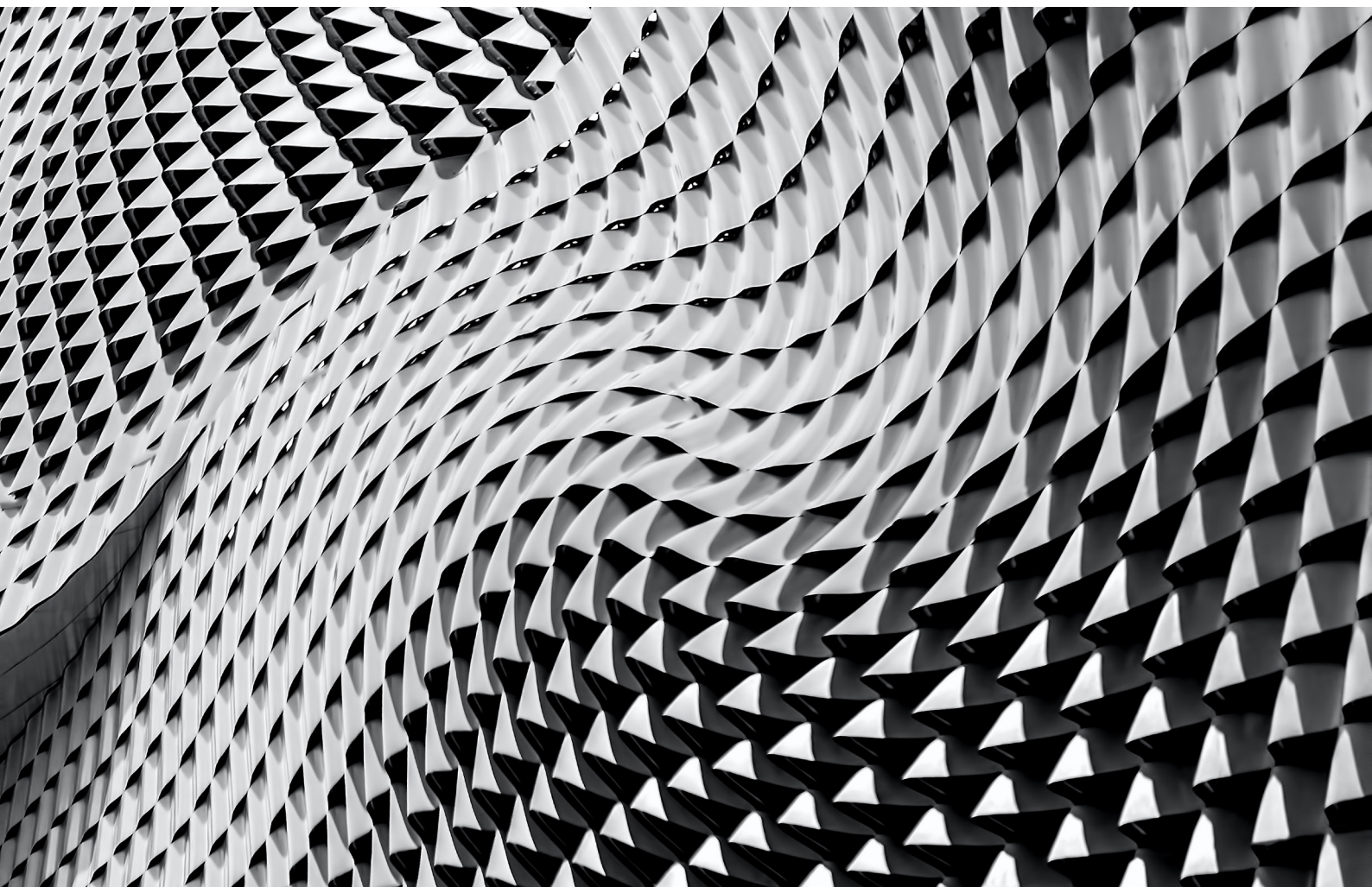


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Beyond COVID-19:
Valuation approaches and evidence
during the COVID-19 health crisis



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1 Introduction

COVID-19 has presented unprecedented challenges to those involved in the provision of valuation advice.

Government-imposed restrictions on movement have created a unique set of circumstances within which valuers are still expected to make a judgement on the value of an asset. Transactional evidence might not exist or its basis of agreement could reflect a market operating very differently to now.

While markets are inherently uncertain, it is recognised that the period since government-imposed restrictions came into force has increased uncertainty; indeed many valuations are accompanied by a declaration of material valuation uncertainty.

However, it is recognised additional support is needed around assessing evidence when valuing in periods of scarce market activity and uncertainty of current and future income.

This document helps RICS members valuing real estate in the aftermath of COVID-19 where transaction evidence is limited.

The document builds on the [Comparable evidence in real estate valuation](#) (1st edition), RICS guidance note, and reminds valuers about the hierarchy of comparable evidence and thought processes needed when using less reliable or unverifiable information.

The document also helps RICS members deal with material valuation uncertainty, where pricing activity might not reflect tones of value, the difference between value and worth, considerations around local and national economic activity and the income approach to valuation during COVID-19.

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2 Comparable evidence

Comparable evidence is at the heart of most real estate valuations and forms the backbone of the market approach to valuation as set out in the [International Valuation Standards](#) (IVS) and [RICS Valuation – Global Standards](#) (Red Book Global Standards). The process of identifying, analysing and applying comparable evidence to the real estate to be valued is, therefore, fundamental to producing a sound valuation that can stand scrutiny from the client, the market and, where necessary, the courts.

