IVSC - Perspectives Paper - Challenges to Market Value (Jan 2021)

Comments by Nick French, Neil Crosby and Chris Thorne

1. Introduction

1.1 We have read this paper and have concerns at the misunderstanding of the concepts of price and value evident in some of the so called "challenges" to Market Value that are identified. Whilst we do not dispute that some of the issues noted in the paper are being experienced in the market, the paper conflates so many different aspects of valuation, such as bases of value, valuation uncertainty, valuation accuracy, valuation anchoring, valuation smoothing, the difference between price and value and paucity of comparable data, that it does not offer a clear view of what Market Value is or the purposes for which it is applicable.

1.2 We believe that the intention of this paper was to provoke discussion around some of the issues valuers of tangible assets are facing which may not be adequately dealt with by the current IVS. However, the muddled presentation and suggestion that these are somehow a problem with Market Value is, at the very least, unfortunate. Of greatest concern is the failure to make clear what is being suggested by others and what is the view of the IVSC.

1.3 By repeating the evident misunderstanding of fundamental valuation concepts, including the definition and purpose of Market Value in an IVSC publication without clear rebuttal risks giving the impression that IVSC is endorsing these interpretations.

2. Price v Value

2.1 The opening statement in the paper that IVSC has received feedback that in some markets there is an increasing difference between Price and Value is unsurprising. It is a statement frequently made when prices are changing rapidly, especially by owners of assets who are not prepared to sell at the price which they could obtain in the market. However, this is not a flaw with Market Value. The problem stems ultimately from ambiguities within the concept, definition and meaning of value in the context of this discussion. Market Value is being misunderstood.

2.2 Depending upon what is understood by "value", differences can be expected between these figures. The starting point for any discussion should be the different concepts of value and how they might deviate from actual price in the market place. The IVSC paper defines value but in our opinion makes a fundamental error in that definition and tries to cover two variants of value within the one definition. This will create massive confusion. There is therefore a need to revisit the concepts of price, value and worth to be able to address the relevant definitions of value and develop a narrative as to why price and value might not be the same.

2.3 Although we appreciate that the definitions of "Price" and "Value" given at the end of the paper are not current definitions in the IVS, we do have significant concerns that they will become part of the explanation of price and value in subsequent editions of standards. This will perpetuate these errors and misunderstandings and bring significant criticism onto the valuation profession from clients and other professional advisors who also deal with price/value linkages in wider asset markets.

2.3.1 **Price** – The Perspectives Paper defines this as:
The consideration asked, offered or paid for an asset, which may be different from the value.

Although this does confirm that price may be different from value, it otherwise is a very poor definition as it mixes together three different concepts; asking price, offer price and the actual price. The price is the price agreed in an actual transaction. Asking and offer prices are possible steps along the way but are not the exchange price and should not be included in any discussion of the differences between price and value. Price can only be observed once a transaction is completed.

2.3.2 **Value** – The Perspectives Paper defines this as:
Value is not a fact, but an opinion given a basis of value of either most probable price to be paid for an asset in an exchange or the economic benefits of owning an asset.

We appreciate that this definition uses a few words extracted from the pre 2015 IVS discussion of the differences between price, cost and value, but the abbreviation of this discussion to produce a "definition" is misleading when removed from the context of the original. A significant problem is the suggestion that there are only two types of value, the most probable price to be paid in an exchange (Market Value) or the economic benefits of owning an asset (Investment Value or worth). A basis of value is simply a hypothesis constructed for a specific purpose. There are many different bases in use and it is wrong to try and reduce these to just two simple definitions. It was for this very reason that previous IVSC Standards Boards did not feel it helpful to attempt a singular definition of value or valuation. If there are different kinds of value they deserve their own basis and definition.

2.4 The fact that some of the propositions expounded in the paper clearly muddle the concepts of price and value indicates a lack of clarity, possibly caused by the long established discussion of these concepts (along with cost) being removed from recent editions of the IVS. The paper at various points discusses Market Value, Investment Value or worth, Prudential Value (sometimes referred to as long term value), and net asset values. Worth may drive price and worth, price and Market Value may be the same figure, but often are not, so the IVS needs to be clear about these different concepts before trying to relate them back to Market Value and identify whether they are a "threat".

