Perspectives Paper:
Challenges to Market Value

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The IVSC issues Perspectives Papers from time to time, which focus on pertinent valuation topics and emerging issues. Perspectives Papers serve a number of purposes: they initiate and foster debate on valuation topics as they relate to the International Valuation Standards (IVS); they provide contextual information on a topic from the perspective of the standard setter; and they support the valuation community in their application of IVS through guidance and case studies.

Perspectives Papers are complementary to the IVS and do not replace or supersede the standards. Valuers have a responsibility to read and follow the standards when carrying out valuations.

By: The IVSC's Tangible Assets Board

Introduction

The IVSC Tangible Assets Board ("TAB") has received feedback that in some markets there is an increasing difference between Price[1] and Value[1]. Whilst quantifying this difference in valuation terms has commonly been acknowledged as difficult in undeveloped markets where there may be few (if any) comparables and non-transparent information, it has also become increasingly challenging in developed markets despite the abundance of information that exists in these ecosystems.

The current coronavirus epidemic has created a significant layer of uncertainty which has permeated all markets and led to various challenges, particularly as it relates to the availability of market information in a pandemic world. This isn't necessarily just confined to the basis of Market Value[1], but it still raises its own specific challenges. How does the valuer quantify Market Value with a lack of

[1] See definition on page 9.

market comparable information in the new COVID-19 world? Where market comparable information is available, have the parties 'acted knowledgeably, prudently and without compulsion'? Does a pandemic environment enable parties to undertake 'proper marketing' or do sales that are witnessed in the early stages of such an event represent an environment comprised of overly willing sellers and opportunistic buyers that is more aligned with a liquidation market?

All of this comes at a time when some organisations around the world are considering a transition away from Market Value because of the difficulties such a basis of value creates during volatile markets. The European Banking Association (EBA) is currently discussing the creation of a more prudential value to work in conjunction with Market Value and meet the requirements of Basel III. The UK Investment Property Forum in conjunction with the Bank of England is exploring a long-term value index to show where we are in the property cycle and to assist banks in making Loan to Value decisions, particularly when properties are at the peak or trough of the property cycle.

And finally, do financial instruments associated with traditional asset classes such as real estate and infrastructure, primarily designed to give greater accessibility to investors, give so much liquidity they challenge the value characteristics that these assets display when held in a traditional sense? Common analysis of 'Price-to-NAV' ratios associated with these financial instruments from one perspective would suggest that 'price is what you pay, value is what you get'. Contrary to this view is that traditional valuation techniques aren't nimble enough to reflect Market Value in volatile markets and as a result these financial instruments often represent a leading indicator of value.

What does the IVSC's Tangible Assets Board (TAB) make of these challenges to Market Value in uncertain times?

Is Market Value a prudential form of value?

There are currently a number of organisations that are considering the introduction of a more 'prudential' form of value. These organisations believe that this will create a more sustainable form of value over the property cycle.

In fact, the European Union (EU) have now stated that they will adopt Basel III which has the following requirements for property valuation (CRE standard 20.75):

> *The valuation must be appraised independently* ***using prudently conservative valuation criteria****. To ensure that the value of the property is appraised in a prudently conservative manner, the valuation must* ***exclude expectations on price increases*** *and must be adjusted to take into account the potential for the current market price to be significantly above* ***the value that would be sustainable over the life of the loan****. National supervisors should provide guidance setting out prudent valuation criteria where such guidance does not already exist under national law. If a market value can be determined, the valuation should not be higher than the market value.*

These requirements translate a 'uniform value concept' and the option to choose between Market Value or Mortgage Lending Value has now been removed. However, it should be noted that the prudential valuation criteria referred to above have not yet been defined and are currently being discussed by the EBA which plays a key role in the implementation of Basel III.

However, in many respects Market Value already is a prudential basis of value as the definition states *'where the parties had each acted knowledgeably, prudently and without compulsion'*.

Whilst this doesn't necessarily remove the volatility that comes hand-in-hand with certain market circumstances, it does act in the public interest in that it reflects value under that premise as at a specified date.

In any case, it is important that all valuation stakeholders (valuers, clients and investors) utilise a premise of value that is relevant and appropriate for the purpose of their valuation.

