Valuation under Rapidly Changing Periods

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Abstract

Over the years we have experience several situations that have tarnished the image of the valuation profession. The phenomenon was more apparent when the market is going through a down surge and worst of all when it slumps to the lowest level. Even though this trend is expected by most of the players in the property industry (particularly the investors and bankers), they didn't seem to appreciate it when it happened. Thus, they start looking for scapegoats to cover-ups for any slack in the prior investment decision made. Experience has shown that in the slowdown of mid 80's, valuers were made as the scapegoat and the profession had to suffer. These allegations and condemnation were definitely uncalled for but then again we also heard or came across odd and isolated cases of incompetent or negligent valuers. Simplified valuation and overvaluation were amongst the few shortcomings aired. To add to the matter, we recently heard complaints coming from distinguished personality about cases of undervaluation. Either way, these would not be good for the profession. The problem could be even more serious especially when we are going through these rapidly changing periods. Accordingly, this paper is prepared to explore the need and expectation of valuation exercise. Hopefully it can and will be translated into the practice of carrying out the exercise. The valuation outcome will then be more relevant and acceptable and it should assist to rule out the possibility of another slandering and simultaneously improve and better the image of the valuation profession.

1.0 INTRODUCTION

The subject matter, depending on how we look at it can be approached in several manners. In one way, we could look at it and discuss through the various techniques available, highlighting the focus and emphasis of each so as to attain the best acceptable result. In short, we could scrutinize a technique, look at how it operates, under what circumstances it best operates and observe the elements that need special care and treatment. Besides that, the advantages and disadvantages of these techniques will also be of relevance to the subject matter. Since there is more than one paper discussing this subject matter, I hope that the other papers will deal and address these aspects of the subject. On the other hand this paper will attempt to explore the issues of valuation under rapidly changing periods from a more macro perspective. This will incorporate fundamental issues such as the definition of open market value (which serves as the parameters for valuation exercise), purpose of valuations, expectation of users vis-a-vis the investor (public/private), authorities and financiers. The main focus of this paper will be on the expectation of a valuation exercise from the perspective of the user and whether or not it is being satisfied.

It may be important to note that good quality valuation satisfying the requirement of the user and the very purpose of it, is the ultimate in determining how valuation exercises should be performed. Similarly, from the valuers perspective, the market value definition is probably the paramount to the subject of valuation. As mentioned earlier on, it serves as the parameters to how a valuation exercise is carried out. Therefore, irrespective of whether valuation is carried out under stable or volatile conditions, it should be accepted or deemed correct, so long as it conforms to the definition. Thus, we could deduce that the point in question is the practicality and application of the open market value definition which can and will satisfy the requirement and expectation of such valuation. In short they should be synchronized to come up with a realistic concept so that valuation exercises could be performed without overburdening the valuers.

2.0 EXPECTATIONS OF THE USER

Newell (1995) pointed out that even though a high percentage of the users are satisfied with valuations done, there is still a problem pertaining to the analytical detail provided in valuation reports. In particular, users are puzzled or at a loss as to how market value estimates were derived. Amongst the perceived weaknesses include the following:

1. inadequate market analysis
2. failure to comment upon likely market trends
3. lacks of details on discussion of analytical aspects
4. limitations on assumptions and qualifications of reports
5. too much reliance on historic aspects of market performance

Based on these outcomes, a further survey was carried out within the region to explore deeper into the perceptions, acceptance and opinion of users pertaining to the current practice. This could well be the most dominant factor in addressing the issue of valuation exercise irrespective of timing or market condition. The survey which involves a sample of 52 people who use the valuation report, comprises people from the property financial sector and the public. The result of the survey carried out through questionnaires and interviews could provide us with a good head start serving as a bridge between the users and service providers.

The outcome of the survey does not vary too much from the 1994 survey (Newell, 1995). It confirms and strengthens the importance of the valuation report in their investment decisions. However when asked whether they agree with the value derived, some 36.5% reported that they are neither sure nor confident with the value estimates. They went further to point out that their perceptions of value were not reflected by the basis of valuation carried out. The other appalling outcome is the high percentage (62.3%) of respondents who opined that the valuation process and analysis made is too simple. When asked as to why they think so, 17.3% of the respondents think that it resulted from the incompetency amongst valuers. It's good to record their confidence in valuers but however a larger percentage (53.2%) think that the present standard incorporating the definition does not warrant a more detailed analysis to arrive at a value. In short the market value definition with all the underlying assumptions, were seemed to be advocating for a simplified approach to valuations carried out. As a result, the valuers were perceived to be overly protected by the definition. Further to this, respondents have also voiced their worry about inconsistencies or simply the lack of standards exercised by valuers.

On the subject of methodology, 53.4% of the respondents would also like to see some element of forecasting be made. According to them, this would be more in line with their perceived value incorporating the future expectations.

Another subject that is of interest is in the response made about techniques or the approach in which valuation is made. The respondents would like to see values derived using more than one approach, and apart from a point estimate, they would also like to see several value estimates reflecting the possible market outcomes.

When asked about their perceptions on how valuation be made especially under rapidly changing periods, 54.8% responded that they would like to see more objectivity in valuation. Statistical tools incorporating detailed analysis should be included in the exercise. However, since there is another session specifically discussing the issues, it will not be treated here.

3.0 OPEN MARKET VALUE DEFINITION

This issue is quite popular since it has never fail to surface in forums like this either within AVA or a greater caucus. Fraser (1993) provides a comprehensive insight into the value concept and the market value definition which even dates as far back as the year 476 AD. There are several versions of market value definitions. However, it'll be a bit impractical to look at each and every one of them. For this purpose, we will limit it to the ones applicable within the region.