3. Investment Value (Worth)

3.1. Although the bottom of page 4 and page 5 explain that price and value are not synonymous the suggestion that the price paid by a special purchaser "would typically represent Investment Value" is incorrect. A special purchaser may well pay a price that is higher than the Market Value as defined in IVS because of synergies that make the asset more valuable to them than others in the market, but it is incorrect to equate this with Investment Value (worth). If both buyer and seller are aware that an asset is of special value to the buyer , e.g. because the acquisition a parcel of land will enhance the value of the buyer's existing land, the price agreed will typically be somewhere between the enhanced value and the price the seller could obtain from any other buyer in the market. This is not the Investment Value (worth) to the buyer.

3.2. We believe that Investment Value (worth) definition is a much misunderstood concept within property valuation and IVSC does need to revisit all aspects of the definition. The paper clearly illustrates these problems and the above reference to Investment Value (worth) in relation to a special purchaser is an example. The key point is that to estimate Investment Value (worth) does not require any knowledge of the Market Value at the same valuation date. It is a freestanding concept of value that relates to the benefits of ownership to the existing or a prospective owner. Worth can be described as the maximum amount that a party would able to pay, in contrast to the Market Value which is the amount that they would *need* to pay. Investment value (worth) often uses different models of analysis to those used to determine Market Value. The relationship with Market Value is purely on the basis of the mismatch between them which can drive decision-making.

3.3. At present the IVSC definition of Investment Value (worth) identifies it as the value to a specific entity. There is an argument that differences between the Market Value and Investment Value are not just because of the different aspirations and situations of specific purchasers, but can stem from a specific group of purchasers for whom an asset has an Investment Value (worth) above that which other prospective purchasers would pay. There are many examples of assets which have been mispriced by the market and groups of purchasers have seen value in the assets not seen by vendors. In an efficient market, these observations should be bid into the exchange price but there are often significant time delays between these events, creating differences between exchange price/Market Value and Investment Value (worth) at specific points in time. This is not worth to one specific party, it is worth to a sector of the market. The counter argument is that while there may be market inefficiencies on any given date, if two or more parties consider that they can pay more than others in the market, and they are acting knowledgably and prudently, this is Market Value. It will also reflect the highest and best use. We recommend that this is something which the IVSC could examine as part of any project to examine Market Value. .

3.4. Regarding the naming of this definition, RICS coined the term "worth" in the 1990s but this proved problematic for IVSC. After the major consultation on the IVS in 2010 (over 60 written responses and round table discussions in three continents) Investment Value was adopted, which is a North American term for this concept. Although, in fairness, this is now followed by the word "worth" in brackets in the IVS glossary, using the term "Investment Value" alone has also proved to be far from ideal because many interpret this as meaning the price which a prospective investor would actually pay, not what they might be able to pay. Others have, erroneously, interpreted it as the price which would need to be paid to purchase an investment, i.e. the Market Value.

4. Prudential Value or Long Term Value

4.1. The paper posits that because regulators require banks and other financial institutions to measure certain assets held as loan collateral at a "prudential value" this is somehow a challenge to Market Value. The exact definitions of prudential value differ between regulators but the underlying purpose is for measuring a financial institution's solvency ratio, a key measure of its financial stability. For this purpose the regulators do not want a spot estimate of the value on a specific date but a figure that can be relied on as being achievable over the period for which financial stability is being measured. The term "prudent" has become used for this context , as a synonym for "safe". There is also a body of work that uses the term long-term value and this work has reviewed the different concepts and definitions of value currently used in global valuation and can inform this review of Market

Value. IVSC is now collaborating with TEGOVA and RICS to make recommendations the European Banking Authority (EBA) on its draft proposals to develop prudential valuation methods for real estate across Europe.

4.2. The paper inappropriately suggests Market Value is a "prudential" basis of value simply because the word "prudently" appears in the definition. This is a simplistic statement. The Conceptual Framework explains that acting prudently means that both parties are deemed to be using their knowledge of the market to seek the price that is most favourable for their respective positions. It has nothing to do with the figure being "safe". Market Value is also clearly a spot value effective on a specific date. Prudential values are also based on a specific valuation date but inputs are not necessarily based on current market levels because the objective is to gain a longer term perspective to the valuation.

4.3. Prudential Value is effectively a risk adjustment of a current value on a given date. A spot value such as Market Value may be an input into the risk adjustment. Different models can used for this adjustment and may stipulated by or need approval from the competent authority. However, typically the current value at the time of assessment will be reduced to reflect the probability of values falling over the period under consideration based on statistical analysis of past market fluctuations. It is misleading to identify the requirement for such risk adjustments as a challenge to Market Value.

