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Characteristics of Listed Property Trust Initial Public Offerings

Market Comparison

Unbundling water rights

Time to re-appraise Spencer – A heretic's view

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Caption:

API NATIONAL PRESIDENT'S REPORT



David Moore

API National President

While the Global Financial Crisis has had rapid and negative impacts on economies around the world, it seems Australia has been performing much better than comparable countries.

In large part of this reflects better regulation and caution within our financial system and in particular our banks. Astonishingly, our big four make up exactly half of the total of just eight AA-rated banks worldwide. The only AAA-rated bank in the world – the Dutch Rabobank – is also active in our market.

Despite the resilience of our banking system, there has been no escaping the fact that the global credit crisis had a relatively immediate flow-on effect to property markets throughout Australia. Most classes of real estate have been impacted. As of mid-2009, there have been some promising signs of activity in certain sectors, particularly those markets feeling the effects of Commonwealth economic stimulus funds. Even so, transactions in many sectors are beginning to occur at new price levels as markets correct.

There has been much debate about ability to be able to value assets in a market where prices are correcting and there is a perception that, in some instances, those sales are forced or distressed. The lack or limited market sales evidence also adds to valuation subjectivity. The debate has also turned to discussion of the relevance of one of the cornerstones of current valuation practice, the doctrine underpinned by the High Court decision in *Spencer v The Commonwealth of Australia*. I also note that some Divisions are addressing the question at State

Conference level with topics such as "Valuing Without Transactions". The debate continues in this edition of the *Australia and New Zealand Property Journal* and we would welcome further feedback and contributions on the topic. Whatever difficulties the market throws up for valuers, it remains the case that a current valuation of an asset is a fundamental requirement for transparency and comparability. I believe Spencer remains at the heart of Australian valuation practice because it remains as the only test that provides the complete answer to the question: What is the market value of this property? Participants in property investment, whether through direct investment or indirectly through REITS, must have confidence that the transaction price reflects market circumstances and Value at the transaction date.

The definition of Market Value remains as valid in a downward market as it does in any other market. I would refer all members of the Australian Property Institute to the *Australia and New Zealand Valuation and Property Standards Manual* with particular emphasis on International Valuation Standards 1 – Market Value Basis of Valuation.

Moving on to other matters, I've been watching the progress of our current National Survey of Members with great interest. I would like to thank all those members who participated and contributed to the focus groups. The findings include a state-wide specific suite of recommendations and will be available at the end of September. Life Fellow and former National President Ian Sanderson reminds me that the last Member survey was undertaken in 1984 and the results published in *The Valuer* in 1985 (Vol. XXVIII, 1985 Page 712).

The new Content Management System (CMS) will open pathways for members in utilising the services API offers.

Members will be able to check the status of their membership, search CPD events nationally, book an event and pay on line. It will be a platform for delivering additional information beyond set-piece CPD events and, potentially, provide access to specialist knowledge that gives API members a professional edge in the property sector. By the end of the year, the new CMS will underpin a new single national website for API with delivery tailored to each member's individual needs.

The new CMS is part of a broader move to centralise many of APIs operations in an effort to improve service delivery for members by reducing duplication and inefficiencies. It will take time to roll out, but it will eventually allow the best that is developed at state level to be made available to all members, wherever they are based.

Last year National Council established a Future Property Professionals (FPP) Taskforce to develop a program that would bridge the gap between higher education and full-time practices. The program is aimed at giving those graduates who have had limited work experience or opportunities to broaden their experience of the property profession by strengthening their overall skills and hence providing added commercial benefit to employers. This FPP program will be rolled out in January and I'm confident it will enable emerging professionals to accelerate becoming "street smart". It's ultimately all about raising the bar and ensuring all of our members maximise their professional competencies.

David Moore

President

Australian Property Institute

PINZ PRESIDENT'S REPORT



Ian Campbell

PINZ President

The current economic situation in New Zealand has been challenging for all in the property sector. Recent events act as a reminder to us all that property performance is better measured over the longer term than the shorter term. Those properties that have been professionally managed, with good location, good tenants and well maintained are better placed for successfully weathering this recession. As a professional institute within the property sector, we have a leadership role to play and this would include amongst our objectives, promoting the benefits of professional property management.

Properties which are regularly maintained and with up-to-date lease documentation make for a well managed investment, whether it is held long term or made ready for sale as a number of owners are now doing. Tenants also appreciate that buildings which are well maintained and professionally run should also reflect the same high standards and care they portray to their own customers. Where tenants are not happy, they simply move on. For the property owner, departing tenants create vacancy and without replacement tenants at hand, cash flow and return is immediately impacted. Accordingly our institute and through its members should always remind owners and occupants of the value that a professionally trained manager can make and the degree of skill and care that is often required.

In New Zealand, we are mindful of property investors who have been less fortunate. For those involved, it is unsettling to see an increase in the number of mortgagee sales advertised in our local

papers. In some cases, investors defer planned maintenance or upgrading in order to service debt. Others get into difficulty when vacancy impacts cash flow. However the circumstance has arisen, investors should never shy away from seeking independent property advice.

In Auckland there was good attendance to our Annual Conference which covered a wide selection of topics including *Where was property going?* We were surprised to hear that during the current global recession, property investments within New Zealand for the year ending 31 March 2009 adjusted far less than other major economies over the same period. As a result, it did show that in contrast to the USA and Britain, New Zealand property investment has avoided a major swing in value. What is occurring now is that our listed property sector, having focused on capital management, is now positioning to take advantage of buying opportunities following an expected V-shaped recovery.

The elected Property Institute of New Zealand Board members for 2009 are: Ian Campbell (President), Graham Barton (Infrastructure, Plant & Machinery), Gordon Munroe (Property and Facilities Managers), Blue Hancock (NZIV Council), Phil Hinton (Property Advisory), Ian Mitchell (Central Region), Mark Dow (Southern Region) and Phillip Merfield of Simpson Grierson (Independent). I am pleased to announce Phil Hinton as our new Vice-President and express my gratitude and thanks to our outgoing president Chris Stanley. Special thanks is also recorded for the continued support from all who contribute to the smooth running of our institute activities, national committees, all domestic and overseas branches, special interest groups, to staff at our National Office and to David Clark our CEO. Our institute is in good health and in good hands.

In August the PINZ Board will meet in Wellington to review the 'go forward'

strategy giving particular attention to fulfilling the requirements of our newly created professional groupings. The Board will also ratify new by-laws brought about through adoption of new rules in late 2008. Our professional communities comprise Real Property Valuation, Infrastructure, Plant & Machinery, Property and Facilities Managers and Property Advisory.

I am pleased with the institute's new structure which also allows for the future expansion of professional groupings as opportunities may present. With legislative changes made to the Real Estate sector and for Financial Advisers, we are committed to the importance of educational and competency training for our members and to promote and maintain professional standards. We are also reviewing the activities within each of our standing committees to better capture our professional community interests. Our task as we are doing is to deliver relevant topics and training accessible for all of our membership.

I wish to record our strong relationship with the Australian Property Institute (API) and support from API President David Moore, members of the API National Council and Grant Warner National Director. Joint content like this quarterly *Property Journal* and the forthcoming International Property Conference in Perth on 20-23 April 2010 attract solid interest in New Zealand.

In summary, the Property Institute of New Zealand is well placed to manage the challenges ahead and future changes in the global and domestic environments. As your new incoming president, I will continue to promote the benefits of membership and to the wider industry the benefits of engaging a property professional.

Ian Campbell

President

Property Institute of New Zealand

Characteristics of Listed Property Trust Initial Public Offerings in Australia 1994 to 2008

This paper follows Dimovski and Brooks (2006a) who investigate the underpricing of Listed Property Trust (LPT) initial public offerings (IPOs) in Australia from 1994 to 1999. This study investigates Australian LPTs from January 1994 to June 2008 and reports a variety of descriptive statistics on 82 such IPOs. The study has two major findings, firstly that LPT IPOs listed after 1999 offered statistically significant underpricing returns to subscribers and secondly that post-1999 LPT IPOs were subscribed much more quickly than those of 1994 to 1999.

Introduction

Initial public offerings (IPOs) of equity capital are a common occurrence in financial markets around the world. Companies and trusts looking for additional equity capital sell their shares or units to the investing public with the investing public subsequently owning a relatively liquid investment able to be sold on a stock exchange. While this financial transaction seems ordinary enough, the academic literature has uncovered the fact that extraordinary returns have been theoretically able to be earned, on average, by subscribers to these new issues. These returns are the result of the issue price of a company's shares being below the price at which the shares subsequently trade on the first day. The terms generally used to describe this are *underpricing returns* or simply *underpricing*.

Some US industrial company IPO studies [Ibbotson (1975), Ritter (1987), Ibbotson, Sindelar and Ritter (1994)] reported average underpricing returns of between 11.4% and 47.8%. Some Australian industrial company IPO studies [Finn and Higham (1988), Lee Taylor and Walter (1996) and Dimovski and Brooks (2004)] reported average underpricing returns of between 16.4% and 29.2%. Su and Fleisher (1999) reported the largest

average underpricing return to date at 948.6% for Chinese A-class IPO shares between 1986 and 1996. Recall these are average returns theoretically able to be earned by subscribers to the IPO from the date of their subscription to the date of listing.

Subscribers to listed property trust (LPT) and real estate investment trust (REIT) IPOs have not achieved anywhere near the average returns that subscribers to industrial company IPOs have earned. Wang, Chan and Gau (1992) report that US REIT IPOs during 1971 to 1988 had a 2.82% average overpricing while Ling and Ryngaert (1997) identifying US REIT IPOs during 1991 to 1994 report an average 3.6% underpricing. Dimovski and Brooks (2006a) identified that Australian LPT IPOs during 1994 to 1999 offered an average return to subscribers that was not statistically different to zero.

Beatty and Ritter (1986) were the first to argue that underpricing was a function of the uncertainty about the value of the IPO. Essentially, the more uncertainty about the value of the issuing company's equity, the higher the underpricing required by the issuer. Wang, Chan and Gau (1992) concur and suggest that because REITs hold underlying real assets, these provide a useful basis of support for the valuation of the IPO.



Dr Bill Dimovski

A senior lecturer in Finance at Deakin University, Dr Dimovski teaches and researches in the areas of REITs, initial public offerings and seasoned equity offerings.



The purpose of this paper is to examine Australian LPT IPOs from January 1994 to June 2008 to report a variety of descriptive statistics and to identify whether the post-1999 LPT IPOs continue to offer a return to subscribers that is not statistically different to zero. The primary equity capital raised in this period was during a steady to rising to even bull market. A period that is clearly different to the present market where the global financial crisis has delivered many severe blows to the listed property sector where debt capital raising has been difficult and liquidity has been vitally important.

The study partitions the LPT IPOs into various categories and identifies the number of LPT IPOs that offered stapled securities, used underwriters and were involved in retail or office property trust activities. It also reports the mean, median minimum and maximum values for the gross proceeds raised, the net tangible assets offered compared to the issue price, the forecast dividend yields for the forthcoming year, the number of days from the date of the prospectus to the date of listing, the target percentage debt to assets of the trust, the percentage cost of the issue compared to the capital raised, the underpricing returns to subscribers and the amount of "money left" by the issuer. The amount of money left refers to the underpricing in cents per unit multiplied by the number of units offered. It represents the gross amount foregone by the issuer; hence the expression money left. The study contributes two major findings. Firstly it identifies that the post-1999-IPOs were different to the LPT IPOs of 1994 to 1999 and offered an average 3.37% statistically significant return to subscribers. Secondly, post-1999 IPOs were subscribed substantially more quickly than the LPT IPOs of 1994 to 1999.

The structure of this paper is as follows. Section 2 briefly summarises some previous property trust and REIT IPO research. Section 3 identifies the data and its sources. Section 4 reports the results. Section 5 contains some concluding comments.

Some previous property trust and REIT IPO research

An early study examining the underpricing of REIT IPOs was by Wang, Chan and Gau (1992) who investigated 87 US REIT IPOs during the period 1971 to 1988. They report a surprising and somewhat difficult to explain statistically significant 2.82% overpricing to the initial subscribers. Wang, Chan and Gau (1992) suggest it may have been ignorance on the part of investors in these IPOs as to why they subscribed at all.

Ling and Ryngaert (1997) investigated 85 US REIT IPOs during 1991 to 1994 to find a statistically significant 3.6% underpricing return to subscribers in these IPOs. Ling and Ryngaert (1997) argued that Rock's (1986) "winner's curse" may have operated in the REIT IPO market. The winner's curse hypothesis suggests that better informed investors buy underpriced issues and do not offer to buy overpriced ones. Because of the limited amount of new equity available, the better informed and likely more influential investors are able to buy a larger proportion of the more profitable IPOs while the less well informed and likely less influential investors are able to buy a smaller proportion of the more profitable issues and a larger proportion of the poorer issues – hence the winner's curse.

Dimovski and Brooks (2006a) examined 37 Australian LPT IPOs during 1994 to 1999 and reported a median

underpricing return of zero and a mean underpricing return that was not statistically significantly different to zero. In examining money left characteristics, Dimovski and Brooks (2006b) speculated that post-1999 LPT IPOs may offer higher underpricing returns than those of 1994 to 1999. The merging of the trustee and manager roles into a single Responsible Entity role was an important event at June 30, 2000. Dimovski and Brooks (2006b) argued that the removal of the trustee safeguard may result in more uncertainty about the value of the REIT IPO and hence may result in higher underpricing.

Essentially, the more uncertainty about the value of the issuing company's equity, the higher the underpricing required by the issuer.

Data and sources

The *Connect 4 Company Prospectuses* database was used for the majority of the data. This database provides electronic copies of the prospectuses used by companies and trusts in raising their new equity capital. The following data has been extracted from each of the LPT IPOs:

- the amount of equity capital raised
- whether the issue was stapled
- whether the major type of real estate activity conducted was retail or office
- whether the issue was underwritten
- the expected net tangible assets compared to the issue price at the conclusion of the IPO
- the forecast dividend yield for the next forthcoming full year

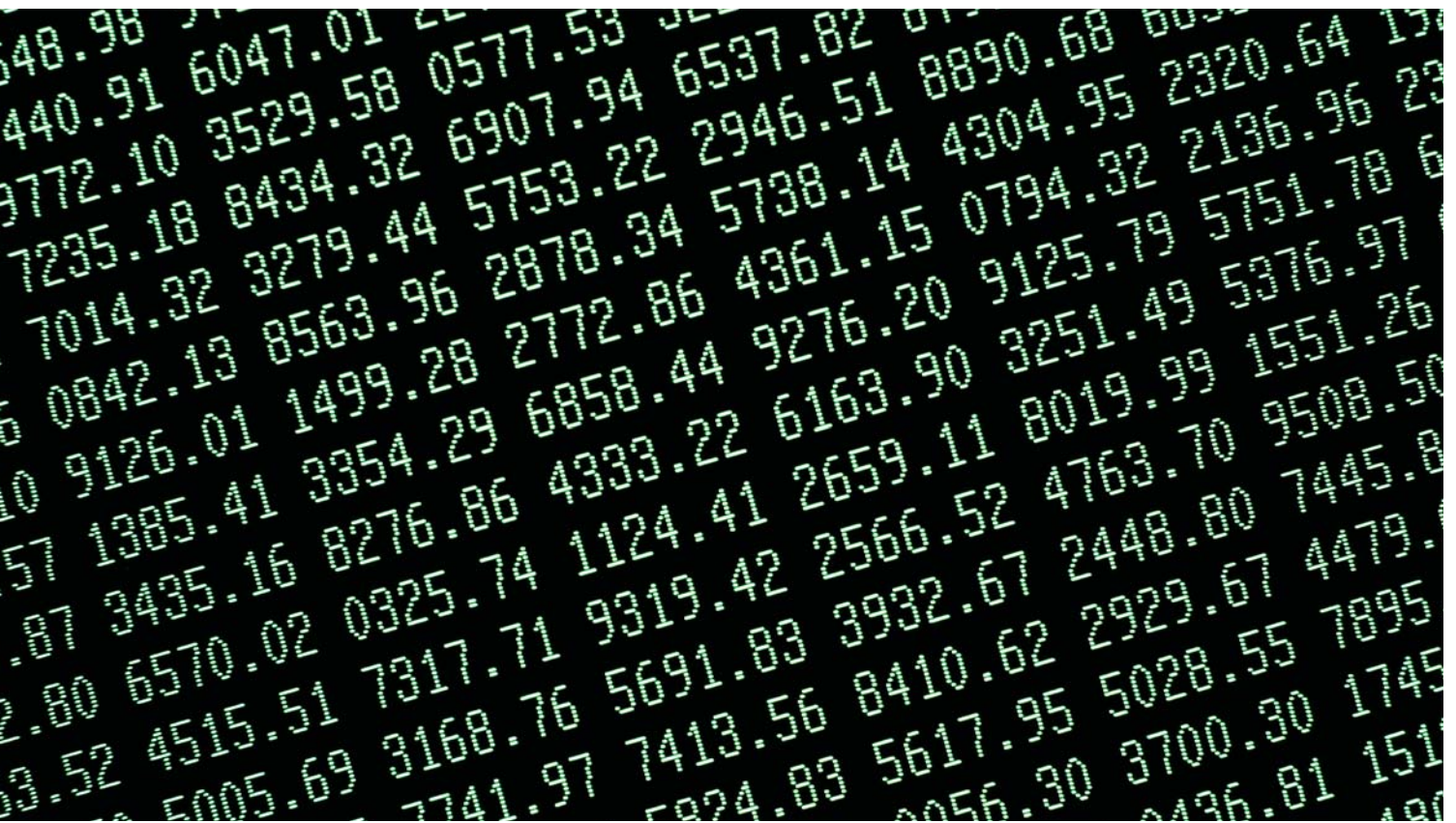
- the number of days taken from the date of the prospectus to the date of listing
- the forecast target debt to equity ratio of the LPT
- the cost of the issue as a proportion of the capital raised.

To determine underpricing returns and money left by the issuer, it was necessary to obtain the closing price of the units on the first day of listing. These closing prices were obtained from the *Netquote Information Services* database and some were verified with *The Australian Financial Review* newspaper. Underpricing returns were calculated as the closing price on the first day minus the issue price, divided by the issue price, all then multiplied by 100 over 1 to derive the percentage return. Recall money left was the underpricing in cents multiplied by the number of units issued.

Results

Of the 82 property trust IPOs during January 1994 to June 2008 48 were underpriced, 14 showed no underpricing and 20 were overpriced. The total amount of new equity capital raised for the period was \$14.015 billion.