What is the difference between Price and Value, and where can these differences be observed?

There have been concerns amongst certain market influencers that there is a difference between Price and Value. So this begs the question, are Price and Value synonymous, or is this a misconception?

Market Value is in part defined as *'the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction …'*, whereas Price is *'the consideration asked, offered or paid for an asset, which may be different from the value'*. In effect, Price looks at the exchange of an asset or liability between parties that might not meet Market Value conditions. This is because markets are imperfect, and it can be possible to have both a fully informed buyer and seller with a difference in views, bith in relation to the asset and the market. These situations can lead to different or erroneous pricing outcomes. Moreover, Price can include a special purchaser who may be willing to pay more for an asset because of its strategic nature, and such a Price would typically represent Investment Value[2]. There may also be situations such as liquidation where the seller may be subject to a forced transaction with a limited marketing period, and such a Price would typically represent Liquidation Value[2] under a forced transaction premise.

In fact, there may be many instances where the Price that parties are willing to transact at may be different from Value. An example could be a company that is forced to divest a production facility as a result of competition regulation. In divesting the production facility, the vendor will have a strong preference not to allow a competitor to acquire the facility as it will ultimately reduce its market share. As a result, the price witnessed as part of the forced divestment may actually be to a purchaser that is far from the highest bidder, and they may even be selected as a purchaser who will take the production facility to a modified or alternate use, that may no longer be the highest and best use. The Price inferred by this transaction, because of its very nature, would seem to collide with the definition and conceptual framework of Market Value.

There may be instances where highly specialised assets are held for sale under sale-and-leaseback arrangements where the vendor is attempting to realise cash without the need to lose control in an asset. The formulation of the lease in this instance may not be on market terms, and the positioning of such may result in the asset realising an artificially low or high sale price relative to Market Value. Does the vendor seek to maximise their up-front cash return through the sale of the asset and forego future profit margins? Or does the vendor forego the higher sale price and seek to have that cash returned gradually over time by setting below market lease rates which results in higher future profit margins?

Whilst there would be universal agreement that Price informs Value, the characteristics of the asset being

[2] See definition on page 9.

transacted, the professionalism of the valuer, the information available along with the specific terms under which it is transacted, set a particular fact pattern that the valuer needs to consider before confirming that Price and Value are synonymous.

Is Market Value nimble enough to react in volatile markets?

Commentators are often questioning if Market Value is backward looking and therefore not as relevant when markets are in flux. There is a perception by some who think Market Value is too slow to react to changes in the market, especially in a downturn where there may be limited documented transactional evidence. This is particularly evident where financial instruments are associated with traditional asset classes such as real estate and infrastructure.

The common observation is the divergence when examining Price-to-NAV ratios associated with these financial instruments, particularly in volatile markets. In these situations, for example, listed stock prices may infer that value is significantly higher or lower than net asset values that are determined using independent asset valuations. There is no doubt that in most cases Price informs Value, but when the unit being valued (a financial instrument or a physical asset) displays differing physical and liquidity characteristics, and is traded using differing mechanisms, what do we make of Value?

These traditional asset classes have long been in existence, but it has only been in more recent decades that the creation of financial instruments associated with these assets have existed. They were created out of demand where the market wanted these asset classes to be more accessible to both retail and institutional investors, but also with a desire to create a greater level of liquidity and portfolio diversification for investors.

So when we observe this divergence between listed prices and net asset values, does the liquidity afforded mean that certain segments of these markets over-react in pricing these financial instruments during these volatile times and are not necessarily acting *'prudently and without compulsion'*? Does a volatile market not enable parties to undertake *'proper marketing'* and as a result sale prices that are witnessed in the early stages of a significant market downturn representative of an environment comprised of overly willing sellers and opportunistic buyers that is more aligned with a liquidation market?

Maybe market evidence simply lags relative to the signals given by listed markets which makes the valuer slower to react? Or perhaps Market Value by way of its definition is 'never as good, and never as bad as it seems' relative to listed markets in both buoyant and distressed markets respectively, holding more of a middle or prudential ground relative to the emotions that are displayed in the trading of associated financial instruments?