4.4. Clearly the concept of Prudential Value in financial regulation is very different from Market Value. It possibly could be defined as the Investment Value (worth) of the asset[1] to the entity as it is specific to a bank's overall regulatory compliance. However, while it may be termed a type of value it is debatable whether this is consistent with the way "value" is used generically in the IVS, and it is certainly not consistent with either the existing definition of value in the IVS or the alternative used in this paper. However, does that matter? Just because the word "value" is used in a term it does not mean that the IVSC have to reconcile it with one of its existing bases. Indeed, 60.2 of the IVS Framework indicates that legislative, regulatory or other authoritative requirements takes precedence over the IVS. Since the concept of prudential value is now established in the current Basel Accord and precisely defined in the regulations issued by the competent authorities in major economies, no one will be using IVS for the calculation of Prudential Value. The most useful role the IVSC can play is to advise users of the IVS of the source and usage of the term "Prudential Value" and how it differs from any of the IVS bases in order to avoid misapplication of the term to other types of value.

4.5. Although the IVSC has joined with RICS and TEGoVA to produce recommendations to the EBA on the application of prudential valuation to real estate held as loan security by institutions this a coalition of valuation expertise to ensure consistent recommendations from the real estate profession are made during the development of the new regulations. Once the new EBA CRE standard is finalised it will not be a matter which should be addressed in any detail in the IVS. The EBA, or the competent authority in other

[1] See for example, the Bank of England Financial Stability Reports from December 2015 onwards referring to work by the two of the authors which now forms the basis of their commercial property analysis and stress testing regime

jurisdictions, will be the body with legal authority and its regulations take precedence over anything that the IVSC might write.

4.6. The work with TEGOVA and RICS makes it clear that a Prudential Value is a separate concept and definition to Market Value. The IVSC evidence to the EBA and EU contains the recommendation that Market Value be used in conjunction with Prudent Value in any valuation subject to any new EU/EBA CRE standard. In other words, Market Value will still be needed to give context to Prudential Value.

5. Market Value

5.1. On page 6 it is indicated that some claim Market Value is backward looking and not as relevant when markets are in a state of flux. There is absolutely nothing in the IVS Market Value definition or the Conceptual Framework that could reasonably support the view that it is backward looking. On the contrary it reflects the price that a willing buyer and willing seller would agree. Both those parties are to be deemed knowledgeable and acting in accordance with the realities of the current market and current market expectations. Therefore, both buyer and seller have to be assumed to be reflecting the market's expectation of the future when agreeing a price on the valuation date. This of course is consistent with the reality of most transaction prices agreed in the market. When an asset is purchased the future in terms of use, changes of use, possible refurbishment or redevelopment, prospective cash flows and expectations of the future market for the asset are all relevant considerations in the pricing.

5.2. If there is a problem of reported values lagging behind prices on the valuation date, this is not a problem of the definition of Market Value but of insufficient allowance being made for changes in the market between the date of transactions which may be considered comparable evidence and the valuation date. This is a problem of the wrong method or model being used, incorrect application of the method/model or valuer competence. It is nothing to do with the Market Value definition. This is hinted at in the narrative on page 7, although this is obfuscated by also conflating it with discussion of the observable differences that often arise between the NAV and the current price of a company's stock, see 6 below.

5.3. Probably the most pressing "challenge" to Market Value are the attempts to apply it to situations for which it is neither designed nor suited. The discussions in the paper describe various situations where a value may need to be estimated but where the conditions of the Market Value definition are not met, for example where there is a special purchaser, the seller is compelled to sell or where the value needs to be relied on over an extended period. There is a tendency by some to equate every value that is required to Market Value, evidenced in the paper by suggestions that the difference between Market Value, any other basis or price is somehow problematic. The reason for this may be historic because prior to 2011 the IVS had a separate standard, IVS1, dedicated to Market Value, but other bases were all lumped together in a single standard , IVS 2. Some may therefore have seen Market Value as the primary basis and that all others were secondary variations on Market Value. To an extent this is addressed in the current IVS 104 but the inclusion of bases and definitions of value required by law or regulation in a few random jurisdictions distract from what should be the key message, that valuations may be required for different purposes and the type of basis used must be appropriate for that purpose.