Table 1 reports various descriptive characteristics for the full sample and for selected sub-samples of the data. A total of 14 LPT IPOs offered stapled securities, 15 were involved in retail activities as their major type of activity and 20 in office activities. A total of 68 of the 82 (or 83%) were underwritten. The average LPT IPO raised about \$171 million of new equity from the IPO while the median capital raising was \$103 million. The largest LPT IPO raised \$790 million. The capital raisings took between 22 and 175 days from the date of the prospectus to the date the entity was listed, with the average of 57.5 days. The LPT IPOs in turn offered average net tangible assets of



around 93.7 cents for each dollar raised and forecast an average dividend yield of 9% for the next forthcoming full year. The majority of LPT IPOs were quite keen to leverage and the sample identified a mean average 48% debt to asset ratio and a median debt to asset ratio of 49%. The average issue costs were around 6.3% of the capital raised but ranged from a minimum of 1.6% to 16.7%. The mean underpricing return theoretically available to subscribers was a statistically significant 2.4% while the mean amount of money left by the issuing entity was slightly over \$4.8 million.

Panel A of Table I partitions the data by the issue period. The first period was the 1994 to 1999 IPO period which involved both trustees and managers in the LPTs and the second was the post-1999 period which involved only a single responsible entity managing the affairs of each LPT. There were 37 IPOs (of which

33 were underwritten and only four of which offered stapled securities) in the earlier period and 45 (of which 35 were underwritten and of which 10 offered

The winner's curse hypothesis suggests that better informed investors buy underpriced issues and do not offer to buy overpriced ones.

stapled securities) in the later period. The earlier period IPOs were a little larger on average than the later period IPOs (mean and median of \$193 million and \$117 million compared to \$153 million and \$100 million) and took a little longer to list (mean and median of 69.6 days and 58 days compared to 47.6 days and 45 days). The earlier LPT IPOs offered broadly similar net tangible assets

coverage compared to the issue price at around 95 cents per dollar and broadly similar forecast dividend yields and debt to equity ratios at about 9% and 48% respectively. Interestingly issue costs were on average less at 5.4% for the earlier IPOs than the latter ones at about 7%. The underpricing return and money left characteristics of the earlier IPOs are statistically quite different. The earlier IPOs did not allow underpricing returns to subscribers and the median money left was zero. Later IPOs allowed a 3.37% mean underpricing return and the median money left was nearly \$1.5 million while the mean money left was over \$4.7 million and significant at the 5% level.

Panel B of Table I partitions the data by issue size and then by issue period. The major features here are that larger IPOs (over \$100 million) are all underwritten regardless of the issue period; the time to list was substantially shorter for the

post-1999 LPT IPOs regardless of the size; issue costs for larger LPT IPOs appeared to be lower in the earlier period; underpricing returns were higher for smaller IPOs in the post-1999 period than in the earlier period (where a mean 1.1% overpricing occurred, and generally no money is left by the issuers).

Panel C of Table 1 investigates stapled securities overall and by issue period. Stapled securities generally consist of a unit in a trust and a share in a company. The unit and the share are generally not tradeable without the other. The trust is likely to be holder of some income-producing real estate while the company is likely to deal in property development activities. Of the 14 stapled LPT IPO entities, 13 were underwritten (the one that was not was only seeking \$800,000 of public money), and were of the larger LPT IPO variety (raising mean gross proceeds of \$137 million), listing in around 50 days. Interestingly though while the larger LPT IPOs offered a significant mean 2.9% underpricing return, these stapled ones offered a return statistically no different to zero.

Conclusion

This study investigated 82 LPT IPOs in Australia during January 1994 to June 2008. The descriptive results suggest that subscribers to the LPT IPOs after 1999 that intended to sell on the first day, on average, could achieve small but significant underpricing returns. It appears that the post-1999 LPT IPOs offered some uncertainty about their value, as in the US, but such very low underpricing also suggests that the underlying property assets for the Australian LPT IPOs may well be a base of support for the valuation of these IPOs. It is also interesting that the post-1999 IPOs were subscribed to and listed more quickly than those of 1994 to 1999.

Of course not only has the name now changed for these listed property trusts to the more universal term of "Real Estate Investment Trust" (or REIT) but financial markets have dramatically altered in recent times. The global financial crisis has hit REITs particularly hard. Instead of IPO capital raisings, the sector has concentrated on secondary equity capital raising to shore up balance sheets and lower gearing ratios. Ben Wilmot of the *The Australian Financial Review* of July 28, 2009, notes that the Australian REIT (or A-REIT) sector has raised around \$14 billion of secondary equity capital from October 2008 to June 2009. This is an extraordinary amount of equity capital injection but then these are indeed extraordinary times. ■

The global financial crisis has hit REITs particularly hard. Instead of IPO capital raisings, the sector has concentrated on secondary equity capital raising to shore up balance sheets and lower gearing ratios.

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Full data tables available on request. Email: editor@api.org.au

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Market Comparison – The Objective Approach Part I

Maurice Squirrell

Associate Professor of Property (Retd),
DDA, B Bus (Acc), MS (Wisc), LFAPI, CPA

Experience and Judgment

“I believe experience can teach lessons which may lead to sound judgment. I believe sound judgment is vital in selecting the critical factors for appraisal. But, I also believe the bright 17-year-old high school student in elementary astronomy can do a better job estimating the distance to the moon than the old man of the mountains who has looked at the moon for 80 years. So, I find it difficult to accept the notion that dependable valuation of real estate is nothing more than experience and judgment.

I would not give a red cent for an appraisal by the “expert” who beats his breast and shouts: “I don’t have to give reasons. I’ve had 40 years’ experience in this business. And, this property is worth so much because I say so.”

After all, value is expressed as a number. And, no man lives who, through experience, has all the numbers so filed in the convolutions of his brain that he can be relied upon to choose the right one without explicable analysis and calculation.”

L. W. Ellwood

Introduction

As part of its role and under its Quality Management System, the Valuer-General Victoria (VGV) seeks continuous improvement in Victorian valuation standards. A review and discussion of some of the science behind past and present valuation theory and methods is part of that continuous process including this short series of articles. VGV is not advocating departure from any requirements under the various Victorian statutes or case law. On the contrary, VGV is encouraging more rigour by the application of science alongside traditional valuation theory.

Many Australian universities have been teaching the materials outlined in this article since the early 1980s; it is time for the profession to embrace them.

The first article (published in the June

edition) dealt with the “value issue”, arguing that fair market value should not, and clearly cannot, be the default concept of value. Rather, there is a range of possibilities and that for many cases the flexibility of the classic Ratcliff definition of “most probable price” better addresses the client’s issue. Appendix A to that article is a flowchart of the valuation process and forms an outline for the report.

This second article outlines an objective valuation process through the use of the valuation report structure and then moves to examine and illustrate objective techniques of market data analysis in the application of comparable sales data and information in the prediction of fair market value, rental value, most probable price, or whatever the objective of the valuation is.

The Report – the main medium of communication with the client

The first step is to establish the valuation issue. What is the purpose of the valuation? Why is a valuation required? What is the business decision the client has to make that requires the input of the valuer? What rights are, or are to be assumed to be, for sale? What is the legal interest to be valued? What are the pressures on the client, if any? What are the critical assumptions, regarding current use, sale terms and conditions and the like? It is only when these questions are answered, and only then, that the value or price definition can be identified.

The second step is to conduct an inventory, particularly of those things we know or should know with the ultimate view to identifying the 'use' basis. Land in itself has no value. Value is derived from the use to which it can be put, and the supply and effective demand for that use.

The appropriate inventory headings in order are:

1. The Physical Attributes of the property, including a full description of the site and improvements and any adverse or beneficial implications.
2. The Legal and Political Attributes, including constraints and opportunities. After this second step has been taken the number of potential uses will, usually, have been greatly reduced.
3. Linkage Attributes, in terms of convenience and accessibility to other sites and their uses, together with site exposure characteristics.
4. The perceptions of the Dynamic or Psychological Attributes of the site need careful identification.
5. Finally, Environmental Attributes covering both on and off-site psychological, economic and ethical issues need identification.

The results of this inventory will reveal the limitations and opportunities of land use for the subject.

The third step is to identify the use, be that highest and best use, the use which may be required, or that which is more objective, firstly determining most fitting use leading to most probable use.

The use adopted must exploit the positive physical attributes already identified, exploit the market opportunities, overcome negative impacts and be capable of providing a justified and prudent investment to the most probable buyer. A suggested sequence to arrive at an appropriate conclusion is:

1. The general market characteristics should be examined to

firstly determine whether the existing use is likely to remain appropriate, followed by examination of other existing and emerging uses on sites in the subject's market area.

2. Identify a small number of plausible alternative uses. These uses will then need some criteria and analysis to be applied to each in order to rank them.
3. Economic criteria – can each use be shown to probably work as a prudent investment? What are the expected revenue and expense flows from each? Solvency and use of default ratios are important here.
4. Risk Ranking – much of this may come from adaption of existing improvements and/or the site to accommodate each of the scenario uses and levels of effective demand for alternative uses.
5. Political Compatibility – in addition to planning policy and zoning statements, what are the real opportunities that the land use controlling authorities will probably allow?
6. Conclusion Statement. A summary table of the outcomes from 1-5 above should then be examined and a use conclusion adopted. The reader should be able to follow a logical path to this conclusion.

The fourth step is to adopt and use the valuation model based on the materials already examined, plus an examination of the most probable buyer:

The appropriate headings are:

1. Most Probable Buyer: Identification of the most likely buyer and their characteristics will probably be revealed by "who's buying what" in the subject's market.
If there is more than one type of buyer – say owner-occupier v investor – then are they competing? Does this mean there are definable sub-markets? If so, what are their characteristics and in which sub-market does the subject lie. Different buyer types will have different weightings for the various attributes and so the importance of variables may shift from buyer to buyer.
2. The Valuation Method. The valuation model chosen will largely be dictated by the market data available to be applied to the question of value or price. The critical issue is to choose the approach and then the technique that is the most reliable predictor of value or price in the given circumstances.

The three preferred approaches are:

- A. Prediction from what buyers have done in prior transactions, or market inference – often called the direct market approach or the direct comparison approach.



This is a very reliable approach where there are a suitable number of comparable sales of recent origin, where market conditions are reasonably stable, and the prediction is at today's date. An objective technique from this approach will be examined in this and the next paper of the series.

- B. Simulation from how buyers would calculate offering price. Where the market does not provide sufficient material for a prediction under A, then the valuer will need to simulate the buyer approach to pricing. This may involve interviewing potential or buyers similar to the "most probable purchaser", using industry formula such as rules of thumb, residual analysis techniques such as DCF and other pricing techniques in use. In some cases market data from geographically different but otherwise similar markets might have to be used. Where it can be demonstrated that buyers use these techniques then this should be seen as a legitimate method.
- C. Inference from normative economic models. Where data that allow A & B above to be used are inadequate, then the valuer will need to use methods that are more the result of how the valuer believes the market would or should operate. Within this bundle of techniques lie the use of cost and depreciation estimates, investment modelling of cash flows, and any other technique that requires a set of assumptions based on the valuer's perceptions rather than those of the actual market at that time.

This article now examines an appropriate **objective** approach and predictive techniques developed over the past 35 years

in the USA which have been demonstrated as suitable for Australian conditions, from A. above.

The first article in this series sets out the three fundamental steps of valuation, viz

1. Identify what is being (hypothetically) sold, and to consider the likely terms and conditions of sale and the purpose for which the valuation is required.
2. To identify properties that can best provide relevant sales data or information that can be used to predict the sale price of the subject, under the conditions discovered under Step 1, to produce the "comparable sales" set.
3. To apply the sales data or information gleaned from Step 2 to infer a value for the subject property.

It is the third step with which we are now concerned.

Put another way, this refers to the transferring of the sales prices to the subject property in such a way that the sales prices are adjusted to reflect the remaining differences between each sale and the subject property, or into a strong and rational range of prices.

This means the adjusted sale prices are imputed to the subject in such a way that a reliable value inference can be made.

In a perfect market the adjusted sales prices would each result in the same inferred dollar value for the subject. While this ideal is usually not present, it is to varying degrees. As previously stated above, the method is reliable to the degree that the prediction is of short range, that the market data is of recent origin and that market conditions are constant.

The remainder of this article is concerned with the identification of the single attribute causing the major remaining value differences between the properties and its application in the transference of the adjusted sales prices to the subject property. This “major” factor is traditionally called a unit of comparison or “common denominator”. Its division into the sales prices produces a “unit of value” which can then be applied to the quantity of that factor or units of comparison possessed by the subject property.

The unit of comparison

The unit of comparison can be defined as the “space time unit” which is typically the most related or correlated with productivity in the buyer’s mind. The best unit is one that is plausible and has the tightest array, or least amount of dispersion or differences when related to price.

Typical/possible units of comparison are:

- For commercial, retail, office etc: gross building area, net lettable area, number of floors, lot area, or frontage.
- For warehouse: building area, effective storage area, building volume, effective building area, lot area.
- For residential: house (as the unit), living area, building area, number of bedrooms, lot area.
- For a motel: number of units, number of beds, building area, room nights sold.
- For subdivisional land: title (gross) area (commonly called inglobo or englobo), number of lots or yield, (gross) developable area, saleable area.
- For rural lands: area, irrigable area, unit stock area, crop yield per unit of area, water right per irrigable unit of area.

Unit of value

The unit of value is found by dividing the sales price by the number of units of comparison for each sale. If this division is made after all other adjustments to sale prices for differences between each sale property and the subject and, all of the differences were captured perfectly, then each sale would produce the same dollar amount per unit of value. This unit of value is then applied to the number of the units of comparison of the subject and the predicted price arrived at.

There are some alternatives to this process, e.g., the unitisation of the sales prices could be made before any or all or some adjustments are made. In any event, at some time in the process the unit of comparison will be chosen. In most cases the unit

should be that unit that most closely changes in the same way as price.

Consider this simple (hypothetical) example of comparable properties which sold under similar circumstances:

Site Area	Sale Price
m ²	\$
100	100,000
110	110,000
120	120,000
130	130,000
140	140,000

It is easily observable that for each 10m² increase, an extra \$10,000 in price has been achieved, and that in each case the price paid for each m² is \$1,000. This is (formally) discovered as follows:

Sale Price		Unit of comparison		Unit of value
\$		M ²		\$/m ²
100,000	/	100	=	1,000
110,000	/	110	=	1,000
120,000	/	120	=	1,000
130,000	/	130	=	1,000
140,000	/	140	=	1,000

This is a perfect pattern, and the “Holy Grail” a valuer seeks to discover. After all, a valuation is pretty much about trying to find a pattern in the sales prices.

In this case, a valuer would have a high degree of confidence in applying \$1,000/m² to other comparable subject properties whose areas are between 100 m² and 140 m².

However this pattern is found, it is always present in varying degrees and therefore the relationship will vary from weak to strong. Reasons for this include the imperfections of the real estate market, the ability of the valuer to make the appropriate adjustments for differences, as well as the skill of the valuer to identify appropriate units of comparison and to measure the strength of the relationships. This involves the valuer investigating the sales evidence very thoroughly so that better and informed decisions can be made.

To introduce some basic statistical procedures that provide assistance in objectively identifying the appropriate unit of comparison, a simple example is used where there is almost certainty of there being only one useful unit.

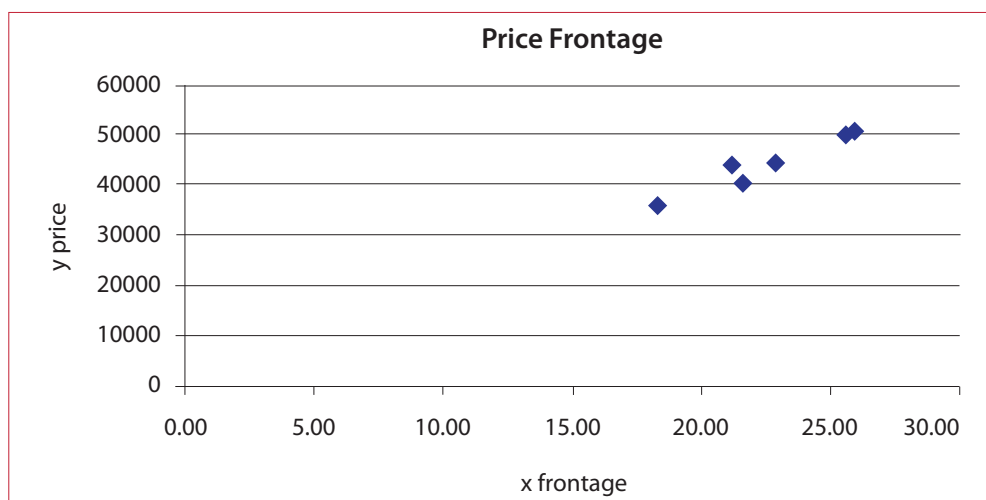
A valuer has examined six vacant lots that have been sold during the relevant period. All are the same depth, have similar locations and other attributes but have different frontages (in metres). The information is:

Using Excel (used here) or any other basic statistical software, examine the following:

Six Vacant Lots	
Frontage	Price
x	y
21.58	40,400
18.29	36,000
25.91	50,800
22.86	44,480
21.18	44,000
25.60	50,000

1. Chart or graph the two variables.

Note: With one exception, Excel has been used in the graphing and calculations in this article. Care needs to be taken in using Excel applications as some procedural differences to orthodox approaches can emerge, leading to false answers. For example Excel assumes the left column is the horizontal axis on a chart.



Note:

- There is a convention that where the value of one of the variables is (thought to be) "dependent" on the value of the other (or others), then this dependent variable is assigned the symbol "y". In valuations y will normally be price.
- A further convention places the dependent variable on the vertical axis.
- The horizontal axis shows the value of the independent variable, i.e., the variable that determines or explains variations in the dependent variable.

2. Calculate and examine the two-variable correlation coefficient: $r = 0.96886326$ or 0.97

Explanation: The symbol "r" is used to represent the Correlation Coefficient. The value of r ranges from -1 through 0 to +1.

An r of -1 represents perfect negative correlation and on a chart the data points would all lie on a line sloping downwards from left to right. Consider the relation generally expected between dollars per unit of area (y) and area(x)!

An r of 1 would represent perfect positive correlation and on a chart the data points would all lie on a line sloping upwards from left to right.

An r of 0 tells us that there is no measurable relationship between the variables i.e., there is no correlation between the variables.

The further r moves from 0 in either direction, the stronger the relationship.

In this case the relationship between sale prices and lot areas is very strong. As lot area increases so do prices; an expected economic relationship.

While the graph illustrates this positive and strong relationship, the value of r provides the objective measure of the strength of the relationship.

3. Examine the Coefficient of Determination:

$$r^2 = 0.938696 \text{ or } 0.94$$

Explanation: The symbol " r^2 " is used to represent the coefficient of determination. The value of r^2 ranges from 0 to 1.

r^2 measures the percentage of the total observed variation in price (y) that maybe explained by the variation in the frontage (x).

