and no disadvantages compared with simple conventional models. Cash flow models can perform the Market Value role just as efficiently and accurately as conventional models, and they can be adjusted to meet the requirements of definitions of Investment Value and sustainable value. We believe that they are the basis for identifying market under- and over-pricing and that they have a significant role to play in the regulatory processes underpinning lending secured on commercial property.

I do not believe that having a relatively transparent, high-turnover market, as in the UK, gives valuers an excuse to develop simplistic rules of thumb to make up for the heterogeneous nature of the asset, and the basic cash flow model can be adapted for the numerous roles demanded by the various definitions of value and the requirement of different clients.

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