5.4. Another challenge is where the definition is compromised by the addition of incompatible assumptions. A common example is when the valuation provided is described as the Market Value on the special assumption that the disposal period is limited. If the stipulated period is less than that which the valuer would consider adequate to allow for "proper marketing" as required by the Market Value definition it is not Market Value and should not be described as such. Conversely, if the stipulated period is one that would allow for proper marketing on the valuation date the valuer simply confirms this and reports the Market Value as per the definition.

6. NAV v Equity Values

6.1. The value of a quoted share is normally the same as its Market Value because there is no reason why the willing, knowledgeable and prudent parties in the MV definition would ignore contemporaneous prices being paid for the same asset in an active market. However, the total value of the stock is likely to differ from the NAV of the company because the value of its shares will be influenced by matters other than the net value of its assets and liabilities. Shares are a different type of asset from the entire company. They each will be transacted in different markets with different liquidity by different types of buyer and seller.

6.2. That the total Market Values of these different assets differ is to be expected. As is correctly noted in the paper, the difference is more prevalent when there is a significant difference between the Market Value of the shares in issue and the Market Value of the assets included in the NAV, as will be the case with REITs or other property funds. However, this is due to differences in the liquidity and fungibility of the assets. It is certainly wrong to suggest this is a challenge to Market Value, but of like not being compared with like.

7. Valuation Uncertainty

7.1. Page 8 of the paper discusses the problem of valuation uncertainty caused by a lack of relevant market data. This is undeniably a problem that valuers will face in times of significant and unforeseen market disruption or when an asset is inherently illiquid or where the opaqueness of the market makes data collation difficult. However, it is inappropriate to identify this as a challenge to Market Value. Whatever the basis of valuation, data is needed to support its calculation, so when this is unavailable or unrepresentative of the current market additional uncertainty will arise. This uncertainty has to be disclosed in the report when it is material to warn those intending to rely on the valuation that additional caution should be taken before doing so.

7.2. An omission from the IVS that has been brought into focus by the onset of the pandemic is the lack of guidance issued by the IVSC on this matter. It is true that a "Letter from the Boards" was issued in March 2020 which largely reproduced the content of the information paper produced by a cross industry project following the 2008 financial crisis in response to calls by the G20 and Financial Stability Board, but it would better if this were appended as guidance to the IVS itself.

8. Use of Comparable Evidence

8.1. We are also aware that too many real estate valuers, and their clients, are under the misapprehension that an estimate of Market Value can only be made if there is transactional evidence. An extreme example of which one of the authors has personal knowledge is a major European REIT explaining that it had not written down the value of a landmark office building in its 2008 accounts because there had been no transactions of similar property to prove it was less valuable than the €1bn paid for it in 2007. This was in spite of its valuers advising that post Lehmann's the Market Value was probably no more than €750m.

8.2. The IVSC could usefully issue more guidance on the use of indirect evidence, or in the parlance of IFRS 13 "unobservable inputs", when estimating Market Value. One example is the proper use of consensus pricing, which is recognised as a legitimate "fall-back" method in financial markets when they become illiquid. Evidence of this method being used in the real estate markets could be found in late 2008 when the IPD Index in the UK reduced by 3%-4% per month during the last quarter in spite of there being almost no transaction evidence. The fund valuers spoke to brokers and investors to establish the probable bid-ask price for different types of property. Although the paper highlights IVS 105 30.3 which indicates this is an acceptable approach, too few valuers have the knowledge or confidence to apply it properly. Use of wider economic indicators and analysing their probable effect on value is also something many real estate valuers lack the confidence, or in some cases the ability, to do when transaction evidence is limited.

9. Questions

We offer the follow responses to the three questions at the end of the paper.

1. Are you encountering difficulties in utilising the Market Value definition and, if so, under what scenarios?

We do not encounter any difficulties utilising the Market Value definition, only that it is often incorrectly applied or is used for a purpose other than that for which it is intended. Some of these problems are obvious from the Perspectives paper. The definition itself is precise and has stood the test of time with no material changes in almost 30 years. It is also widely accepted and used.

2. Are there bases of value that don't currently exist that you would like considered as part of the IVS to remedy any difficulties you might be having with the Market Value definition?

There are currently too many bases in IVS 104. Liquidation value is not a distinct bases of value but an assumption of how a collection assets is lotted (grouped) for sale. The various bases specific to national law or regulation (mostly North American) in IVS 105 90-120 have no place in a set of international standards. Apart from their inclusion being inappropriate it would simply not be possible to identify every definition of value that is used around the world. The role of the IVS is to promote consistent definitions and approaches across borders not to act as a glossary for every known valuation definition used anywhere in the world. It should focus on promoting a few key bases with definitions that are capable of being used in different jurisdictions and that cover the main purposes for which a valuation expert may be required.