In this case we can say that 94% of the change in prices is determined or explained by area.

In valuations, this is the critical objective measure in selecting the unit of comparison.

Sound valuation practice involves the valuer in not just relying on the conventionally accepted unit as being the prime unit without testing the premise upon which it is predicated. The valuer should not simply accept the unit always used for these kinds of properties – find out what is being bought. What is the productive use?

To do this, the valuer needs to test a series of sale prices with a series of possible units of comparison.

In a perfect market the adjusted sales prices would each result in the same inferred dollar value for the subject.



A slightly more complex and more revealing analysis in Melbourne's CBD fringe:

Let's examine the following recent market data of sales of a major commercial development site.

Adjusted Sale Price - \$	Site Area - M ²	NLA - M ²
y	X ₁	X ₂
28,436,019	7,051	47,000
23,692,500	8,237	49,602
18,975,000	6,902	40,348
52,030,000	15,200	121,600
7,628,000	4,235	17,856
41,000,000	16,749	136,000
25,200,000	3,942	55,000

The sales prices have been adjusted for such matters as time and special terms and conditions as appropriate. The following graphs are used to find the best unit of comparison that explains value.

Note that while in practice it is difficult to get many useful sales; wherever possible more sales rather than fewer are always desirable.

Further, in looking at graphs or charts for help, sales of properties that are some distance away from the typical group can be useful in anchoring the relationship, as shown below by the two properties shown to the right side of the graph. These sales should not simply be regarded as outliers, perhaps to be discarded after further investigation, and which would be situated a significant distance from the linear line formed by the bulk of the sales.

The first graph (ref. page 160) shows that some of the individual (adjusted) prices are some distance from the line of best fit, but they do provide an anchor. If they are otherwise "comparable" then there is a reasonable and useful relationship between price and site area and this is confirmed by the $r^2 = 0.74$

The second graph (ref. page 160) shows a tighter array along the line – a better fit – and the $r^2 = 0.85$. As a result, of these two alternatives, m² NLA should be adopted as the primary unit of comparison.

Lonsdale, King & La Trobe Street properties Melbourne Circa 1980s				
Sales Address	Sale Price	Frontage	Gross Build	Land Area
	\$	M	M ²	m ²
115 Lonsdale	285,000	7.00	669	178
212-224 King	680,000	30.95	1,690	570
14-20 King	520,000	20.30	1,672	837
597-601 Lonsdale	730,000	15.00	2,187	904
526 La Trobe	350,000	17.40	1,076	363
r ² =		0.3668	0.9032	0.6693

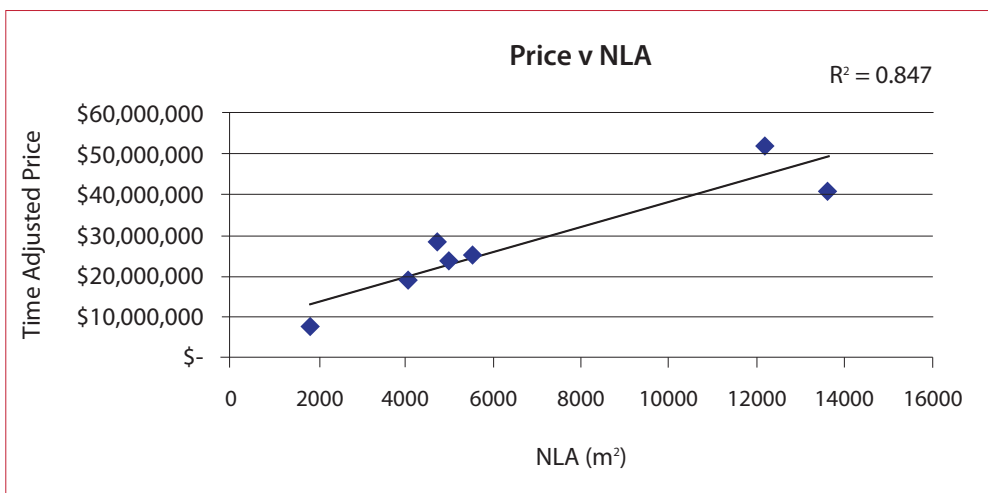
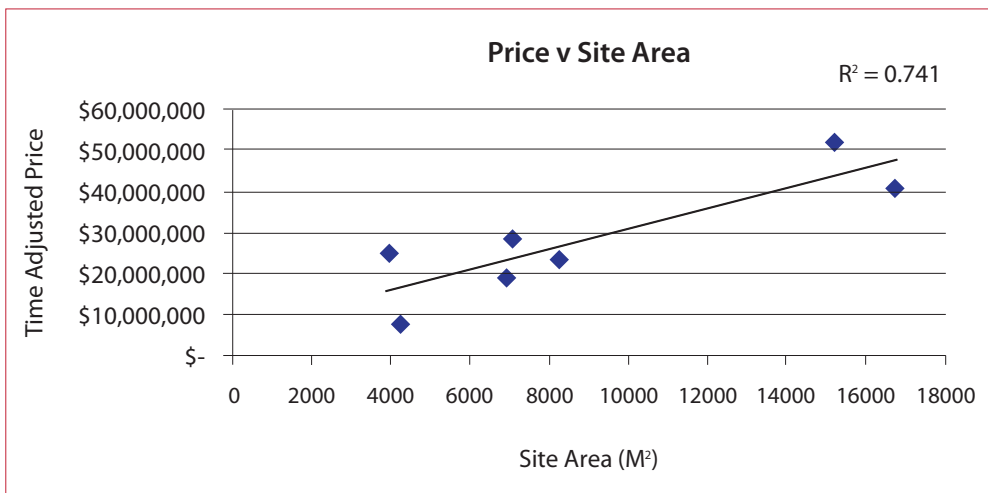
Correlation Coefficients Matrix				
	Sale Price	Frontage	Gross Build	Land Area
Sale Price	1			
Frontage	0.6057	1		
Gross Build	0.9503	0.4959	1	
Land Area	0.8181	0.3774	0.9456	1

Clearly Gross Building area is indicated as the prime Unit of Comparison. This unit determines or explains 90% of the changes/variations in price and can therefore be expected to be more reliable than Land Area, given the sales properties the valuer has chosen.

However, particularly given the ease of this analysis, the valuer should take the opportunity to examine the relationships between the other (independent) variable and price, and between themselves. A Correlation Coefficient matrix facilitates this.

If these properties were in a strong retail area and each had similar depths and improvements the valuer might consider/ expect Frontage to be the prime unit of comparison. If office predominates then Building Area would be considered. If the area is in transition with any existing buildings of (relatively) little value, but with similar development potentialities, then perhaps Land Area might be the stronger unit. A further unit that should now be tested would be potential building area.

The matrix also alerts the valuer to the strength of other relationships that might need to be explicitly considered beyond this point. Further, changes over time might suggest that



redevelopment seems to be approaching. In some cases the valuer might be surprised at the apparent weakness of the main relationship and find that a closer examination reveals that there is more than one class of buyer in the market, say owner-occupier v investor v developer, and that examination of sub-markets is needed. We will return to this issue in the next article.

The following sales were taken from the Melbourne CBD fringe in the 1980s.

Bouverie Street Exercise				
Property	Adjusted Sale Price	Site Area M ²	Frontage M ²	GBA
203 Bouverie St	2,811,500	1,090	20	1,700
318-322 King St	1,214,000	382.54	12	392
215-221 Franklin St	2,142,250	964.91	47.5	2,889.19
5-7 Anthony St	805,000	400	16.76	1,226.32
110 Franklin St	1,232,000	467	7.6	850
r =		0.9667	0.4880	0.6076
r ² =		0.9345	0.2381	0.3692

This analysis shows that prices have moved more closely with changes in site areas. The strength of the relation is much stronger than that with either of the other two potential units – r² 0.93 v 0.24 & 0.37. The emergence of this unit is probably indicative of this sub-market being ready for redevelopment and the valuer would be well advised to talk to the purchasers about their future use plans at the time of purchase. If the subject is truly a member of this set then much of the valuer's work is now done.

Other uses of correlation analysis includes gaining insights, understanding and confirmation of other relationships and should be carried out, as a matter of routine, when the appropriate data are available.

The following correlation coefficient matrix (r) was generated from 79 sales of flats in the upper-class suburb of Kew, Melbourne in 1979, collected by R. Webster: Contract Price is the (dependent) variable shown in Column 1 (C1). Data on 21 independent variables were collected (x1 x2 x3 ... x21) and placed in C2 ... C22. The statistical program MINTAB calculated the 231 possible correlation coefficients in less than a second. With larger data sets, higher level statistical programs such as Minitab and SPSS may provide much quicker analysis than Excel.

This is a reduced set of interest, dealing with eight independent variables of interest.

LAND and BUILD denote land and building area respectively.

ROOM and BED denote the number of rooms and bedrooms respectively.

SCHOOL, TPT (public transport), SHOP and RES (reserves) are values based on distance. They were scored on a scale of 0-5 measured in 100s of metres, where 5 is "less than 200 metres", and 0 is "more than 500 metres".

MTB > corr c1 c2 c3 c6 c7 c16 c17 c18 c19

Correlations (Pearson)

	CONTRACT	LAND	BUILD	ROOM	BED	SCHOOL	TPT	SHOP
LAND	0.364							
BUILD	0.804	0.209						
ROOM	0.785	0.418	0.879					
BED	0.658	0.151	0.817	0.726				
SCHOOL	0.125	0.097	-0.051	0.013	-0.054			
TPT	0.052	-0.423	0.059	-0.034	0.035	0.177		
SHOP	-0.577	-0.032	-0.503	-0.428	-0.444	0.101	0.1480	
RES	0.308	0.183	0.299	0.266	0.208	-0.233	-0.106	-0.155

Cell Contents: Correlation

An examination of the matrix reveals the following:

1. BUILDING area is the most highly correlated variable with price and explains or determines 0.64 (r^2) of the variation in the prices. This is probably not unexpected.
2. LAND area is poorly correlated with price – again not unexpected given the nature of the use.
3. ROOM and BED (number of) have a strong relationship with CONTRACT (0.785 & 0.658), and, between each other (0.726). Further, both these variables are very highly correlated with BUILD. These relationships are probably not unexpected and to a large extent provide objective evidence of the expected.

In this discussion, where there is a "dependent" variable of interest – in this case CONTRACT (sale price), the correlations between the "independent" variables are often described as "partial correlations".

4. Further, each of ROOM and BED are strongly correlated with the (probable) prime unit of comparison – BUILD (0.879 & 0.817). Because of this relationship the valuer has objective

evidence that the prime unit (BUILD) can also act as a proxy for ROOM and for BED and that no further adjustments may need to be made for these two variables.

Such relationships between independent variables are often described as cross correlations or as multi-collinearity.

5. SCHOOL, TPT, SHOP and RES (reserves & parks) denote distance in metres of the property from each amenity. Their respective r values with price each suggest that the importance of being near to such facilities was not as strong as conventional wisdom usually dictates. The strongest positive relationship is with reserves and parks. There is almost

indifference about schools and transport, and there is significant evidence that **buyers did not want to be near shops.**

I suspect the valuer would not be surprised at this outcome given the demographic socioeconomic characteristics, particularly the mobility of the motor car in such locations, and the noise and traffic congestion associated with (in this suburb) the old junction shopping strips.

Transformations

This article has thus far considered the relationship between two variables on the basis of a linear relationship. That is, that a one unit change in the independent variable always results in the same

dollar change in the dependent unit. On a graph or chart this means that a "line of best fit" is a straight line.

Where the prices of the "comparable" set of properties are highly comparable with the chosen unit of comparison then it is likely that the potential units will not, within the often small sub-market they form, exhibit a (significant) non-linear relationship even though the whole market (or a larger portion) may.

Further, it is a lot easier to work with linear or close to linear relationships.

In real estate, however, the relationships between price and some units can often be expected to be non-linear.

This means that one or both variables may need to be changed from their normal form or be "transformed" (changed) to better reflect their relationship. Popular transformations are square root, logarithm, exponential and negative reciprocal. (Negative reciprocal or $-1/x$, rather than just the reciprocal is used to preserve the *order* of the observations). To be consistent, all data must be tested in the same way – you cannot compare the r of

unit in a linear form with the r of another unit tested in a non-linear form.

Excel provides assistance where the variables on a graph seem to have a non-linear relationship, by offering a choice of six types of "trend lines". (Note that this discussion is not dealing with the "trends per se" but this choice of lines can be used to examine the fit of the observations to the "best" line.) If these are thought inadequate, then other changes can be considered that might enable a better fit and which results in a higher r².

Brunswick Warehouses

Note: The data in the following table are presented in rows rather than the more conventional columns. Notice that this can be confusing for others to follow and the resultant correlation matrix needs to be very carefully read. This layout, as presented to the author, is not recommended.

BRUNSWICK WAREHOUSES							
	Sales:	1 C1	2 C2	3 C3	4 C4	5 C5	Subject
R1	Build. Area	432	1,644	1,371	2,797	1,216	1,410
R2	Build. Height	7.5	8	6.5	5.5	6	6.5
R3	Build. Vol.	3,240	13,152	8,912	15,385	7,296	9,165
R4	Frontage	36.6	30	24.40	39.7	16.80	22.3
R5	Lot Area	2,670	2,045	1,615	3,087	1,618	1,894
R6	Sale Price	500,000	950,000	476,000	800,000	509,000	...

Correlation Matrix						
	Row 1	Row 2	Row 3	Row 4	Row 5	Row 6
Row 1	1					
Row 2	-0.562166	1				
Row 3	0.9438094	-0.28419	1			
Row 4	0.314809	0.104307	0.272375	1		
Row 5	0.386455	-0.13469	0.265256	0.937264	1	
Row 6	0.6239195	0.250511	0.806005	0.41388	0.355243	1
r ² =	0.3892756	0.062756	0.649644	0.171297	0.126198	

Best r² = 0.649644

In this case, Building Volume provides the best unit on this analysis.

The following transformations were then applied to this independent variable (Building Volume): Ln x, 2/x, 3/x, x^{1.5}, x², x^{2.5}, -1/x. The summary table, below, reveals that squaring the Building Volumes provides a modest increase in r².

	r	r ²
xm3	0.806005	0.649644
Ln x	0.717439	0.514718
2/x	0.769293	0.591812
3/x	0.753488	0.567745
x ^{1.5}	0.826395	0.682929
x ²	0.832975	0.693848
x ^{2.5}	0.829511	0.688088
-1/x	0.594699	0.353667

Common transformation options should be routinely considered, explored and exploited by the valuer. At this critical point in the analysis, the aim is largely to find the pattern in the sales prices that enables the subject's place to be found. Note: transforming the y variable can introduce other issues not covered by this article.

Combining variables

In examining a correlation matrix the valuer might decide to construct a new "super" variable by combining two or more independent variables. This should be seriously considered where, for example, there are two independent variables strongly correlated with price but not between themselves.

Nevertheless, even in those cases where the two independent variables are cross-correlated, and the valuer feels it important to use the information from both, then combining them can achieve this.

Note: Higher level statistical models, such as multiple regression analysis, tend to avoid the use of two highly cross-correlated variables as independent variables in their original form. However, there is a standard (sophisticated) statistical model

available to combine "similar" variables, called Factor Analysis and where each "factor" can become an "independent variable". This is too elaborate in the conventional valuation case, particularly where small data sets prevail.

For example, USA experience has shown that with medium- to high-quality residential properties the three main independent

variables are often: area of living area, location to amenities and a quality factor. While these three variables may be highly cross-correlated, and not necessarily linear, by transforming where appropriate and combining them, perhaps by multiplying them together, may "explain" 90% of price variation.

The following extract of data is from a matrix of 26 residential sales in Melbourne's south-east.

Lot #	Price	Area	Frontage	Frontage* Area	frontage ^2* Area	frontage ^3* Area
32	\$162,000	372	12.50	4,650	58,125	726,563
33	\$162,000	372	12.50	4,650	58,125	726,563
34	\$165,000	398	13.37	5,321	71,145	951,212
...
...
187	\$177,000	420	14.00	5,880	82,320	1,152,480
188	\$177,000	420	14.00	5,880	82,320	1,152,480
189	\$177,000	420	14.00	5,880	82,320	1,152,480
r ² with	price	0.7683	0.8421	0.8688	0.8924	0.8971

This demonstrates the valuer's progression of improving the r² value, believing that the information from both variables needed to be kept, retaining the advantages of still having one independent variable, which is ultimately **a partially transformed and combined but single variable**.

Twenty years ago, the writer was concerned with a similar set of residential sale prices in assessing a claim for compensation for land taken for the extension of the Melbourne Eastern freeway.

There was a similar number of sales but the initial plotting of price & area, and then price per unit of area with area revealed a weak relationship between the two variables. But there was no reason to suggest that the market was acting as irrationally as the plots showed. It was decided to have the data run through a "best curve fitting" computer program which suggested that raising the lot areas by a power, as I recall, of 0.78 provided

an acceptable description of the relationship, and which outcome was accepted by all parties.

Conclusion

This article, using the outline of an objective valuation report structure through to the choice of the valuation methodology model and then, adopting the market inference or direct market approach, sets out the first objective steps in that process.

The article has covered some very basic arithmetic and statistical procedures that enable confident objective outcomes to be discovered and used. It has set out procedures that valuers can and should carry out as a matter of routine to discover and enhance relationships between price and potential units of comparison with particular regard to the assistance that the Coefficient of Determination (r²) can give. The thrust has also been to obtain as much objective help from the chosen unit of comparison so that, in statistical terms, there is only one independent variable.

The next article will examine the next objective steps that the valuer should consider when necessary and will set out the rest of the report structure that is themed through these two articles. ■

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Current issues in the analysis and valuation of established retirement villages



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The retirement village industry in Australia has achieved significant growth over the past 20 to 30 years and is now entering a more mature phase where greater focus on medium- to long-term issues is anticipated. The entry of the larger institutional investor into the sector in the early part of this decade resulted in a higher proportion of these assets being held to greater reporting requirements and accountability. Furthermore there are now villages which have operated successfully for more than 30 years displaying an established track record, enabling analysis as to the veracity of assumptions within the Discounted Cash Flow (DCF) method of analysis and valuation.

The early 2000s was distinguished by a boom in asset prices, from which retirement villages were not immune. The Global Financial Crisis (GFC) which commenced (internationally) in 2007 resulted in a significant decline in asset prices across the board. The extent of this decline on retirement village assets is yet to be fully determined in the transaction market.

Retirement village values in Australia are primarily determined by the Deferred Management Fee (DMF) business model; an owner's interest in the village incorporates the value of the DMF business, any unsold units plus developable land, where applicable. Standard industry practice is to use a method of value appropriate to each of these components: DCF analysis determines the value of the owner's interest; direct comparison and/or incorporation into the DCF determines the value of any unsold units and the value of the units "in one line"; and direct comparison and/or hypothetical

development determines the value of the developable land.