Having consideration to all of this, a valuation is *'the act or process of determining an opinion of value of an asset on a stated basis at a specified date*'. This does not mean that Market Value is 'backward looking' but rather requires the valuer to look at all the facts and circumstances; bckwards, sideways and into the future. Market Value considers the long term cash flow for an asset over a defined period of years and when a forty-year cash flow is used, short impacts in the income stream from a change in market conditions may not have a long term impact on the cashflow or on the Market Value provided. However, though the valuer may anticipate future trends, they cannot foresee future events that may have significant market implications such as a financial crisis or a pandemic.

How can Market Value be interpreted when there is little or no market activity, or when a market event means that historical transactions become less relevant?

It has been noted that some valuers have excluded the use of 'offer prices' as comparable information for valuations, and this exclusion was causing some difficulties in less transparent or undeveloped markets. This issue may also be evident where the data available in the market is perceived to be of insufficient quality to be used in the valuation process.

Of specific note here is the following section contained within IVS 105 Valuation Approaches and Methods, paragraph 30, Market Approach Methods:

> *30.3. If few recent transactions have occurred, the valuer may consider the prices of identical or similar assets that are listed or offered for sale, provided the relevance of this information is clearly established, critically analysed and documented. This is sometimes referred to as the comparable listings method and should not be used as the sole indication of value but can be appropriate for consideration together with other methods. When considering*

> *listings or offers to buy or sell, the weight afforded to the listings/ offer price should consider the level of commitment inherent in the price and how long the listing/offer has been on the market. For example, an offer that represents a binding commitment to purchase or sell an asset at a given price may be given more weight than a quoted price without such a binding commitment."*

As such, offer prices can be used as comparable information provided the valuer follows the guidance stated above. Where offer prices do need to be considered, care needs to be taken and clear and transparent commentary should be provided within the valuation report as to the comparable information utilised. This should include commentary where possible as to the current state of the market and any related trends that might be observed.

There are also situations where markets appear to have moved quickly, or where widespread disruption from external sources has affected markets such as a financial crisis or a pandemic, which also creates an issue for valuers where historical transactions may become less relevant. This has recently seen various Valuation Professional Organisations around the world issue 'significant valuation uncertainty' guidance to its stakeholders as a result of COVID-19.

Where there is a lack of relevant market data, there may be a need to extrapolate inputs from directly observable prices for similar assets, or to rely on unobservable inputs. These are inputs for which market data are not available but that can be developed using the best information available about the assumptions that market participants would use when pricing the asset.

The use of extrapolation or unobservable inputs can be a source of uncertainty because of the difficulty of finding objective evidence to support either the adjustments or the assumptions made. The valuation method used may adjust for input uncertainty. For example, in a discounted cash flow model the cash flow inputs are based on current expectations of future performance and are therefore uncertain. However, market participants' views of the potential risk or reward implied by the expected cash flows differing from those that actually occur in the future can often be reflected in the discount rate applied.

Whilst all of these situations make the valuation profession challenging, it's a situation where a valuers experience and skillset comes to the fore. There is no better professional at hand to advise on value than a valuer in these uncertain times. By utilising commonly accepted valuation standards and guidance to educate and communicate valuation matters, the valuer is a vitally important resource to their stakeholders, to act above all in the public interest.

The IVSC will continue to consider the topics in this article and would welcome your insight and feedback in order to understand what issues (if any) you or your stakeholders have with the use or interpretation of Market Value in your jurisdiction. In this regard, we would be appreciative if you could provide this by answering the following questions:

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

Please forward your responses to the IVSC Tangible Asset Board via the following email: contact@ivsc.org

Definitions

Investment Value/Worth: *is the value of an asset to a particular owner or prospective owner for individual investment or operational objectives*

Liquidation Value: *is the amount that would be realised when an asset or group of assets are sold on a piecemeal basis. Liquidation Value should take into account the costs of getting the assets into saleable condition as well as those of the disposal activity. Liquidation Value can be determined under two different premises of value: (a) an orderly transaction with a typical marketing period, or (b) a forced transaction with a shortened marketing period.*

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

Price: *The consideration asked, offered or paid for an asset, which may be different from the value.*

Valuation: *The act or process of determining an opinion of value of an asset on a stated basis at a specified date consistent with IVS.*

Value: *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.*