The introduction of so called "premises of value" in recent editions of the IVS has reduced the clarity of the standards. These are mostly examples of what are called assumptions elsewhere in the standards so beg the question as to what is an assumption and what is a premise? The exception is highest and best use which presented as a distinct "premise" when is inherent in the correct application of Market Value because the parties are deemed to be knowledgeable about the potential use of the asset and both seeking the price that is most favourable from their respective positions.

Regardless of any view that there are too many definitions, Prudential Value is a concept within the Basel III accord and therefore IVSC may need to include an explanation of this to avoid inappropriate use or application of the term.

The most pressing area for review is Investment Value (worth) which could benefit from examination is whether Investment Value is the most appropriate term and, in addition, whether it is applicable to more than one entity. Previous definitions have suggested that it could extend to a "class of investor" but this was removed because the potential conflict with Market Value. Given the concept is not related to Market Value, this may fall outside the original intention of the Perspectives Paper but the confusion evident as to the difference between Market Value and Investment Value means that clarifying the latter, and whether it is applicable to a group of prospective buyers needs urgent consideration.

3. Are there certain aspects surrounding the conceptual framework associated with Market Value that you would like further guidance on to assist in the valuation process?

Like the concise definition, the Conceptual Framework for Market Value has been around for nearly 30 years and has only needed minor updating over that time. What we do find is that different concepts of value are not widely understood by valuers, including Market Value. Examples of this are evident in this paper. This may be partly because the Conceptual Framework is not made sufficiently prominent or cross referenced from elsewhere in the IVS. Another example of the lack of awareness of the importance of the Conceptual Framework is that the RICS has moved over the course of 25 years from only permitting its members to use the Market Value definition providing the full Conceptual Framework was also included in the report, to removing the framework from the Red Book altogether with only a cross reference to the IVS, which is rarely followed.

The IVSC needs to more widely promote and educate users and potential users of the IVS about the Conceptual Framework for Market Value, perhaps by providing case studies to illustrate how they help to solve many of the questions valuers (and their clients) have about Market Value and, by implication, their misunderstanding of other bases.

10 Conclusion

10.1 The IVSC could consider a detailed paper, perhaps as a consultation for possible revisions to IVS 104, which outlines and discusses all the points concerned with the operation of Market Value and other bases. Concepts such as, valuation uncertainty, identification and use of comparable data, valuation accuracy, lagging, anchoring and smoothing, the difference between price and value and cost, etc. should be addressed as distinct (but inter-linked) issues. The Perspectives Paper, as is, may identify the problems but the exposition is unstructured and, in our opinion, particularly so with regard to the new definitions which add to the confusion surrounding the differences between Market Value, Price and Worth. In particular, the definitions of "value" and "price" included in the paper need to be expunged completely.

10.2 We trust you find this response helpful. If you would like any further clarification of the comments we have made please do not hesitate any of the authors of this response.

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About the Authors

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Nick is a recognised expert in the area of property valuation and appraisal. Previously, he has worked at as a professor at various Universities in the UK, Europe and the USA teaching extensively in the areas of valuation, investment and corporate real estate. In 2018, Nick set up Real Estate Valuation Theurgy, a vehicle that allows him to continue writing papers, presenting conference papers and working with the real estate profession at home and abroad. Nick is the Editor of the Journal of Property Investment & Finance.

He is also a member of the Royal Institution of Chartered Surveyors (RICS) and has regularly served on the various committees such as the UK Valuation Board and the Corporate Real Estate Strategy Group. He was also a member of the Professional Board of the International Valuation Standards Council (IVSC). In 2020, he was the principal author of the European Group of Valuers' Associations (TEGoVA) Report – Pricing to Market: An Investigation into the use of Comparable Evidence in Property Valuation.

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He is currently lead author of the IVSC/TEGOVA/RICS (2021) collaborative evidence paper on prudent valuations to the EU, and was lead author of the RICS Guidance Notes on Bank Lending Valuations (2018), Valuation of Development Property (2019) and Financial Viability in Planning (2021). He is also the lead author of all four editions of Property Investment Appraisal (1988, 1995, 2008, 2021).

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