Whereas the existing residents' profile and incoming prices of the units are known; the analysis of an established retirement village incorporates assumptions on the part of a valuer/analyst:

- The Discount Rate of the DMF business;
- The growth rate of prices of the physical units;
- Take-up rates, turnover periods of residents and rates of sale of used units;
- Refurbishment of units;
- The term of the DCF;
- Estimates of the village life cycle including redevelopment opportunities; and
- Operational factors.

These factors are all interrelated, in that changing one assumption will have a bearing on other assumptions.

While much of the focus has been on discount rates and their movements, the other components can have an equally significant influence on values and returns.

Discount rates

In the late 1990s the main owners/operators of retirement villages constituted the not-for-profit (including religious groups and charities) sector and private operators. In the years 2004 to 2007 significant sales activity occurred in the retirement living sector. Institutions sought to gain a position in this prospective sector and to diversify their existing investment portfolio offerings; furthermore established operators sought to increase market share.

The ready availability and relatively lower cost of debt and equity finance coupled with the bullishness of investor sentiment resulted in tightening of discount rates, and in one case were reported as below 10% for a portfolio sale. Following the GFC, the reduced availability and higher cost of equity and debt finance resulted in discount rates trending upwards in line with other types of investment property.

While the not-for-profit sector still constitutes a significant owner, the seniors' living sector has now been incorporated into the investment property universe and as a consequence its performance can be anticipated to be coupled with institutional investment property.

A retirement village incorporates both an operating business and an interest in the real property which is different from most conventional forms of real property investment. An investor is exposed to this additional business risk, and following traditional portfolio theory would require an additional risk-adjusted return.

There has been limited evidence of "clean" transactions of established villages



taking place since mid-2008; hence the new market level of discount rates has yet to be established.

Growth rates

The "value" and growth rate of retirement village units is primarily impacted by the main catchment area residential market. The majority of residents in any retirement village need to sell their existing home to finance the move.

In Australia in 2007-2008 the residential property market experienced a notable correction with declining sale prices and increased marketing periods. Correspondingly village operators have experienced an increase in vacancy levels, a slowing of the rate at which residents enter the village and greater price sensitivity. This situation cannot be expected to last forever and any DCF analysis in excess of 10 years can be anticipated to have residential market cycles of this nature (although not necessarily of the magnitude recently experienced in some markets).

Longer term average rates of growth do not necessarily incorporate volatility in the DCF, particularly when zero or negative rates of growth can be anticipated in the initial years. These lower initial rates can result in a significantly lower value when compared to applying an average rate of growth across the entire term of the DCF.

Term of the DCF

The returns from an established retirement village are realised when a resident departs and a new one enters the village, "a turnover". At this point the owner receives the DMF plus any share of capital gain in accordance with the resident's contract. The time between individual turnovers and the number per year in a village can fluctuate markedly, therefore for a DCF to represent a stabilised return a cash flow of between at least 25 and 40 years is required.

For traditional property investment, DCF techniques generally focus on a 10-year term, with a terminal value based on capitalisation analysis at the end of the cash flow. With a DCF term of between 25 and 40 years the importance of this terminal value varies.

A longer term DCF changes the emphasis of differing components. The longer the DCF, the lesser importance the terminal value comprises, however the capital expenditure, particularly in the earlier years, to maintain that value assumes greater importance.

The term of the DCF has particular implications with the ageing of retirement village stock; studio and single bedroom units are proving harder (in some cases impossible) to sell to new residents and the situation is anticipated to be exacerbated in the future. Any strategy of remodelling existing units or constructing new units plus paying out departing

residents needs to be incorporated into any DCF analysis.

The failure to incorporate all cash flows, particularly negative cash flows borne by the operator, can result in inaccurate results.

Village life cycle refurbishment and remodelling

Retirement villages are similar to other property assets, in that obsolescence and other age-related factors become more important the older the village. Analysis on the age of retirement village stock across Australia has shown that pre-1980 stock can be anything between at least 10% and 30% of total retirement village stock in that state.

As a generalisation the age of a retirement village is correlated with the size of individual ILUs, where the older the village the higher the proportion of studio and single bedroom units compared to two bedroom plus study, three bedroom and larger units found in many new villages.

Assuming a village is to be retained, accommodating this ageing product within the cash flow requires further strategies to be analysed, namely:

- Retain the units and convert to DMF based serviced apartment accommodation, residential aged care or rental accommodation.
- Demolish or reconfigure older units resulting in newer larger accommodation.

Not only are the majority of the expenses related to these strategies paid by the operator, there is the additional cost of paying out departing or relocating residents all of which is balanced by future contributions from incoming residents or rental income. Furthermore

the community facilities, including the dining and kitchen facilities, may need to be upgraded and this cost incorporated into the analysis.

This activity requires capital which may be met by the sinking fund, however where this is inadequate the operator would need to source new funds. Such capital requirements would also need to be incorporated into the DCF analysis.

The “value” and growth rate of retirement village units is primarily impacted by the main catchment area residential market.

Village life cycle – decommissioning

A further issue with regard to smaller and older villages is their long-term viability. Many of these lack the community facilities now “mandatory” in newer villages and comprise smaller (studio/one bedroom) units. Their ability into the future to continue to attract incoming residents at prices that will maintain the financial viability of the village becomes questionable.

The decommissioning of a village requires paying out the existing residents when they depart (also dealing with the social considerations of increasingly isolated remaining residents), the clearing/cleaning of the site and addressing potential rezoning issues, and the final sale of the land.

In areas where the alternate use may be considerably greater value than the existing village this may result in a positive value. However in instances where the village represents the highest and best use, or an alternate use may not be achievable under existing zoning, determining any residual value may be difficult.

Repairs and maintenance

Repairs and maintenance are paid out of the ongoing retirement village budget, which is met by the weekly/monthly charges (recurrent charges) levied to residents and are essentially run on a break-even basis as the various retirement village acts dictate whether villages may or may not operate at a profit.

In older villagers and those which have extensive community facilities these repairs and maintenance expenses can result in significant service levies.

Retirees generally have fixed incomes and are very sensitive to ongoing charges, particularly whether they are perceived as “value for money” (in their timeframe). Villages with high levies relative to other competing villages may find it difficult to continue attracting residents. This would impact upon vacancy levels and the time between turnovers in a DCF analysis.

Refurbishment

The refurbishment of vacated units becomes a greater issue as a village ages and incorporates carpeting, painting, remodelling of the kitchen and bathroom. This is undertaken at the time of a turnover when the unit is vacant. The residency agreement, contracted when that vacating resident entered the village, dictates the apportionment between the operator and the resident.

Older units require more work of this nature resulting in an increasing real cost in the DCF analysis. Therefore the older the village, the greater the requirement for refurbishment of individual units in order to keep attracting new residents. Inadequate levels of refurbishment would then impact upon incoming prices of units, time taken to attract new residents and capital growth assumptions.

Capital maintenance and replacement

Various state retirement village Acts (and whether the village is strata titled) treat the costing and apportionment of these two components differently. Capital maintenance includes items such as repainting of community facilities, overhauling lifts, hot water services and resurfacing driveways. Capital replacement includes roofing, major plumbing, replacement of lift engines and electrical works.

The degree to which the cost of these items are met by the village sinking fund and the village operator and the ability of either to meet this financial requirement has the potential to become a significant issue as villages age.

Recent trends in the development of

retirement villages can only exacerbate this. Traditionally many villages were single level semi-detached across a large site, however the trend towards higher density retirement living results in a village having a larger number of capital works issues including underground communal car parking, lifts and plant and equipment.

Accounting for capital replacement within the DCF requires an estimate of these future items which may only be identifiable and achievable following inspection by an appropriately qualified building engineer and any due diligence on a village requires obtaining appropriate survey reports.

Sinking fund

The village sinking fund can be used to meet various capital items and state

retirement village Acts address the management and level of contributions differently. Older villages have greater requirements for capital expenses and the ability of a village sinking fund to meet these needs to be ascertained and incorporated into the analysis. Conversely younger villages have a greater period in which to accumulate a sinking fund.

Conclusion

Predicting future events can be problematical, therefore where longer term averages (growth rates, down time between turnovers, vacancy levels, etc) are adopted these need to incorporate the significant variation which can occur in these factors. The nature of the DCF is to incorporate volatile cash flows rather than rely on long-term averages. ■

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EMPOWERING YOUR PROPERTY VALUATION BUSINESS

Unbundling water rights

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This paper was written by a taskforce established by the Victorian Professional Board who have focused on water rights since the unbundling of irrigation water.

The views expressed are those of its authors.

From 1 July 2007 the Victorian State Government unbundled irrigation water from direct property/land ownership.

Water can effectively be held as a chattel item and is not required to be attached to a parcel of land to gain access to same. There is however a limitation as to the amount of total water available to be sold out of an irrigation district. This is for the ultimate protection of remaining irrigators and to reduce the potential of water baron/cartel domination of the water market.

The value of water

Once water became a tradeable commodity during the mid 1990s the use of rural land, the availability and value of water has had a dramatic impact on where and what water usage has occurred. As a result of the continuous dry period, the worst on record, water values have risen substantially. In the mid 1990s the value of one megalitre was approximately \$400/megalitre, whereas today the same is now valued in the range of \$2,000-2,500/megalitre

(permanent). Temporary water (annual use only) has risen from less than \$50/megalitre to peaks of well over \$1,000/megalitre during the 2007/08 season.

The market – water as a separate asset

Markets have changed. The market now analyses rural sales very differently to the traditional method of assessment. Purchasers now consider values of the individual items of the property, such as water – including water holding/amount,



water right

its availability or reliability – water system/tag, total water right available (assuming 100% water right available), the land improvements (including irrigation infrastructure, and land area) and finally building improvements (including dwelling, shedding, and specialised items, i.e. dairy, vines, etc.). This has been a substantial change from the traditional rural market place where the land, its improvements and water were included as one merged value.

The market has now identified that water is a specific, separate item. The recent tagging of water systems now enables the trading of water between the varying systems, subject to the water retaining its original “tag” or water allocation source. Thus its annual allocation reflects the allocation applying in the river from where the water was sourced.

Under the *Water Act* 1999, high reliability water share can be offered subject to a Limited Term Transfer. These fixed term water leases are required if different entities (in common ownership) own land and water (i.e. family trust owns land and farmer’s super fund owns water).

Additional charges to receiving water have also occurred. These include a water share entitlement, delivery share and infrastructure fee – all annual fees associated with the water ownership that must be paid. Some of these annual costs may still be incurred on a property if the total water right is sold. However the subsequent payment of an exit fee (in many districts it is 15 times the current delivery fee) can be made to close the water access to that specific property.

This payment could have an impact on the underlying value of the water and/or the rural property. The delivery share may subsequently have to be re-acquired in the event that an owner wishes to irrigate the property again.

Expertise of valuers of water

Valuers undertaking valuation assessments of irrigation farming properties must be well versed in the needs and requirement of the valuation instruction and specifically address the current entitlements applying to the property, along with identifying applicable levels of value for the various

water sources available (channel, bore, high security, general security, classification and water tagging.) The assessment of the correct level of value for the water must be made – possibly an in situ value or sale value.

Water can effectively be held as a chattel item and is not required to be attached to a parcel of land to gain access to same.

Prospective first mortgage lenders should also be well versed in regards their own lending criteria and the requirement to lodge an interest/caveat on water share entitlements to protect their interest in the asset (land and water). Report documentation should identify levels of value for specific properties (water right) and property components, highlighting and identifying prospective values for these items. That is an in situ value or realisable value if they were to be removed from the property. ■



A literature review on the impact of sustainability on commercial property values

STUDENT PAPER



Teha Hoffman

A student paper presented by Teha Hoffman, of the Faculty of Business and Informatics at CQUniversity. Teha Hoffmann is a cadet valuer at Knight Frank (Cairns).

Introduction

As evidence has become available to show that human behaviour has severely damaged the Earth, the concept of sustainability has grown in popularity. This concept requires a triple bottom line approach to be taken, incorporating economic, social and environmental factors (Boyd 2006a). As a result of this, the market for sustainable buildings has also been growing; however there is a lack of evidence as to the economic benefits of these buildings. Further to this, little research has been undertaken as to the impact of sustainability on commercial property values. There is also a lack of sales and lease evidence for sustainable buildings, with this lack of market data making it difficult for valuers to assess the value of sustainable buildings. Views in the literature also differ as to whether traditional valuation methods are capable of valuing sustainable buildings or if more advanced methods are required.

The benefits of sustainable buildings are generally agreed upon in the different literature and these are identified. The various sources of demand for sustainable developments are recognised as tenants,

the government and investors and these are briefly reviewed. A discussion is then presented where the main findings of the literature reviewed are summarised, compared and contrasted. Finally, limitations of the project and areas for future research are identified.

Implications for the valuation process

Quantifying sustainability

Although there has been increased interest in the concept of sustainability and the relationship between sustainability and its impact on a building's value, there is limited empirical data on the impact of sustainability factors on the economic performance of property assets, and limited sales and lease transactions involving sustainable buildings (Myers, Reed & Robinson 2007 and Boyd 2006a). This poses a problem for valuers in putting a value on the sustainable features of a green building even though the advantages of the building may be significant (Robinson 2009c). It is evident and agreed in all sources of the current literature that there is a need to be able to quantify the benefits of sustainable development and how these are value adding.

Kimmet & Boyd (2004, p.1) stated that "measuring social and environmental metrics of property is necessary for meaningful triple bottom line (TBL) assessments", and that if valuers continued to ignore triple bottom line concerns, their assessments might soon be less relevant. They suggested that



Sustainability factor	Conduit
Building adaptability	Risk premium, cash flow, rental growth, depreciation
Accessibility	Rental growth, depreciation
Building quality	Rental growth, cash flow, depreciation
Energy efficiency	Rental growth, risk premium, cash flow, depreciation
Pollutants	Rental growth, risk premium, cash flow, depreciation
Contextual fit	Rental growth
Waste and water	Rental growth, cash flow, depreciation
Occupier satisfaction	Risk premium
Occupier impact	Risk premium

triple bottom line valuations would be able to benefit from criteria already established in green building codes and further suggested using a star or colour grading in valuation reports similar to the green building codes used. It was, however, acknowledged by Kimmet and Boyd (2004) that there was a lack of corresponding social criteria identified. The environmental performance indicators identified in green building codes for valuers to use included energy, water, waste, transport, materials, emissions and disclosure factors, and it was suggested by Kimmet & Boyd (2004, p.15) that valuers would be able to collate the performance ratings of these to find an average score. A metrics approach that “allows for a graduated assessment of many different criteria” was then suggested to determine how this affected market value with a high rating justifying a premium to the valuation, and a low score having a negative influence on the value (Kimmet & Boyd 2004, p.16). The approach suggested by Kimmet & Boyd is a sound one and by adopting environmental indicators used in environmental ratings it will make it easier to obtain data, keep data consistent and identify how this affects value, as well as being a system that the general public can understand.

Environmental benchmarks include resource consumption of energy, water and air-conditioning, design and use relating to the environment, transport, building fabric and the interior; and governance factors (Boyd 2006a). Proposed social benchmarks include accessibility, health and safety, community engagement, cultural issues, local impacts, stakeholder relations and occupier satisfaction and productivity. The indicators used by Boyd in undertaking this case study are more advanced, as they include a wide range of social and environmental indicators which need to be considered in a triple bottom line assessment.

Ellison & Sayce (2007) undertook a research project to suggest a set of sustainability criteria against which the sustainability of any commercial property could be assessed. They also contended that the main reason for the limited response to the sustainable agenda by the commercial property market was that there was no accepted way of identifying sustainability (Ellison & Sayce 2007).

In order to select their sustainability criteria Ellison & Sayce (2007) used four focus groups of property professionals specialising in valuation and appraisal, with the table above showing the sustainability

criteria selected and their linkage through to value (Sayce, Ellison & Smith 2004, p.227):

The criteria developed by Sayce and Ellison are useful in that the effects of the criteria are related directly and specifically to their effect on components of the existing valuation processes.

The effect of sustainable buildings on value

There are conflicting opinions and evidence in the current literature as to the effect of sustainable buildings on value. Boyd (2006a) agreed with this statement, and asserted that it was important for investors to know what the impact of sustainability measures would be on their return from investment property; however the literature was inconclusive at present.

Boyd examined the research of Kats (in Boyd 2006a) which found that financial benefits of sustainable buildings included savings from lower operating and maintenance costs together with improved productivity and health of occupants. Boyd (2006a) also examined the Sustainable Property Appraisal Project undertaken by Sayce, Ellison and Smith (2004) which adjusted four key variables; being rental growth, cash flow, risk premium and depreciation for various sustainability criteria. The findings of Sayce et al (2004) were that if sustainability was taken into account, the standard appraisal process was currently over-valuing. Boyd (2006a, p.10) however disagreed with this and argued that “the rent currently being paid relates to the existing level of sustainability of the building”. If the building had a higher level of sustainability the rental level may be higher. Therefore it could arguably be suggested that the “less sustainable” building was correctly valued by the market and that a “more

sustainable" building would have a higher value. Boyd's reasoning seems more credible as compared to that of Sayce et al, who are suggesting that the valuation process is currently over-valuing the majority of property.

Parker (2008) cited evidence from the US which shows that sustainable buildings were found to command a rent premium (US \$2.40-11.33 psfpa), have higher occupancy (3.6-4.1%) and sell for more (US\$61-71 psfpa) than non-sustainable buildings, but he was also of the view that there was relatively little conclusive evidence yet to be found in Australia. Other international research examined includes a survey conducted in Canada and the USA showing that green buildings outperformed non-green buildings in areas of return on investment, building value and occupant wellbeing (Miller & Buys 2008).

Moyer (2009) claimed that systems and standards have been developed to measure and classify environmental performance including Australia's Green Star system, however until now there has been an absence of data to provide a link between the effect of environmental ratings on the performance of assets. Moyer (2009, p.53) further discussed results from a study which is claimed to provide the missing link between investment performance and green ratings for Australian office buildings with the findings showing that rental values were increasing faster for buildings with higher energy or water ratings by as much as \$5 and \$6 per square metre respectively more than those with lower ratings. The evidence is said to suggest that sustainable office buildings provide stronger rental growth than less sustainable offices and the findings are also the same for capital values, with values increasing up to almost 14% faster

for sustainable buildings (Moyer 2009, p.53). In addition to this, vacancy rates are also said to be lower for higher-rated offices (Moyer 2009).

Valuing sustainable buildings and the role of valuers

There are a range of opinions in the current literature regarding how sustainable buildings should be valued and the role of valuers in showing the economic benefits of sustainable buildings. With regards to valuation methods, opinions are generally split as to whether existing valuation methods are adequate or new methods need to be adopted.