The definitions adopted by countries in ASEAN, are quite similar. They are very much in tandems with the International Valuation Standards Committee (IVSC) which is quite similar to that of the Royal Institution of Chartered Valuers (RICS) definition of open market value. The only distinct difference is apparent in the Thai Standards, where it chose to use the term "maximum value" instead of "estimated value" or "best price" advocated by the IVSC. Accordingly the definition of open market value for the purpose of our discussion will be based on the RICS/IVSC's definition which reads as follows:

> *"Open market value is an opinion of the best price at which the sale of an interest in property would have been completed unconditionally for cash consideration on the date of valuation, assuming:*
>
> *a. a willing seller;*
>
> *b. that, prior to the date of valuation, there had been a reasonable period (having regard to the nature of the property and the state of the market) for the proper marketing of the interest, for the agreement of the price and terms and for the completion of the sale;*
>
> *c. that the state of the market, level of values and other circumstances were, on any earlier assumed date of exchange of contracts, the same as the date of valuation;*
>
> *d. that no account is taken of any additional bid by a prospective purchaser with a special interest, and*
>
> *e. that both parties to the transaction had acted knowledgeably, prudently and without compulsion."*

In any case though, the variations are not critical in this discussion since the paper will focus on the relevant underlying assumptions which in fact is not in contradictions. These assumptions will have to be verified and tested, i.e., inasmuch as satisfying the requirement or expectations in which valuation exercise are being sought.

Based on the outcome of the survey, it is quite safe to say that the assumption apart from (d) above, is rather loose and would require due attention.

4.0 PURPOSE OF VALUATION

This issue is probably not as significant in the context of our discussion. Nonetheless, it should also be address since it will influence how valuations are made.

As most of us already knew, valuations are carried out for various reasons. The two broad categories would be either statutory and non-statutory valuation. Statutory valuations as the term implies reflected valuations carried out based on statutory provisions. In Malaysia, examples of these will include valuation for stamp duty which is governed by the Stamp Duty Act, valuation for compensation which is governed by the Land Acquisition Act, and etc. On the other hand, non-statutory valuation would include valuation such as for sale/purchase, valuation for security and etc.

Due emphasis should be given toward these different purposes of valuation since they require specialized treatment with regards to value. Notwithstanding the fact that all value should reflect the open market value, these purposes usually advocate varying approaches or concept of value determinants. To illustrate these phenomena, we could look at valuations carried out for the purpose of say insurance and compare it with valuations for security. Insurance valuation, even though referring to the open market value estimates, pegged more to the reinstatement cost as the basis of the investment decisions. On the other hand, security valuation, even though again refer to the open market value estimates, will use the forced sale value concept as the basis for the investment decision.

5.0 SUGGESTED SOLUTION

Based on the above discussions, we could formulate some suggestion as to how the valuation exercise should be carried out, especially under this rapidly changing periods. They should be sound and as much as possible account for the expectation without having to deviate from the basic fundamentals and principles of value. These suggestions are as follows:

1 Open Market Value Definition

The assumption built into the definition definitely needs to be reconsidered. Even though we can argue that the present did not hinder an extensive analysis in the valuation exercise, we must also accept the fact that it does not actively promote for the extensive analyses are carried out. The responsibility to undertake this extensive analysis is left with the valuers and with the current state of the market, it would not be surprising to see valuers choosing to ignore it. As a matter of fact this is proven through a previous study which reported that 73.2% of the respondents selected amongst the property consultants would not undertake detail and extensive analysis unless for large cases. To sum-up the discussion on this issue, it will be good for everyone if the definition explicitly provides for a detailed analysis. This way, we could strengthen the value estimate derived and at the same time we could also ensure that it consistently being done.

2. Valuation Standards

This is a fundamental factor and will always be an issue. It can only be overcome, by making members of the profession aware, adhere, appreciate it and committed toward producing good output. No doubt a certain degree of policing will help but as experience has proved, self-discipline will be the ultimate goal.

3. Methodology or Techniques of Valuation

As mentioned earlier on, this paper will not look into the very details of each technique. Perhaps it will suffice by looking at it from the surface.

From the survey, issues like objectivity, detailed analysis and elements of forecasting were brought up. Incorporation of these factors into any valuation exercise will definitely enhance its reliability, accuracy and purpose. It maybe a bit more cumbersome, translated to be a bit more expensive, but it should be worth it in the long run. At present there are a number of techniques that have been developed and with the help of computers it should not be too difficult to undertake.

As far as objectivity is concerned, statistical packages such as the SPSS will facilitate for a detailed analysis with ease. Ordinary least square or Multiple Regression Analysis could be carried out in the data analysis, resulting in more sound and objective value estimates.

With regard to forecasting, time series and trend surface analysis would serve as some sound tools to utilize and since it involves forecasting, simulation could be carried out to treat the uncertainty or risk. Again there is software for this department coming in the form of "@risk" or "Crystal Ball". Probability estimates and scenario analysis on the other hand will provide multiple results with their respective probability of an outcome.

6.0 CONCLUSION

Whilst this survey has raised some fundamental issues concerning valuation exercise, it may not be representative. We might want to run it again with a bigger sample to ensure its validity. Nonetheless, it does provide us with an insight into the situation and should we heed those results, we will definitely improve our valuation and prevent the unwanted event from recurring.

We should also take notice of the specific approach to valuation under varying market condition. The statistical or quantitative approach which requires a lot of data would be ideal during stable and boom periods but its' application would be a bit slack during a slump.

To conclude, we could say that valuation that should be carried out under rapidly changing periods, likewise with other periods must be of good quality and more objective. It should include a comprehensive data analysis, some amount of forecasting and detailed calculations to arrive at an estimate of value.

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