The RICS (2007, p.6) is of the opinion that "property valuation has a key role to play in transforming existing markets and in demonstrating the added value provided by 'greener' buildings". The RICS (2007, p.7) further maintained that the financial advantages to be gained from sustainable buildings should be demonstrated under the existing valuation models and that the challenge lay in showing how sustainable buildings performed better, not in developing new valuation methods.

Regarding the role of valuers, Armitage (2009, p.10) noted that valuers were bound to comply with *International Valuation Standards* as adopted in Australia by the Australian Property Institute and to reflect the market's interpretation of the impact of sustainability on value which would require valuers to gain an understanding of the principles of sustainability. Armitage (2009, p.11) further stated that valuers would need to broaden their expertise to include an increasing range of triple bottom line issues, and was confident that valuers would rise to this challenge.

Lutzkendorf & Lorenz (2007) maintained that the valuation process had a key

role to play in increasing demand for sustainable buildings though the assessment and communication of their financial advantages and reduced risks. Lorenz (2008a) further asserted that the valuation profession would play a central role in helping make sustainable development mainstream in a number of ways. The first of these was that by incorporating sustainability information into valuations it would help financial professionals to be able to include sustainability issues in property investment and financing decisions. The second of these was by being an independent point for all property-related information. In regard to valuing sustainable buildings, Lorenz & Lutzkendorf (2005 and 2008) suggested that advanced valuation methods such as hedonic pricing worked better than traditional valuation methods.

Benefits of sustainable buildings

General benefits

There are a number of benefits of sustainable buildings identified in the current literature with the most prominent being higher rents achievable, lower operating costs, lower depreciation rates, improved staff productivity and the decreasing value of non-green buildings. These benefits are discussed in more detail below.

Lorenz (2008a) listed the various benefits of sustainable buildings for investors as ranging from improved marketability to longer useful life spans, increased occupant productivity, lower operating costs and more stable cashflows. Quinn (in Madew 2008) stated that applying green principles to the design, construction and operation of buildings could result in huge savings to owners



The atrium of 30, The Bond, Sydney

over the life of the asset as well as improvements in productivity. Drapac (in Robinson 2009a, p.55) stated that sustainable buildings had longer life cycles and reduced valuation risk when compared to non-sustainable buildings, as well as other benefits such as increased productivity, happier work environments and an enhanced corporate image. Myers, Reed & Robinson (2007, p.3) listed the potential benefits of sustainable buildings as being reduced use of natural resources, reduced greenhouse gas emissions, reduced environmental footprint and improved occupant health and comfort. Parker (in Robinson 2009c) identified that non-green stock would become obsolete more quickly than sustainable buildings, and that emphasis should be placed on losses inherent in not going green rather than gains made from going green.

Lorenz & Lutzkendorf (2008, p.489) broadly classified the benefits of sustainable buildings as either financial gains (direct or indirect) or reduced risks. Lorenz & Lutzkendorf (2008, p.489) summarised research available on the benefits of sustainable buildings and conclude that "it is now generally agreed that sustainable buildings are more cost and energy efficient, functionally effective, profitable and marketable than conventional buildings and that

they exhibit increased functionality, serviceability, and adaptability as well as increased comfort and well-being of occupants while at the same time offering loss prevention benefits, risk reduction potential as well as reduced negative impacts on the natural environment". They listed the research by Katz and Kats et al who showed that increases in upfront costs of around 2% resulted in life cycle savings of 20% (in Lutzkendorf & Lorenz 2005). Lorenz & Lutzkendorf (2008, p.490) concluded that "there can be no doubt that sustainable buildings can clearly outperform their conventional counterparts", and pointed out that some banks in Europe now offer better lending conditions for sustainable buildings.

Demand for sustainable buildings

The demand for sustainable buildings has increased considerably in recent years with the main sources of demand being identified in the literature as government, tenants and investors. Most authors seemed to be of the consensus that the majority of demand was coming mainly from tenants. The three main sources of demand are discussed briefly below.

Tenant demands

It is maintained by a number of authors such as Madew (2008), Boyd (2006a) and Myers (2008) that it was the tenant who was driving the demand for, and causing a shift to more sustainable buildings. The *Colliers International 2008 Office Tenant Survey* showed the increasing importance companies and their employees were placing on environmental credibility and sustainable workplaces (Crossley 2009). The survey also showed that the priorities of organisations and tenants now included a strong focus on sustainability with a key driver of this being a sense of corporate social responsibility (Crossley 2009). In addition to this the survey stated that 71% of tenants surveyed "have changed or are planning to implement changes to their workplace requirements to occupy properties that are more sustainable over the three-year period" (Crossley 2009).

Government

It is agreed by a number of authors that governments, particularly in Australia, are having a positive influence on the demand for sustainable buildings. Graves, Swadling & Wigger (2009) stated that many government tenants were now giving preference to energy rated buildings with Madew (2008) further asserting that

governments in Australia were important in leading the market to adopt green building practices with new buildings purpose-built for government tenants. A survey conducted by Ernst & Young (in Robinson 2009c) found that government tenants were driving the demand for sustainable buildings. Myers (2008) was of the view that most sustainable buildings were still being constructed by developers with agreements with governments who were trying to prove the financial viability of sustainable buildings to the rest of the market.

Investor demands

Sustainable property investment was defined by Lorenz (2008a, p.6) as "investing in pursuit of sustainability". It was further claimed by Lorenz (2008a, p.6) that it was becoming more popular as it was now recognised that economic success was linked to environmental and social performance. Drapac (in Robinson 2009a) added that the biggest limitation was a lack of understanding and knowledge, however believed that despite this the market was moving towards sustainable investment. A property investment fund was released by Drapac in Australia in 2008 specifically for rated sustainable buildings with the aim of demonstrating that sustainable buildings would outperform the market over the long term.

Discussion of findings

It can be stated from analysing the literature, that authors generally agree there is an increasing interest in sustainability and sustainable development, and furthermore that there is a need to be able to identify the social and environmental aspects of sustainability and their economic benefits. There is also a general consensus that there are economic benefits from sustainable

buildings and their effect on property value needs to be demonstrated in order for the market for sustainable buildings to really flourish. However, there is disagreement as to how the valuation profession should undertake this task, and if the current valuation methods are suitable and adequate to calculate the benefits of sustainability. There is also disagreement as to who is to blame for the lack of data and evidence available, and exactly what the role of valuers should be in the process.

A number of authors' works were researched to examine whether the

With regards to valuation methods, opinions are generally split as to whether existing valuation methods are adequate or new methods need to be adopted.

impact of sustainability on property values could be measured using the current valuation techniques. Lorenz & Lutzkendorf (2008) explored the concepts of both market value and worth and suggest that advanced valuation methods such as hedonic pricing worked better than traditional valuation methods. Boyd (2006a, p.4) disagreed with the views of Lorenz & Lutzkendorf and stated that the "traditional investment valuation method is capable of assessing the impact of environmental and social factors on the financial performance and that the advanced methods do not replace the traditional approach. When reasonable market data on the impact of the environmental and social factors is available, which is not the case at present, the advanced methods may supplement the traditional method

but they are unlikely to replace it." Sayce, Ellison & Smith (2004) also used traditional valuation methods when undertaking their Sustainable Property Appraisal Project (SPAP) in order to incorporate sustainability factors into calculations of property worth, whereby a series of criteria relevant to sustainability and property worth were identified and then incorporated into a standard valuation model. Reed & Wilkinson (2007b) suggested a triple bottom line approach to considering financial aspects of green buildings and then looked at how sustainability would influence the primary valuation approaches, being the comparison approach, capitalisation approach and discounted cash flow approach. From the literature reviewed, it can be maintained that the traditional valuation methods are adequate and that advanced methods will not replace these approaches. The research undertaken by the authors noted above, and their findings on the influence that sustainability has on value, is examined in greater detail below.

Boyd (2006a) undertook a case study of an office building in Brisbane using the cash flow valuation model to examine if it was capable of determining the triple bottom line measure. The key variables were identified as: the construction cost, the initial rental level, rental growth rate, operating expenses and capital expenses. The case study showed that triple bottom line assessment was achievable with current valuation models; however the difference between returns achievable between sustainable and non sustainable buildings was minimal. Boyd (2006a) did note, however, that in the future sustainability features should provide a better return from investment property taking into account indicators of future demand.

Ellison & Sayce (2007) noted that investors and occupiers needed to understand the range of ways sustainability issues could affect building worth and present a set of sustainability criteria that would help the first stage of this process. The impact of performance under each criteria selected was translated into an impact on property value through changes made in the allowance for rental growth, depreciation, risk and cash flow using a standard valuation approach. A range of buildings was valued with the findings of the research by Sayce, Ellison & Smith (2004) showing that it was possible to reflect sustainability using the cash flow approach and that performance under the sustainability criteria could be reflected in a calculation of worth. They further claimed that the new values produced in the pilot studies showed that the standard appraisal process was currently over-valuing if sustainability was taken into account. This claim can be disputed and Boyd's superior suggestion adopted that the appraisal process was sound and was not overvaluing, but rather that a premium was added on for sustainable buildings.

Lorenz & Lutzkendorf (2005, 2008,) generally discredited traditional valuation methods and contested that as property was changing as a commodity to incorporate sustainable design features in determining value, new methods of assessing worth and value were required. Lorenz (2008a) also talked about a "correction" in property values that would occur when sustainability elements were taken into consideration, and asserted that as environmental and social values were currently not yet recognised by valuers, conventional buildings might be traded at an unjustifiable premium as a result of this. Lorenz & Lutzkendorf generally seemed

critical of the valuation process and believed that valuers should be reflecting sustainability issues in their reports already. However, it could be disputed that a valuer's opinion was meant to reflect the market and be market based, and until data was available valuers could not be expected to accurately achieve this. Lorenz & Lutzkendorf (2008) also believed that until the necessary data to assign a valuation bonus or reduction was available, valuers should still provide a description of the sustainability characteristics of property, an opinion as to their benefits or risk associated with non sustainable buildings, and an opinion on the impact of these benefits or risks on property value.

Valuers could write a section in the valuation report commenting generally on sustainability issues and showing data that is available to date, but conclude that there is not enough information and research yet available to be able to calculate how this affects the value. It is however a dangerous and very subjective area to be asking valuers to comment on how sustainability issues impact on value when they have not yet been advised on how to do this, or been given an accepted method on how these benefits and risks should be taken into account when calculating the value of a property. Once more research has been undertaken and there is more definite information available to valuers it should be included in valuation reports.

With regards to implications for the valuation process, Reed & Wilkinson (2007b) felt that consideration needed to be given to how the level of sustainability affected the value of a property and furthermore how this affected the overall business case for sustainable buildings. Reed & Wilkinson (2007b) suggested a triple bottom line approach

to considering financial aspects of green buildings and then looked at how sustainability would influence the primary valuation approaches. Reed & Wilkinson (2007b, p.214) lastly recommend that a starting point for the valuation process was to consider how sustainability affected depreciation and obsolescence, noting that it was important for valuers to become aware of the relevance of sustainability in the built environment and to factor it into their valuation considerations.

The research presented by the authors above differs in opinion about the impact of sustainable elements on property value, how these elements should be incorporated into valuation models, and whether current valuation methods are suitable for undertaking this task. Boyd's views that a premium will be added on for sustainable buildings and that current valuation methods are adequate to incorporate sustainability are easy to follow and justify. Sayce and Ellison and Lorenz and Lutzkendorf disputed this and claim that the standard appraisal process is over-valuing if sustainability is taken into account. Lorenz and Lutzkendorf further theorised that traditional valuation methods are not adequate to value sustainable buildings and that advanced valuation methods would be more appropriate.

Limitations and future research

Areas for further research

General problems and issues identified by authors in the literature are a lack of direction and guidance for valuers, a lack of sales and leasing evidence on sustainable buildings, and a lack of data showing the economic benefits of sustainable features. Areas that have not been adequately addressed, and research

areas that require further work are summarised below.

Boyd (2006a) recommended that in order to undertake cash flow studies on sustainable buildings, research should be undertaken in the identification and quantification of key performance indicators (KPI) for both environmental and social characteristics as well as the measurement of the impact of the KPIs on the input variables of the investment cash flow study. The most difficult variable to assess was identified as the future rental income because of a lack of market evidence, and Boyd (2006a) suggested that research was required into the willingness of tenants to pay a premium for sustainable space. Myers, Reed & Robinson (2007, p.18) agreed with this view and pointed out areas for further research as being the need for sustainable attributes to be measurable and comparable, as well as a need for these attributes to be standardised so that their impact on value and the influence on sustainability could be given in the valuation equation. The RICS (2007) also suggested that areas of further research should include an investigation on the relationships between economic benefits and environmental and social aspects of building performance.

Little is known about the relationship between sustainability and value and Reed & Wilkinson (2007b) contested that this was for a number of reasons including that most green buildings were government projects, and few green buildings had been sold so it was difficult to determine the associated premium. Myers, Reed & Robinson (2007, p.1) further stated that a lack of sales and leasing evidence for sustainable buildings made it very difficult for valuers to assess the market value of these buildings through current valuation methods. Myers (2008) also pointed out that a lack of

sustainable buildings in any one market and the unique nature of sustainable buildings made it even harder to analyse comparable variables between buildings. These were all identified as areas where further research was required to be carried out.

Conclusion

The importance of sustainability and sustainable buildings has been growing in recent years and there is a general consensus that sustainable buildings provide a number of benefits, however there is currently a lack of data that shows the impact of these benefits on a buildings market value. There is also a lack of consensus as to the identified

In order to be able to measure the economic benefits of sustainable buildings, social and environmental criteria required for this need to be identified.

sustainable elements that should be measured and how these should be incorporated into the valuation process. Although research has been undertaken by a number of authors on the impact of sustainability on a commercial properties market value, there is a lack of agreement at this stage as to how these impacts can accurately be quantified.

This paper has shown that evidence of the economic elements of sustainable buildings is required, as is the need to identify the impact of these factors on a building's market value. In order to be able to measure the economic benefits of sustainable buildings, social and environmental criteria required for this need to be identified.

Literature showed that it was unanimously agreed upon that sustainable buildings had many benefits. The main benefits of sustainable buildings were

identified as including lower operating costs, higher rents obtainable, lower depreciation rates, and increased staff productivity. Demand for sustainable buildings has been identified as coming from three main sources being tenant demand, investor demand and government demand.

At present the literature shows that the effect of sustainable buildings on value in terms of research and data is inconclusive. The literature also shows that the opinions on the role of valuers differ. It is undecided upon what method valuers should be adopting to show the effects of sustainability on value.

A critical review of the literature presented two main approaches to measuring sustainability and its effect on value, being the use of hedonic pricing methods presented by Lorenz and Lutzkendorf's research, in contrast to the traditional valuing methods which were supported by Boyd as well as Sayce, Ellison and Smith. Although Sayce, Ellison and Smith agreed with Boyd that traditional approaches are adequate, they offered the disputable claim that if sustainability elements were taken into account, the current valuation methods were over-valuing.

Despite the different views presented in the literature, there is a real lack of data to back up the different approaches. Because sustainable buildings are relatively new, there is very little historical information to use, and it greatly limits factual comparable data, that can be used to see what the impact of sustainability is on a property's market value. This is the main area that all contributors of the literature would like to see further researched in the future. ■

References are available upon request.
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Working with the Property Law Act: Practical challenges and the impact on commercial leasing

The Property Law Act 2007 has now been in force in New Zealand for more than 18 months and it is time to take stock of the impact it has had on commercial leasing, both in case law and practical changes.

Cancellation of leases

Forfeiture has now been renamed cancellation. Subpart 6 of the Act creates a code as to how leases and licences can be cancelled by a landlord or licensor for breach or an event occurring giving a right to cancel.

To cancel for non-payment of rent, the rent must have been in arrears for not less than 10 working days, otherwise the notice requirements for cancellation of lease for non payment of rent and for breach of other requirements are very similar. The form of the notices and their service are mandatory. Before cancellation of the lease, notice must be served by the lessor on the lessee of an intention to cancel the lease. In the case of non-payment of rent the lease cannot be cancelled until the expiry of the period specified in the notice for which the breach has not been remedied (not less than 10 working days). In the case of intention to cancel the lease for breach of other covenants it must be after the expiry of a period that is reasonable in the circumstances if the breach has not been remedied.

In the case of cancellation for non-payment of rent, if the lessor believes on reasonable grounds that the lessee has given up possession of the premises (whether or not the lessee actually has done so) the lessor does not need to serve a notice of intention to cancel the lease on the lessee but must serve the

notice instead on all of the following whose names and addresses are known to the lessor: any mortgagee or receiver of the leasehold estate, any sublessee of the lease and any mortgagee or receiver of the interest of a sublessee.

Failure to serve notice on these additional parties does not invalidate the notice, but potentially extends out the period when relief from cancellation can be applied for. This has now led to the practice of searching the PPSR for secured chargeholders as part of this process so that these parties may have notice served as well as the tenant of the intention to cancel a lease for breach.

If a notice of intention to cancel the lease for breaches other than non-payment of rent has defects that relate to the issue of the quantum of compensation, this will not invalidate the notice as a tenant can offer an amount it considers to be reasonable compensation for the breach in reply. Reasonable compensation for the breach may include reimbursement of the lessor's reasonable expenses in giving the notice and any other thing done reasonably by the landlord in relation to the breach.

Relief against cancellation or failure to renew

In a recent case a landlord sought an order for possession of leased premises on the grounds of non-payment of rent. The tenant conceded that the rental was in arrears but applied for



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Contents of notices for cancellation of leases

The notice must adequately inform the recipient of:

Cancellation for non-payment of rent – s245	Cancellation for other breaches – s246
The nature and the extent of the breach complained about	The nature and the extent of the breach complained about
The amount that must be paid to remedy the breach	If the lessor considers that the breach is capable of being remedied by: the lessee doing or stopping from doing a particular thing, or by the lessee paying reasonable compensation, or both what they must do or stop doing and the amount of compensation they must pay
The period within which the breach must be remedied (which must not be less than 10 working days after the date of service of the notice)	
The consequence that, if the breach is not remedied at the expiry of the period specified in the notice the lessor may seek to cancel the lease in accordance with s244	The consequence that, if the breach is not remedied at the expiry of a period specified in the notice that is reasonable in the circumstances the lessor may seek to cancel the lease in accordance with s244
The right under s253 to apply to court for relief against cancellation of the lease, and the advisability of seeking legal advice on the exercise of that right	The right under s253 to apply to court for relief against cancellation of the lease, and the advisability of seeking legal advice on the exercise of that right
	The effect of defects not invalidating notices under section 247(1) and (2)

relief against cancellation of the lease under the Act. The judge outlined the relevant legal principles surrounding relief against forfeiture/cancellation. Where the breach is a failure to pay rent, there is a presumptive right to relief on payment of the arrears and costs. This is because it is "inequitable" that the benefit of the lease should be lost to a tenant who has restored to the landlord all that the landlord is entitled to under the lease. The ability to forfeit the lease and take possession is regarded by the court as security for payment. Where a tenant is insolvent, the court will not grant relief as a general rule. Mere suspicion of insolvency is not sufficient to outweigh the presumptive right to relief on payment of rental and costs. This, however, was a case where the tenant sought relief without having paid the arrears. Previous case law had indicated that the court will grant relief only where the money has been paid or there is a high degree of certainty that it will be paid. The judge considered that the fact that a tenant had to borrow money to pay arrears would not in itself mean that relief was denied, but here, there was no evidence to indicate that the tenant would, or had the means to in the future, pay the arrears and costs. It would be inequitable for the landlord to have the tenant "inflicted on it as a tenant on an ongoing basis". The judge was not prepared to grant relief on the facts and on the balance of the above two principles and an order for possession was made in favour of the landlord.

Another case shows the workings of the Act in a judge exercising his discretion to not grant the renewal of a lease when the tenant had failed to give notice to renew six months before its expiry. His Honour stated that the Act has a similar process as under the previous Act, however the court's discretion to grant

relief against cancellation arising from a failure to renew is different from the court's inherent jurisdiction to grant relief where there has been a failure to pay rent. If, after a failure to pay rent, rent and costs are paid up, the court will generally disregard any other causes of complaint that the landlord may have against the tenants.

The judge also described a distinction between restrictions on relief against cancellation for breach of a term of the lease, and relief sought for a failure to renew. Where relief sought is from a failure to renew, issues of breach do not give rise to the right to forfeit and so are not directly in issue. The court's discretion to grant relief remains broad. In this case, His Honour considered that the lessee's behaviour, any purported misconduct and breaches by him or her are all factors the court may consider in declining relief. The judge concluded that there were four serious breaches of the lease by lessee including not using the land for its permitted use and failing to obtain soil fertility tests. His Honour was

also satisfied that there was a particular prejudice to the landlords having a "hostile and uncooperative tenant who is breaching the lease", particularly as the landlords lived in immediate proximity to the land leased by the tenant so contact was inevitable. "I consider that the breaches of lease are sufficiently serious, and the breakdown of relations caused by Sibrad's [the lessee's] conduct so severe, that the discretion to grant relief against forfeiture should not be exercised."

Assignments

After 1 January 2008 where a person accepts a transfer or an assignment of a lease, that person becomes the lessee of the land without the need to acknowledge the lessor as the lessor of the land or take possession of the land. That is, if there is an effective assignment the assignee becomes the lessee of the land.

Where the lessee takes an assignment of the land without the consent of the lessor, in most circumstances there will have been a breach of the assignment

provisions in the lease. The lessor can still invoke its rights under the lease such as peaceably re-entering and cancelling the lease after notice or making a claim for breach of the covenant to obtain consent to the assignment but the assignee in effect becomes obliged to perform the terms of the lease.

The prior tenant still remains liable for the payment of rent and to observe the tenant's covenants in the lease. If the assignee agrees with the lessor to vary the lease, the variation does not increase the liability of the assignor beyond the original liability in the lease at the time of the transfer or assignment, however this does not apply if the lease provided for the variation.

Section 242 implies covenants in every assignment by the assignee with the assignor that rent will be paid, every covenant in the lease will be observed or performed, and an indemnity is provided against all claims and expenses for breaches such as non-payment of rent. This indemnity also benefits the assignor or anyone claiming through the assignor, such as a previous assignor.

Transfers and assignments of lease by previous transferors or assignors prior to 1 January 2008 are also protected by the covenant and indemnity.

Subleases

The Act refers to a "superior lease" instead of a headlease. For all subleases commencing after 1 January 2008 if a sublease for an entire premises is granted for a term of the same length or longer than the headlease it no longer operates as an assignment of the entire rights of the sublessor, so there are no more

With the passage of time it is clear that judges have not taken a radical direction but are interpreting the Act in a similar way to the previous Act.

problems with miscalculation of dates. If the term of the sublease exceeds the term of the superior lease, the term of the sublease will be reduced to expire at the same time as the superior lease. If the superior lease is at a later time extended or renewed, the term of the sublease will automatically be extended and will then expire either at the same time as the extended or renewed superior lease or at the earlier time at which the sublease is already expressed to expire. This does not affect any remedies that might be available to a sublessee as a result of the reduction of the term of the sublease.

Where a superior lease is surrendered for the purpose of entering into a new superior lease, and where the sublease provides that it expires on or before the date on which the term of the new superior lease expires, the sublease will continue as if it had been granted out of the new superior lease except where obligations are more onerous than under the original sublease. This is to allow a new superior lease to be entered into by the landlord without changing the positions of a subtenant. This does not of course allow the landlord to enter into a superior lease that might expire prior to the term of the sublease.

Lessor consent

The Act sets out a process if the landlord receives a request for consent from a tenant relating to an assignment entry into a sublease, parting with possession of the leased premises, a change in the business use from a permitted use, mortgaging the leasehold estate for any part of the premises or for any part of the term of the lease. Consent is not to be unreasonably withheld or delayed by the lessor where the lessor's consent is required. The lessor must give consent within a reasonable time or notify the lessee in writing if the consent is withheld.



Leases may still provide an absolute prohibition of any of the above matters. This may see landlords in a stronger position (particularly in mall retail leases) making absolute prohibitions against changes of use so that these can be dealt with completely at the landlord's discretion.

Circumstances where consent is unreasonably withheld include the lessor requiring consideration to provide consent or seeking to impose on the lessee an unreasonable condition or if the lessee is a bankrupt, is in receivership or liquidation. If the lease specifies the tenant has to pay reasonable expenses on the assignment such as legal fees that is allowed. The lessor must give the lessee reasons for refusal of consent or the imposition of conditions or preconditions if the lessee requests this in writing. If a lessee, assignee, sublessee or mortgagee suffers loss because of a failure of the landlord to provide consent reasonably, that person may recover from the landlord any payment required

to be made to obtain such consent and damages for any loss suffered. Parties cannot contract out of these provisions pursuant to s.229, and any such clauses will have no effect.

Where tenants often fail is that they do not provide enough information to a landlord when requesting consent. In a recent case a tenant sought the approval of the landlord to an assignment of its lease to a proposed assignee. Before making a decision on that request, the landlord sought appropriate details as to the prospective assignee's financial status. The proposed assignee became dissatisfied and cancelled the agreement. The plaintiff subsequently sold the business to another purchaser, but at a price \$42,000 less than had been offered by the initial assignee. The tenant argued the landlord had breached its legal obligations with respect to consenting to an assignment of the lease and issued proceedings seeking to recover the loss on the sale of the business. The landlord took no steps with respect to those

proceedings and judgment was entered by default on 5 November 2008. The landlord then applied for the judgment to be set aside.

There were two questions to be considered. Firstly, whether the landlord had unreasonably withheld consent under the Act? Secondly, if not, did he fail to either give consent or notify in writing that consent was withheld within a reasonable time? The judge held that it was reasonably arguable that at the date the agreement was cancelled the landlord had not declined to give consent, it was still considering whether or not to grant consent. It simply sought alternative security or information following receipt of minimal and unverifiable information concerning the financial circumstances of the assignee. Also, His Honour considered that it would be reasonable to argue that the landlord had not failed to act on the issue of consent within a reasonable time. His Honour held that on the evidence, the defendant appeared to have a substantial ground of defence. Whilst the defendant could not reasonably explain its delay in the matter, on balance the judge was satisfied that the overall justice of the case was that it should proceed to a full hearing in the normal way and the original judgment was set aside.

Conclusion

With the passage of time it is clear that judges have not taken a radical direction but are interpreting the Act in a similar way to the previous Act. Whilst there have been key changes codifying some notices to tenants and the issue of consent being reasonable, as long as care is taken by landlords when exercising powers under leases to comply with the new code they should not run into too many problems. ■



Legal Notebook

Recent cases, headline issues
and new legislation

What duty of care is owed to the mortgagor when the mortgagee is exercising its power of sale?

~ SUPREME COURT OF VICTORIA - COURT OF APPEAL ~

Investec Bank (Australia) Limited v Glodale Pty Ltd & Ors [2009] VSCA 97 (14 May 2009)

The main issue in this case was whether the Appellant ("Investec Bank") as mortgagee in possession had taken reasonable care in ensuring that the respondents' two holiday apartment blocks in Port Douglas were sold at market value. The Appeal Court found that Investec Bank had failed to take reasonable care in ensuring that market value was obtained and dismissed the bank's appeal.

The facts

Investec Bank lent \$11,800,000 to Glodale Pty Ltd ("Glodale") under a Loan Agreement, which was secured by mortgages over two holiday apartment blocks ("the Verandahs" and "the Boathouse") owned by the second and third respondent companies Boz One Pty Ltd ("Boz One") and Boathouse Port Douglas Pty Ltd ("BPD"). All three respondents were corporate vehicles of Mr James Rolfe.

Glodale defaulted under the loan agreement and Boz One and BPD went into receivership. Investec Bank appointed a receiver and manager of the two companies, who in turn appointed Sutherland Farrelly and Ray White Commercial to sell the properties. Tender documents were issued and 18 tenders in total were ultimately received. When the receiver had entered into contracts for the sale of both properties Investec Bank learnt that First Melbourne Capital Pty Ltd ("FMC") had a second mortgage on the subject properties. FMC refused to discharge the second mortgage, preventing the completion of the sales by the receiver. Investec Bank consequently took possession of the properties as mortgagee and adopted the contracts of sale entered into by the receiver.

The properties were sold "in one line", meaning that each property is sold as a whole notwithstanding that the units are held on separate titles. The alternative is to sell the units individually, a process which is known as "gross realisation".

The valuations

The *first valuation* of the two properties was carried out by a Cairns valuer prior to Investec Bank advancing funds to Glodale.

	Gross realisation Current market value	Gross realisation Forced sale value
The Verandahs	\$6,059,455	\$5,453,510
The Boathouse	\$5,135,000	\$4,260,000



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The second valuation was carried out by another Cairns valuer on behalf of Investec Bank, after Glodale defaulted under the loan agreement.

	Individual strata titles Market value	In one line Market value	Forced sale value
The Verandahs	\$6,545,000	\$5,563,250	\$5,563,250
The Boathouse	\$4,860,000	\$4,131,000	\$4,131,000

The third valuation (“the Sutherland Marketing Report”) was provided on behalf of Investec Bank by Sutherland Farrelly, who had been appointed to sell the properties. It constituted more of a marketing report than a valuation. The responsible valuer was experienced as a valuer and agent in the state of Victoria, but he had no qualifications or experience in Queensland. Particularly not in Far North Queensland. The report recommended that the properties be sold on an “in one line” basis.

	In one line – market value
The Verandahs	\$3,750,000 - \$4,250,000
The Boathouse	\$3,100,000 - \$3,600,000

The fourth valuation was undertaken by an expert Queensland valuer, who was called as a witness for the respondent at the trial.

	In one line – market value
The Verandahs	\$5,563,250
The Boathouse	\$5,467,711

The second valuer wrote to Investec Bank informing them that they had been approached by several prospective purchasers since the marketing of the properties had commenced, and that those purchasers intended to sell on the units for profit once they had purchased the properties in one line. The second valuer’s concern about the lack of involvement of a local agent in the sale, and that the third valuation constituted an undervaluation of the properties were also communicated to Investec Bank. The second valuer gave the advice to sell the properties on an individual basis rather than in one line.

Relevant legislation

Section 85 of the *Property Law Act 1992 (Qld)* provides that a mortgagee must take reasonable care to ensure that the property is sold at market value.

“43 In *Commercial and General Acceptance Limited v Nixon (1981) 152 CLR 491* the High Court considered the application of s.85 of the PLA in the context of an assertion by the mortgagee that the advertising of the property

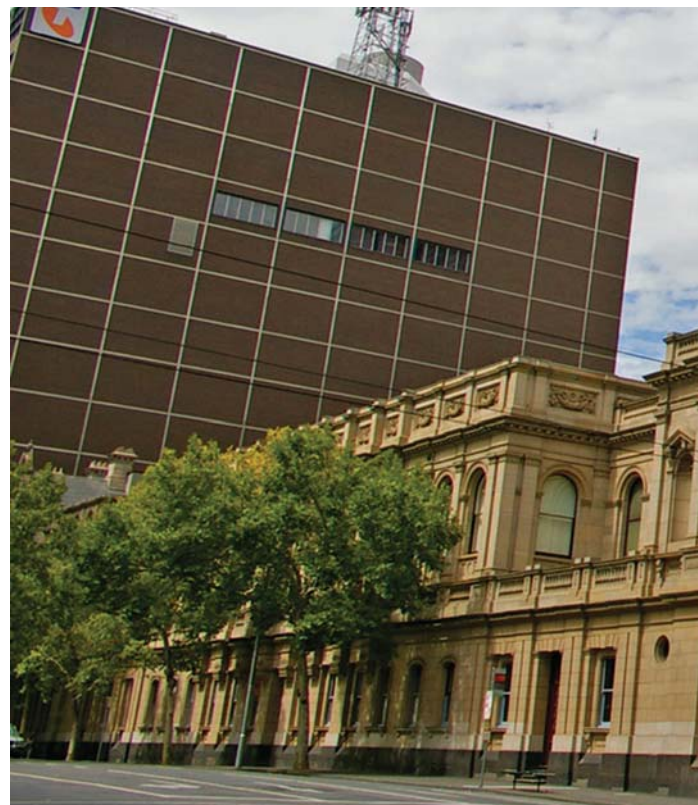
by the mortgagee was unsatisfactory and insufficient and in breach of the duty imposed by the section. Gibbs CJ said as follows [at 494-495]:

Although a mortgagee is not a trustee of the power of sale for the mortgagor, it is nevertheless clear that in conducting a sale of the mortgaged property he is not entitled to sacrifice the interest of the mortgagor in the surplus of the proceeds of the sale. It is equally clear that the mortgagee must exercise the power in good faith.

The duty of a mortgagee exercising a power of sale in Queensland is clear; it is to take reasonable care to ensure that the property is sold at market value ... The duty of the mortgagee is not merely to take care to ensure that the sale is carried out by competent agents. It is to take reasonable care to ensure that the property is sold at the market value.

In that case, Brennan J said of the duty:

*The duty is defined in terms which look to the result of its performance – a sale at market value – and the phrase ‘reasonable care to ensure’ describes what is to be done to effect that result. **The duty relates to the acts which are to be done, not to the appointment of a person to do them.** I would therefore construe s.85(1) as imposing upon*



the mortgagee a duty to do what ought reasonably to be done to ensure a sale at market value, though he is at liberty to perform the duty by the hands of others. **If an omission is made in doing what ought reasonably to be done to ensure a sale at market value, the duty is not performed**, and it is immaterial that the omission was made by another upon whom the mortgagee relied to do it. Although it may have been entirely reasonable – or even necessary – for the mortgagee to rely upon another to do the omitted act, that circumstance does not establish that the mortgagee’s duty was performed [at 521]. (Emphasis added.)”

Section 420A(1) of the Corporations Act 2001 (Cth) provides that a controller must take all reasonable care to sell a corporation’s property for not less than the market value, or for the best price that is reasonably obtainable having regard to the circumstances existing when the property is sold.

The duty under these provisions should be regarded as the same, according to *Fortson Pty Ltd v Commonwealth Bank of Australia & Anor* (2008) 100 SASR 162.

The Court of Appeal findings

The Court of Appeal found that Investec Bank had, in not engaging a Port Douglas agent, failed to take reasonable care in ensuring that market value was obtained for the two properties.

The Court made the following observations in relation to the agent engaged by Investec Bank: “[a] total lack of knowledge of the Far North Queensland area” [at 58]; “[his] failure to carry out any inquiries as to the Port Douglas market before engaging the Cairns agent ... reflects his lack of analysis of what was a highly relevant issue” and that he did not “appreciate that there were two distinct markets; one in Cairns and one in Port Douglas” [at 59]. The Court further noted that “... once it was accepted that the Cairns market and the Port Douglas market were separate and distinct, then there was an obligation cast upon the bank and its agents ... to give consideration to the engagement of a Port Douglas agent” [at 60].

As to whether the bank had breached its duty in selling “in one line” rather than by a gross realisation, the Court referred to the decision of the trial judge and concluded:

“67 The respondents’ contention that a sale in one line was necessarily in breach of the obligation to exercise reasonable care as it produced a lower amount than that which would be obtained on a gross realisation basis cannot be accepted. His Honour was correct in concluding that it was open to the bank to sell in one line provided that the circumstances demonstrated that such a course was reasonable. This is particularly so given his Honour’s finding that the loan was in default, debt was increasing rapidly and there had been a failed attempt to sell the properties. A relevant consideration, unquestionably, was the significant increase in interest (in excess of



\$100,000 per month) with no evidence of the loan or the ongoing payments of interest being repaid absent a prompt sale.

68 There is no demonstrable error in his Honour's conclusion that the method of sale was reasonable in the circumstances."

Once a breach is established the court looks at whether the sale price can be equated with the market value of the property.

"74 ...As Young CJ observed in *Ultimate Property Group Pty Ltd v Lord* (2004) 60 NSWLR 646, 657:

unless it can be demonstrated ... that the property in fact sold for under the market price, it is merely a case of *injuria sine damnum*.

75 In the event that it is established that the property has been sold for under market value the next enquiry is to determine the measure of the loss. In determining the calculation of market value, Courts regularly invoke what was said by Griffiths CJ in *Spencer v The Commonwealth* (1907) 5 CLR 418 [*Boland v Yates Corporation* (1999) 167 ALR 575, [15]]. "What would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not desirous to sell?" [(1907) 5 CLR 418, 432. See also 441 (*Isaacs*)]. Market value is the price that a willing purchaser would have to pay a vendor willing but not anxious to sell in order to obtain the property [*Commonwealth v Arklay* [1952] HCA 76; (1952) 87 CLR 159, 170].

76 The market value is not determined by the nature of the sale. That the sale is conducted by the mortgagee is irrelevant. There can be only one market value. As the Queensland Court of Appeal said in *Emerson v Custom Credit Corporation Limited* (1994) 1 Qd R 516, 521.

The Court specifically rejected the

proposition that in determining market value a Court was to take into account the fact that the subject sale was forced because the mortgagee is always an anxious vendor and a mortgagee's sale is always a forced sale.

77 An issue that arose at the trial and on the appeal was the question of the market value of the property when there were two different modes of selling the property which produced differing estimates of market value, depending on the method chosen. Necessarily, in a case under s 85 or s 420A, examination of the process of sale will be conducted retrospectively. Both sections speak of a market value, not values. The sale of commercial properties may often require a decision to be made as to the appropriate method of sale. As long as the particular process chosen is reasonable, then the market value will be referable to that process. In the event that it is not reasonable, the Court will determine the appropriate process and the consequent market value. In the present case, once it

is determined that a reasonable method of sale as part of the process was to sell in one line, then the market value will be that attainable on such a sale. The converse holds true; if it was determined that a gross realisation mode of sale should have been adopted, then that will be determinative of the market value of a sale conducted in that manner. This is consistent with the proposition that what is in issue, is the process, and it is that process which will determine the market value. It follows that there are not two market values for the purpose of a determination under either s.420A or s.85."

The Court of Appeal rejected Investec Bank's argument that the market value should be determined by the sale price or, alternatively, by the Sutherland Farrelly Marketing Report, and affirmed the trial judge's findings as to market value. Conclusively, the Court dismissed the appeal and remitted the question of the quantum of the counterclaim to the trial judge for assessment. ■



Influence of judicial determinations in property valuations – time to re-appraise Spencer

A heretic's view

By John Lawson of Hamilton Lawson Pty Ltd



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This paper reviews the definition recommended by the Australian Property Institute – that is one that has emerged from judicial opinion, largely from the High Court of Australia in Spencer versus the Commonwealth 1907. The valuation profession through such authorities as Murray (1949) and Rost and Collins (1971) embedded such definitions of value into all valuations no matter what the purpose. This paper attempts to explore the intellectual logic of such extrapolations given that many valuations are, such as valuation for mortgage purpose, an assessment of risk, in which there is anticipation to recover funds by the sale of that asset in the market of which it is a component part.

Introduction

The present global economic crisis has resulted in falling prices in real estate, creating implications for financial institutions that will eventually provide a compelling environment to review the fundamentals of valuation principles and practice.

This paper will examine the universal application of the market value definition recommended by the Australian Property Institute "... the estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion".

The logic of such a universal application of such a definition needs to be examined testing linking of purpose, methodology and assessment given that a valuation for mortgage purpose is an assessment of risk where there is in anticipation of a need to recover funds by sale.

A study of valuation literature will reveal that the influences that shaped valuation principals and practise can be categorised into process, economic change and judicial opinion.

Process

Methodology and, as a consequence, education has largely been extracted from process. What was observed in field practise found its way into lectures and valuation literature (Boykin and Ring, 1993). Over the years valuation procedure and methods of assessment have been presented to courts where a dispute has occurred under legislation where the courts reviewed and weighted valuation methods and gave opinions as to their appropriateness. Authorities within the profession have reviewed the judicial process as appropriate intellectual testing leading to validation.

Economic change

Every economic crisis has brought about a review into reasons why real estate assets were over-valued.

This is the first of two articles in this edition's Real Time section that aim to generate debate within the property professions. In this article John Lawson questions the applicability of the High Court's Spencer test in a range of scenarios, ultimately questioning why the valuing profession adopted the test for all valuations regardless of purpose. The views expressed are those of the author.

The Great Depression of 1929-1933 had a profound influence on appraisal thinking in the USA. The method of valuation employed at that time was to use recent comparable sales that were themselves highly inflated, resulting in overblown valuations that further assisted in ratcheting up prices. During the Great Depression 40% of the USA's residential mortgage loans fell into default (US Federal Reserve Bank), culminating in many banks being insolvent. With banks failing to recover funds by forced sales in non-existent markets a need transpired to reassess appraisal thinking. This allowed the valuation process to include methods that anticipate the return of markets to a state of equilibrium.

Comparable sales method had clearly failed in erratic market conditions. Methods were needed that would justify lending insulated from volatile conditions

to justify the advancement of funds thereby simulating demand in residential markets and assisting recovery of the national economy.

As part of this process Babcock (1932) adapted Fisher's theory (1892), that value is the present value of the future financial benefits that accumulate to an owner and also argued for the application of the replacement cost method. However both methods are underpinned by normative economic theory. It was at this time that the three methods, sales comparison, investment value and cost were formalised into valuation practice, as was the definition of "fair market value".

Wendt's (1974) observations of Babcock's contributions is that Babcock blurred the debate by extrapolating normative methods of valuation designed for unusual economic conditions into markets that were in a normal state of long-term adjustment to equilibrium. Wendt argues that those who supported Babcock's concepts influenced the American Institute of Appraisers to adopt a normative position in the definition of value. Boykin and Ring (1993) refer to this as a "freezing of appraisal thinking during attempts to raise appraisal standards with an aversion in appraisal thinking to depart from dogma" (p. 27).

In the period of 1989-93 when price and rentals fell for most real estate markets by margins up to 40%, underwriters of professional liability for valuers started to question the skill and competency of those engaged in valuations.

Judicial influence

Under various state and Commonwealth legislation governments have the right to acquire real estate but have an obligation to pay compensation and "just terms". This term had its origin in Greek philosophy and writing and from this concept

evolved the "just price" in Roman law in 186BC. It was believed price should relate to quality, creating a distinction between value in use and value in exchange.

The definition of value adopted by the Australian Property Institute emerged from judicial opinion, largely from the High Court of Australia in *Spencer verses the Commonwealth* 1907 and one promoted by both Murray (1949) and Rost and Collins (1972). Here the court sought to resolve a dispute in a resumption of land case as directed by the legislation on "just terms". By necessity such definitions must be embedded in normative economics by seeking the most advantageous circumstances that an owner is likely to enjoy, that is, what it should be as opposed to what it is or reality. Therefore a normative definition of value excludes the recognition or existence of risk. The presence of risk in valuations in the recovery of funds was ignored by Rost and Collins (1971) who stated: "The concept of value accepted

for statutory purposes and for most other purposes is that authoritatively formulated by the High Court of Australia in *Spencer v. The Commonwealth*" (p.31). This mindset was further reinforced in the publication of *Valuation Principles and Practice* by the Australian Institute of Valuers and Land Economists (now API) in 1997: "This judicial commentary is viewed as being an essential part of valuation knowledge" (p.1), and Alan and Walker (2007) who state: "The *Spencer Case* is an impregnable fortress of judicial wisdom which continues to be applied today because in the 100 years since it was formulated no judge, barrister, academic, valuer or politician has been able to improve upon it. For every valuer, the *Spencer test* remains as the only complete answer to that most frequently encountered and difficult questions: what is the market value of this property? As a profession, we should metaphorically charge our glasses to *Spencer* and 100 years of good law".



The perception that the courts had some mystical authority to determine a universal value definition for all purposes has never been explained nor justified but is likely responsible for deflecting an understanding of the rationale of economic theory in the prediction of price. Smith (1986) makes the observation that there are inconsistencies in underlying appraisal (valuation) theory as does Dotzour, Grissom, Lui and Pearson (1990). Kummerow (2000) suggested that the underlying problem is the difficulty of making a confident prediction of price in an inefficient market.

The courts and valuers had a common problem with imprecise information compounded by different circumstances under which transactions took place. The courts resolved this problem by defining various definitions predicated on a normative economic environment that met the requirements of legislation that required the courts to find value to the disposed owner on "just terms".

Additionally, where the price prediction models produced irreconcilable results the courts had no option but to refer to a valuer's assessment as an opinion, and one that the profession was willing to endorse as a principal of valuation. In embracing this view, both the courts and profession recognised the degree of difficulty in predicting price in an imperfect market. Radcliff (1972) promoted recognition of the reality of imperfect markets by adopting the concept of "most probable price" but this has been continually rejected in Australia.

In early legislation courts found a need to interpret sections of some Acts requiring assumptions to be made. Hyam (1997) provides an example in the deliberations of the Privy Council in the Minister for Public Works v Thistlewayte, where their

Lordships take into account abnormal circumstances in which land was being acquired when the price of land was subject to government controls. These assumptions are often articulated as concepts such as the "willing buyer, willing seller", and are used to achieve the intention of the relevant Act and allow the judiciary to arrive at a determination that provides a logical progression. Such concepts become precedents referred to in later judicial deliberations, reinforcing their adoption. Hyam (1997) refers to the deliberations of the High Court (Commonwealth v Arklay) in which Dixon CJ, Williams and Kitto JJ state: "It is a familiar rule which in Australia was authoritatively formulated in Spencer's case (1907)" (p.309).

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The Spencer Case

The case of Spencer v The Commonwealth in the High Court of Australia (1907) was a dispute concerning the amount of compensation payable when the site was compulsorily acquired by the Commonwealth.

The Court was required to decide compensation on "just terms" and in doing so arrived at the "Spencer" definition of "fair market value". The perception is that this concept was unique to Australia. The concept had its beginnings in the Middle Ages previously referred to as "found in the doctrine of justum pretium". Some of the first recorded cases to refer to the concept involved compensation cases in the USA in 1892.

The Spencer case centred round a wide discrepancy in the amount claimed and the valuation principles from which the assessment was made to arrive at "fair market value". Spencer's first application, made in 1905 to the High Court of Australia before Mr Justice Higgins heard evidence of values from \$4,000 to \$16,800. These variations resulted from a dispute as to the most appropriate site use ranging from industrial to residential. Justice Higgins awarded compensation of \$4,500 which Spencer appealed in 1907 before Chief Justice Griffith, Justices Barton and Isaacs. In their deliberations the Justices adopted a number of concepts with the definition of "value" being central. Taking place was the first debate in Australia on the question of value and by extension market value. Griffith, CJ, questioned whether Justice Higgins had properly addressed this issue and the following quotes became recognised as giving the test of fair market value.

Griffiths, CJ, wrote: "In my judgement, the test of value of land is to be determined. Not by inquiring what price a man desiring to sell could actually have obtained for it on a given day, i.e., whether there was, in fact, on that day a willing buyer, but by inquiring: 'What would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not desirous to sell?'"

Isaacs, J., elaborated this test: "To arrive at the value of the land at that date, we have, as I conceive, to suppose it sold then, not by means of a forced sale but by voluntary bargaining between the plaintiff and a purchaser willing to trade but neither of them so anxious to do so that he would overlook any ordinary business consideration. We must further suppose both to be perfectly acquainted with the land and cognisant of all circumstances which might

affect its value, either advantageously or prejudicially including its situation, character, quality, proximity to conveniences or inconveniences, its surrounding features, the then present demand for land, and the likelihood as then appearing to persons best capable of forming an opinion of a rise or fall for what reasons so ever in the amount which one would otherwise be willing to fix as to the value of the property”.

In another part of the judgement, Isaacs J. stated “that regard must be paid to the most advantageous purpose for which the land was adapted”.

Cases involving negligence

In court cases involving negligence none discussed the question or definition of market value, although in *Inez Investments Pty Ltd v Dodd* April 1981 (see Hyam) reference is made to the Spencer in the context of “fair market value” and the use of sales as “prima facie” evidence.

Nevertheless it is interesting that a number of court cases refer to the principal of an “acceptable margin of error”, *Sutcliffe v. Thackrah* [1974] 1 All ER 859: “Valuation of land by trained competent and careful professional men is a task which rarely if ever admits of precise conclusion so there is an acceptable margin of error.” The interest is that it would seem to imply that the courts have adopted the concept of an imperfect market.

In a later UK case, *Singer & Friedlander Ltd v John D Wood & Co.*, in the Queen’s Bench Division, 3 June 1977, Justice Watkins found the following: “As Mr Ross said, valuation is an art, not a science.” The judge goes on to state: “Pinpoint accuracy in the result is not, therefore, to be expected by he who requests the valuation. There is, as I have said, a permissible margin of error, the ‘bracket’ as I have called it. What can

properly be expected from a competent valuer using reasonable skills and care is that his valuation falls within this bracket. The unusual circumstances of his task impose upon him a greater test of his skill and bid him to exercise stricter discipline in the making of assumptions without which he is unable to perform his task; and I think he must beware of lapsing into carelessness or overconfidence when the market is riding high. The more unusual the nature of the problem, for no matter what reason, the greater the need for circumspection.”

Here the judge acknowledges that “pinpoint” accuracy is an unreasonable expectation and a valuer should possess skills based on an art, not those developed scientifically, to make a prediction that falls within the bracket.

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However the justice believes the valuer should be cognisant of prevailing market conditions and the likelihood of these conditions to be sustained or to change.

In the Royal Commission into the Finance Broking Industry 2000, Ian Temby QC makes a comment under General Conclusions:

7. failure to adequately state the risks associated with the development projects that could result in the stated value not being realised;
8. statements regarding present or anticipated market conditions or likely demand that were unsupported by any stated evidence; (P.333)

Mr Temby considers it is one of the duties of a valuer, when valuing for mortgage purposes, to bring to the

client’s notice the level of risk that debt funding could encounter or a change in market conditions that could threaten the recovery of funds.

Consequences of the Spencer Case

Judicial precedents became established principles which valuers were obliged to embed into their definition of value if they wished to gain the support of courts in cases involving a dispute over compensation. It was these judicial concepts that were incorrectly adopted as the intellectual anchor of valuation principles throughout Australia for all valuations regardless of purpose. Bonbright (1937) recognised that it was a distortion to extrapolate a set of judicial opinions formulated for resolving a dispute on just terms into an environment where the purpose is different, such as the recovery of funds. Whipple (1995) refers to this as failure by valuers to understand the role of the courts and to both comprehend and distinguish the difference between normative economics and positive economics.

The normative definition of “fair market value” fails to recognise the probability of the predicted price being realised and fails to communicate the inherent risk to the client. This lack of acknowledgement fails to transfer the risk to the provider of the debt, which consequently remains with the valuer and the valuer’s underwriter of professional indemnity.

The perception in Australia that the concept of “willing buyer, willing seller” emerged first from the Spencer case is incorrect as evidenced by Bonbright (1937) who refers to court cases in the USA as early as 1892 with *Kansas City, Wyandotte & Northwestern R. R. Co. v Fisher*, 40 Kan. 17 at 18, 30 Pac. 111



(1892). Plus in 1908, *24 Calor Oil & Gas Co. v Franzell*, 128 Ky. 715 at 735, 100 S.W. 328 at 333 1908. With regard to “willing buyer, willing seller”, the concept is referred to as a judicial test of value.

Bonbright (1937) puts the proposition that the concept of “willing buyer, willing seller” is an attempt to bridge the gap between market price and value to the owner as it hypothesises that the seller can find a “willing buyer”. It also makes the assumption that one buyer and one transaction constitutes a market.

The application of the “willing buyer, willing seller” concept was ridiculed by a number of American justices. In 1917 Justice Rose in *McGill v Commercial Credit Co* referred to: *“The effort is to find out not what a real buyer and a real seller, under the conditions actually surrounding them, do, but what a purely imaginary buyer will pay a make-believe seller, under conditions that do not exist. You are forced to wonder what would happen if everything had been different from what it was. It is not easy to guess what will take place in Wonderland, as other people than Lewis Carroll’s heroine have found out.”* Again in 1934 in *Helving v Wilbridge*, Justice Learned Hand ridiculed the “willing buyer, willing seller” test. The judiciary in the USA came to an earlier understanding by shifting the focus away from the “willing buyer, willing

seller” test to “value to the owner”. The British were also debating value test and concepts. In 1918 the Ministry of Reconstruction in a Second Report of the Committee dealing with the Law and Practise Relating to the Acquisition and Valuation of Land for Public Purposes had adopted the American standard of “willing buyer, willing seller” then debated the preference of “full compensation” using the concept of “value to the owner”.

Extrapolation by Valuation Authorities

Murray (1949) personifies the perception of a theory of value as one that evolved from the courts. Murray’s extrapolation was to become absolute for all valuations regardless of the intended purpose. Rost and Collins (1971) further reinforce this perception. It is reiterated in recent times by the Australian Institute of Valuers and Land Economists (now API) in their publication *Valuation Principles and Practice* (1997) and McNamara (1997) who dismissed the growing research in the US as a deflection; promoting the embodiment of legal precedent as providing guidance to consistent disciplined methodology in valuation. McNamara is challenged by Achour-Fischer (1999) who contended that the US has provided the majority of intellectual input into the profession over

the previous five decades, beginning with Ellwood (1947) who integrated modern financial models from other disciplines into the valuation profession.

Murray (1949) argued for a need to adopt judicial opinion, rather than neoclassical economic theory in order to underpin any working theory. Since the inception of the valuation profession in Australia, Murray’s work has had a profound influence; his publication was used as the primary text in Australia until the 1970s. His perception of a theory of value continues to dominate today. Given its dominance, it is appropriate that Murray’s work be reviewed in detail. It provides a description of the arguments within the debate that was in common with the USA and UK debates.

Murray’s promotion that courts formulated valuation theory confuses the role of a theory of value and a valuation theory. Murray quotes support from Friday (1922) who argued that the market was not the determiner of value, and that the mechanisms of the market were inferior to the practical workings of the court.

Murray (1949) equivocates, stating that if economic analysis is to be in touch with reality then attention must be given to empirical verification, particularly in the fields where effective analysis is possible. It appears that in this instance Murray



accepts that if measurement is possible, then empirically based valuation theory could be developed. In examining the concepts of value and price, Murray (1949) refers to a debate between Cassell (1924) and Edgeworth (1924). Murray aligns himself with Edgeworth's normative economic theory of value, dismissing Marshall's contribution and that of subsequent schools of economic thought. Murray's position is amplified when he states that "... the theory and practice of appraisal owes little to economics and much to jurisprudence". (p. 90)

Murray, in contrast to Bonbright (1937), failed to acknowledge that the courts must adopt a number of assumptions in order to meet the criteria of an Act and therefore required to make decisions, requiring substantial value judgements that are not necessarily underpinned by theory. For instance, a court criterion is to make a just and/or equitable decision normally based on the legal concept of "fair market price", often to a dispossessed owner (e.g., James v Swan Hill Sewerage Authority, cited in Hyam 1998), where the court is required to find value to the owner:

Critique

Whipple (1995) was the first to carry out any insightful analysis of the judicial deliberations of the Spencer Case. In

his analysis Whipple states that it was never the intention of the High Court for the Spencer Case to be used as a value definition. Whipple contrasts the need by the court to find compensation in a pragmatic manner based on a range of hypothetical assumptions to achieve a result as defined by the relevant Act. However Whipple cites the problem as a failure by the profession to recognise: *"When definitions are cited approvingly by the courts, the rule of precedent sets them in stone so that they pass unchallenged. The upshot is their adoption by habit rather than by analysis."* (p. 83) Hyam (1997) also appears to be aware of the problem where he offers an interpretation in regard to the Spencer case (1907): *"That the expression used by the members of the high court in that case was 'value' not 'market value'."* (p.309) There is evidence that the judiciary seeking to act equitably to a dispossessed owner, must assess value to the owner as opposed to market value. Further in his interpretation of the judicial deliberations in the Commonwealth v Arkly, Hyam (1997) concludes that: *"It will be seen in this passage the High Court treated the test laid down in the Spencer's case (1907) 5 CLR 418 as being an appropriate test to determine 'the value of land to the owner'."* (p.309) It would appear there were some debates within the judiciary as to how to arrive at value to the owner within the interpretation of various acts. Hyam

draws attention to the consequence of different provisions in various acts where acts specifically provide a delineation of component of value that when totalled allow the courts or the minister to provide for value to the owner:

Whipple examines the logic of Griffith, the Chief Justice, as articulated in his deliberations and finds that Griffith was satisfied that the amount awarded by Justice Higgins represented the market value of the land acquired. But Whipple interprets Griffith's later comments as not being satisfied that the question of value was addressed. Whipple's conclusion on this point is that what Griffith is seeking is an assessment of value as interpreted by the need to compensate.

In his examination of the tests applied by the three justices in the Spencer case, Whipple uses the economic template of normative economics verses positive economics. Whipple concludes that the definition of "fair market value" used by the justices was a mixture of both normative and positive definitions but with the weight of tests falling into the normative economic theory. It would be unfair to imply a criticism of the justices using such an economic template by which to judge their decision, as they had inherited an agenda set by legislation. However Whipple observes that the *"failure [by the valuation profession] to distinguish between normative and positive economics definitions of value has arguably caused as much mischief in valuations as Keynes attributes to economics."* (p. 83)

It is important to note that the valuation profession has made no response or given any recognition of Whipple's critique. Whereas Whipple's criticism is based on economic grounds Bonbright's was on the intellectual corruption between definition and purpose.

In fact, Bonbright highlighted the limitations of adopting a subjective approach to valuation. Bonbright is unequivocal in drawing a clear distinction between a judicial need for fair price and market value. *“The very fact that an intelligent valuation of property is out of the question without reference to the purpose for which the valuation is desired, indicates that the major task of developing the legal theory of valuation rest with specialist [valuers]”* (p.7) Here Bonbright not only recognised a need for different value definitions for different purposes, but appealed to all that it is critical. Bonbright is far from promoting a legal definition of value as a generic theory of valuation, witnessed by his discussion of concepts of marginal utility, and debating the distinction between “market value” and “exchange value”.

Accuracy

In a compensation dispute the courts require a single point estimate, however the courts acknowledge that such accuracy is unrealistic. Notwithstanding, the API market value definition does not signify a range of possible price outcomes. Consequently the inherent difficulty in a valuer’s task in making a precise prediction from implicit information gathered from an imperfect market is not communicated.

Price will vary according to the perceptions of buyers and sellers of a property’s position in a market. These perceptions will be influenced by the nature and composition attributes, prevailing economic condition and the history of recent price behaviour, creating a situation where a property has a price range in which a number of probable prices exist. Given these considerations, the question to be addressed is the degree of accuracy that is possible. This

question is a vital one as the potential for financial loss is considerable when the volume of valuations and the amounts involved is contemplated. Therefore the question of accuracy must also be a risk component.

The need for accuracy necessitates measurement and by implication a benchmark expectation of accuracy posing further examination of what is the incidence of inaccuracy and why inaccuracy occurs. Although the courts view valuations as an opinion they have attempted to grapple with the question of accuracy. In the benchmark case *Singer & Friedlander v John D. Wood* (1977) 2 EGLR 84, Watkins J. refers to the permissible margin of error being 10% either side of a value that may eventuate. Outside such judicial processes the question of accuracy has created little debate or research in Australia, with most of the debate centring on the standards, methodology and quality of reports.

Some academic studies have sought to define the level of expectation in the question of accuracy. Parker (1998) refers to an industry survey in which the users of valuations indicated that an error level of 5-15% was realistic. The measurement of accuracy of valuations is fraught with problems including, but not exclusively, the choice of methodology, time when the valuation was completed, changing market dynamics including its depth and resilience or lack of, and constant shifts in equilibrium. In Australia there appears to have been only four studies that had any statistical basis to their analysis of valuation accuracy, e.g. Newell and Kishore (2002); Parker (1998). All studies were exceedingly limited and highly qualified, none was holistic and consequently could only give a hint as to the accuracy of valuations. In the area of absolute percentage difference an average

inaccuracy of greater than 10% over the 10 years of some 34%.

Possibly the most indicative analysis was by IPD/Drivers Jonas UK in a study conducted over the period 1988 to 1997 indicating the following results;

Table 1 Drivers Jonas Results:

% Variation	% in that variation
+/- 10%	30%
+/- 20% (including the above 10%)	67%
Greater than 20%	33%

Source: Crosby (1999) Valuation Accuracy, variation and bias in the Context of Standards and Expectations (p.15)

Matysiak and Wang (1995) carried out a study using 317 properties selected at random with transactions between 1973 and 1995 with valuations taking place six months prior to the sale. These results were;

Table 2 Matysiak and Wang’s Results:

Average undervaluation	21.1%
Average overvaluation	11.5%
Absolute error	16.7
Average error	6.9%

Source: Matysiak and Wang (1995) using database of JLVW

The studies referred to would tend to indicate that there is an expectation of a level of accuracy of between 5% and 10% but this perception is at variance to the results of limited research which indicates a wider margin of error. Although this area of research into valuation accuracy is extremely limited and demands more attention, what research there is indicates that accuracy in valuation is problematic. Such a conclusion calls into question

the use of single estimates. In addition, research on standard of skills and the quality of valuations must shift some valuations into the area of risk.

Conclusion

Any value definition that includes the tests of "fair market value", "willing buyer, willing seller" and "perfectly acquainted" is inappropriate if the purpose of the valuation is to anticipate recovery of funds by a market transaction. These tests embedded the definition in normative economics and therefore exclude the recognition of risk and create an intellectual corruption between the definition and purpose.

In addition the definition requires a single point assessment, however the accuracy of such predictions has never been demonstrated, but defence offered is that a valuation is an opinion. What research is available indicates that single point predictions are highly unrealistic and the courts recognise that a margin of error is realistic. The status of opinion must carry with it the recognition that there is a high probability of a number of outcomes.

The status that any assessment is an opinion avoids any empirical reconciliation as is the resulting prediction. This status deflects the application and benefits of empirically tested price prediction models. Statistical analysis provides probability measures that would allow the prediction of price to move away from an opinion to a prediction accompanied with a probability reflecting market risk.

The question to be asked is: Why did the valuing profession adopt the court's tests for "fair market value" as formulated by the justices in Spencer for all valuations regardless of the purpose. As has been shown, authorities such as Murray (1971), Rost and Collins (1975), the Australian

Institute of Valuers and Land Economists (now API) publication *Valuation Principles and Practice* (1997) have promulgated the adoption of such tests of fair market value. In recent times Allan and Walker (2007) in the *Australian and New Zealand Property Journal* – in an article on 100 Years Since Spencer with the sub-heading *Case was decided: Still Good Law* (p.174) – have supported the continuation of such a test.

There is no satisfactory answer to this question except the speculation offered by Greer and Farrell (1983) who suggest that the "defenders of the traditional definition find solace in its having been generated by the courts." (p.329)

A possible historic or cultural explanation stems from the elevated status of valuations commissioned for both taxation and compensation disputes as it would only be in a judicial setting that those definitions and the methods of assessment would be tested. No other form of examination existed and the results would be widely reported within the profession. Judicial procedure and precedence provided an intellectual structure on which the profession could build an educational process that had the imprimatur of legal authority providing a perceived legitimacy. ■

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By Mark McNamara



Introduction

Over the past two decades there have been a plethora of articles, academic comment and industry feedback as to the nature, appropriate analysis and meaning of capitalisation rates. It's fair to say the valuation community has come a long way in adopting sophisticated analysis and accepting more in-depth analysis of investment sales. That said, it is the writer's view an understanding of the nature of yields is lacking.

This paper aims to examine the nature of contemporary yield analysis of the valuation profession in New Zealand. The major firms use the equivalent yield as a basis for sales analysis and valuation of investment property. An examination of the equivalent yield is called for: What is an equivalent yield? What are its implicit assumptions and is it logical? Why have practitioners embraced its use and should it be used at all?

These questions are probed in this paper and an alternative approach will be suggested that is not new, pioneering or out there. Rather it has fallen on deaf ears and needs to be given attention.

What is an equivalent yield?

The internal rate of return computed from an income stream which is not adjusted for inflation or deflation is termed the equivalent yield. To understand what this means an example is illustrated. This example forms the basis of most contemporary yield analysis and valuation in New Zealand by major firms.

A suburban shop investment was leased in 2008 on a six-year lease with three-yearly reviews at an initial ratchet

(upwards only from the rent set at the commencement date) review at \$50,000 pa. The market rent has risen to \$60,000 pa in 2009 and the property has just sold for \$650,000. What is the equivalent yield?

The answer can be approached from two standpoints. Firstly, the Layer approach consists in finding the capitalisation rate of the term rent in perpetuity. The rent increment due in two years' time (called the "top slice") is capitalised at the same rate in perpetuity and is deferred for the period of the term:

Layer Approach	
Net Contract Income	\$50,000
PV perpetuity @ 8.99%	\$556,328
Plus Shortfall	\$10,000
PVI perpetuity @ 8.99%:	\$111,266
deferred 2 years @ 8.99%	\$93,672
Capitalised Value (before costs)	\$650,000

Secondly, the Rent forgone approach could be applied. Here the market rent is capitalised in perpetuity. From this is subtracted the present value of the rent forgone. Again the equivalent yield is used throughout:

Rent Forgone Approach	
Net Market Income	\$60,000
PV \$60,000 in perpetuity @ 8.99%	\$667,594
deferred 2 years @ 8.99%	\$562,030
less	
PV \$60,000, 2 years @ 8.99%	\$105,565
Shortfall	-\$10,000
deferred 2 years @ 8.990/0	-\$17,594
Capitalised Value (before costs)	\$650,000

Because the same rate was used for each component of the income stream, both approaches give the same result. To solve the equivalent yield, an iterative procedure must be adopted to determine the rate that equates to the sale price.

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This is the second article in this edition's Real Time section that aims to generate debate within the property professions. In this article Mark McNamara argues for growth explicit models to be incorporated into an overhaul of the bases and methods the valuation profession uses in dealing with the complexities of evolving property markets. The views expressed are those of the author.

What are its implicit assumptions and is it logical?

Baum and Crosby make the following observation regarding the equivalent yield:

"This illustrates that the equivalent yield model operates under a no growth assumption; but low initial yields imply growth, so the model is irrational. The lack of a logical basis requires the valuer to manipulate equivalent yields in the valuation stage for the non perfect

Four-year term case:

Layer Approach		Rent Forgone Approach	
Net Contract Income	\$20,000	Net Market Income	\$20,000
PV perpetuity @ 8%	\$250,000	PV \$20,000 in perpetuity @ 8%	\$250,000
Plus Shortfall	\$0	deferred 4 years @ 8%	\$183,757
PV perpetuity @ 8%: \$0		plus	
deferred 4 years @ 8%	\$0	PV \$20,000, 4 years @ 8%	\$66,243
		Shortfall	\$0
		deferred 4 years @ 8%	\$0
Capitalised Value (before costs)	\$250,000	Capitalised Value (before costs)	\$250,000

Fifteen-year case:

Layer Approach		Rent Forgone Approach	
Net Contract Income	\$20,000	Net Market Income	\$20,000
PV perpetuity @ 8%	\$250,000	PV \$20,000 in perpetuity @ 8%	\$250,000
Plus Shortfall	\$0	deferred 15 years @ 8%	\$78,810
PV perpetuity @ 8%: \$0		plus	
deferred 4 years @ 8%	\$0	PV \$20,000, 15 years @ 8%	\$171,190
		Shortfall	\$0
		deferred 15 years @ 8%	\$0
Capitalised Value (before costs)	\$250,000	Capitalised Value (before costs)	\$250,000

comparison. The manipulations necessary are difficult intuitively and become increasingly difficult as the comparables get less perfect. Without manipulation, the equivalent yield model gives almost no help to the valuer"

To illustrate the point, take two properties let at their market rent of \$20,000 pa. One has a rent review due in four years' time; the other has a term fixed at 15 years. A physically similar property was sold for \$250,000 which is an equivalent yield of 8.00%.

The valuations are identical despite the fact that, in a growth situation, the first property is much to be preferred. Clearly, the equivalent yield used with the longer-term period should be adjusted – but by how much? In the absence of a transaction which is comparable, the required adjustment can only be made intuitively.

Why have practitioners embraced its use and should it be used at all?

The equivalent yield is appealing because one rate is applied through both fixed term and perpetual income streams in the

calculation. This aspect seems to simplify the analysis because there are fewer variables to consider. Is this a reason to adopt its use? The writer's view is unequivocally no. The foregoing examples demonstrate it is not rationale. The fundamental flaw of the equivalent yield is the absence of growth implied in its calculation. A growth explicit model is a rationale basis in the analysis of yields and valuation.

The Modified DCF Approach – a growth explicit approach

The growth explicit model starts by analysing the all risks yield for implied rental growth. This assumption requires a target rate of return assumption. If the 10-year NZ bond is assumed to be the closest vehicle to a risk-free investment, a property investment is usually assumed to be more risky, and therefore requires a higher target return. This yield, often termed the Internal Rate of Return (IRR) is dependent upon the property to be valued and there is no reason why prime and secondary properties should have the same risk. The next step is the calculation of implied rental growth. One formula for implied rental growth is:

$$(1+g)^t = \frac{\text{PV\$1 pa in perp @ k} - \text{PV\$1 pa t yrs @ e}}{\text{PV\$1 pa in perp @ k} \times \text{PV t yrs @ e}}$$

Where:

g=Implied annual rental growth rate

t = Rent review pattern of the all risks yield

e = Internal rate of return

k=All risks yield

Referring to our example of the investment shop, assume IRRs for comparable shops were 10.50%. With the IRR known, the implied rental growth (g) and all risks yield (k) can be analysed. Both are unknown and have to be assessed using an iterative procedure. The resultant all risks yield would analyse out at 9.00% (k) and the implied growth would be 1.63% (g). The analysis is set out below:

Implied Growth Rate formula:

$$(1+g)^t = \frac{\text{PV\$1 pa in perp @ k} - \text{PV\$1 pa t yrs @ e}}{\text{PV\$1 pa in perp @ k} \times \text{PV t yrs @ e}}$$

$$(1+g)^3 = \frac{11.10781 - 2.46512}{11.10781 \times 0.74116} = \frac{8.64269}{8.23269} = 1.049801$$

$$\text{=====> } g = 1.049801^{(1/3)} - 1 = 1.633214\% \text{ pa}$$

Modified DCF Approach

All Risks Yield

Net Contract Income	\$50,000	
PV \$50,000, 2 years @ 10.5%		\$86,198
Reversion income:	\$60,000	
PV of \$60,000, 2 years @ 1.63%:	\$61,976	
Capitalised in perpetuity @ 9%:	\$688,416	
deferred 2 years @ 10.5%		\$563,802
Capitalised Value (before costs)		\$650,000

The value of the reversion is calculated for the trial values and compared with the known answer, \$650,000 until the value of k is found which, with the given rent review interval, gives the required result. In the framework set out above, both k and g are unknown. A solution to this problem is creating an equation encapsulating all variables (including g) in one expression. This reduces the requirement to solve two unknowns to one unknown, k, because g can be tied into one expression thereby allowing k to be solved. g is solved as a by product of the algebra. The writer has constructed the following formula which ties all variables together:

$$v = \frac{m \left[1 + \left(\left(\frac{\frac{1}{k} - \frac{1 - (1+e)^{-p}}{e}}{\frac{1}{k}(1+e)^{-p}} \right) - 1 \right)^r \right]}{k} - (1+e)^{-r} + t \frac{1 - (1+e)^{-n}}{e}$$

Where:

r = Reversion Period

V = Valuation

m = Market Net Income p.a.

p = Rent Review Pattern

k = All Risks Yield

e = Equated Yield

n = Term Income Period

t = Net Operating Income p.a.

In order to understand the model, two parts are identified. The first part is the reversion,

$$\frac{m \left[1 + \left(\left(\frac{\frac{1}{k} - \frac{1 - (1+e)^{-p}}{e}}{\frac{1}{k}(1+e)^{-p}} \right) - 1 \right)^r \right]}{k} (1+e)^{-r}$$

which derives the future value of the reversion rental in perpetuity by inflating the market rental (in current dollars) by the implied growth rate (g) before capitalising at the all risks yield (k) and then deferred for the period of the term at the discount rate (e) adopted. Note that g is tied into the formula which is expressed as:

$$\left[\frac{\frac{1}{k} - \frac{1 - (1+e)^{-p}}{e}}{\frac{1}{k}(1+e)^{-p}} \right] - 1$$

The second part,

$$t \frac{1 - (1+e)^{-n}}{e}$$

is the term contract income which is discounted to present value at the discount rate. The market value of the property is deduced by adding these two components (term plus reversion).

The power of this formula may not be initially obvious. Microsoft Excel or most programmable calculators have in-built solver tools enabling formulas to be input and most use Newton's

method to calculate approximations of unknown variables. With the formula constructed, an unknown can be calculated at the touch of a button. So there is really no excuse to dismiss the approach if it appears too complicated.

Misconceptions of both approaches

The writer has noted a number of misunderstandings regarding the Modified DCF Approach and Equivalent Yields. Some of these are:

- In most instances there is little difference between the equivalent yield analysed and the all risks yield. So why bother analysing the all risks yield.
- It's just an issue of terminology. All risks yield, equivalent yield – they are kind of the same.
- The equivalent yield, that is the relationship between market rent and sale price.
- If you value as you analyse, and analyse as you value then it's indifferent which approach is adopted.

Dealing with the first bullet point, the suggestion that an equivalent yield should be retained on the grounds it bears little difference to a growth explicit approach is rejected by the writer because, as demonstrated, the equivalent yield approach is irrational. The second bullet point is self evident. An all risks yield implies growth; an equivalent yield implies no growth. The third bullet point is clearly ignorance of the definition of an equivalent yield. And the last bullet point can be refuted on similar grounds to the first bullet point. The suggestion that an equivalent yield should be retained on any grounds of rationality is rejected by the writer.

Conclusions

One of the major features of the fallen property market in New Zealand has been the reassessment of the methods used by valuers to assess the market value of investment property. The recession has had a number of other effects where the valuation profession is under increasing pressure to review and overhaul both bases and methods which can deal with the complexities of evolving property markets. Growth explicit models are key in attaining this goal. The Modified DCF Approach is founded in logic and can deal with over-rented, under-rented and vacant investment properties with ease, and provides an array of meaningful metrics assisting financiers, investors and property professionals in making decisions with investment property. In essence, the Modified DCF Approach bears the hallmarks of sound valuation: it is accurate and rational. ■

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