Although many valuers are experienced in handling and analysing comparable data, approaches vary. In developing markets, comparable evidence is often more difficult to obtain, and valuers may be less familiar with its use. The valuation process is also becoming increasingly regulated worldwide. RICS members are required to maintain suitable records of inspections, investigations and key valuation inputs, including the evidence used to support a reported valuation and are subject to monitoring to ensure standards are maintained. Many clients also request supporting evidence.

Real estate markets are imperfect and are generally characterised by a lack of comprehensive information. Therefore, while the theory of real estate valuation and the use of comparable evidence can be explained, there is no substitute for the valuer's detailed, in-depth market knowledge and valuation experience. The competence requirements for RICS members can be found in more detail in [Red Book Global Standards](#) PS 2 (Ethics, competency, objectivity and disclosures).

- Ideally, comparable evidence should be:
 - comprehensive: there should be several comparables rather than a single transaction or event
 - very similar or, if possible, identical to the item being valued
 - recent, i.e. representative of the market on the date of valuation
 - the result of an arm's-length transaction in the market
 - verifiable
 - consistent with local market practice and
 - the result of underlying demand, i.e. comparable transactions have taken place with enough potential bidders to create an active market.

Comparable evidence underpins the valuation of almost all traded assets. Provided the above criteria are met, it should provide an accurate indication of value.

Challenges arise, however, when considering assets that trade in less active markets and/or where there are significant differences between the assets providing the evidence and the asset being valued. In such circumstances the evidence available may not be directly comparable. It will therefore need to be analysed and reconciled in order for it to be used in the valuation. This is often the case for real estate. In such circumstances the skill and judgement of the valuer assumes a much greater importance.

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3 Hierarchy of comparable evidence

There is a wide range of sources for comparable evidence available to the valuer, although some will be more relevant than others. Sale or leasing transactions that have taken place for similar real estate to that being valued will provide the best evidence, while databases and indices will offer more general guidance. It is seen as good practice for valuers to stay 'close to the market' by, for example, contacting agents and investment experts, attending and reviewing auctions and their results, webinars and other sharing of market intelligence. This can be undertaken by a simple telephone call through to more structured pro-formas. In each case a valuer should look to capture a record of the insight received through a file note.

Rent review and lease renewal agreements reached via negotiation or settled by an expert can also provide good comparable evidence for market rental levels if the data is fully validated and appropriately analysed.

In some countries, valuation cases that have been subject to litigation have resulted in the courts adopting a hierarchical approach to the evidence being presented.

In general, however, a precise hierarchy of evidence is difficult to define as different sources assume a greater or lesser importance depending on market conditions, the purpose of the valuation and the exact type and nature of the asset being valued.

Ordinarily, certain types of evidence usually take precedence over others and the list below provides an indication of relative importance. It is not prescriptive and will vary according to market conditions and local practice.

COVID-19 represents a specific set of circumstances, particularly in light of the period of imposed lockdown and indeed the unknown pace of market recovery and in what shape or form that recovery might look like.

There may be:

- a lack of up to date evidence
- special purchasers
- a lack of similar or identical evidence
- markets may have less transparency.

For all these reasons, relevant comparable evidence may be harder to find. The valuer will, therefore, need to analyse and interpret the available evidence further and use it as guidance rather than as direct evidence of value.

In some circumstances this can result in a significant degree of uncertainty in the reported valuation figure (see chapter 5). Red Book Global Standards VPS 3 (Valuation reports) requires material uncertainty to be reported. Guidance on how to report an uncertain figure is given in VPGA 10 (Matters that may give rise to material valuation uncertainty).

Evidence that would ordinarily be considered most relevant in terms of time elapsed between transaction and valuation may now be less relevant because when it was the agreed, the market was either not impacted, or impacted to a lesser extent, by COVID-19. There may be a lack of any direct comparable evidence or the only comparable evidence that is available would ordinarily be considered too remote (such as date, type, distance, characteristics, hierarchy) to be suitable.

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5.1 Hierarchy of evidence

The hierarchy of evidence remains and RICS members should aim to acquire the most reliable, from Category A through to Category C (as seen in [Comparable evidence in real estate valuation](#) (1st edition), RICS guidance note). The valuer should still use professional judgement to assess the relative importance of evidence on a case-by-case basis.

Where evidence is increasingly remote from the subject property, the rationale behind the valuation is especially important. This should be clear and provide any reader at a future point in time a clear understanding of the circumstances and facts around the valuation.

Category A – direct comparables

This category relates to all types of relevant transactional comparable evidence, including:

- contemporary, completed transactions of near-identical properties for which full and accurate information is available; this may include data from the subject property itself
- contemporary, completed transactions of other, similar real estate assets for which full and accurate information is available
- contemporary, completed transactions of similar real estate for which full data may not be available, but for which enough reliable data can be obtained to use as evidence and
- similar real estate being marketed where offers may have been made but a binding contract has not been completed and asking prices*.

Category B – general market data

This category relates to data that can provide guidance rather than a direct indication of value, including:

- information from published sources or commercial databases; its relative importance will depend on relevance, authority and verifiability
- other indirect evidence (e.g. indices)
- historic evidence and
- demand/supply data for rent, owner-occupation or investment.

Category C – other sources

There is also a wide range of data that might provide broad indications of value, including:

- transactional evidence from other real estate types and locations, and
- other background data (e.g. interest rates, stock market movements and returns, which can give an indication for real estate yields).

*Ordinarily asking prices do not provide reliable evidence of value and would be treated with caution because they often differ substantially from the agreed final transaction price.

At the present time however, asking prices may be the only evidence available and if interpreted carefully by an experienced valuer, asking prices can provide guidance on current market conditions and trends in value.

Asking prices can be useful when combined with information on the level of demand and offers received, though the valuer is required to verify that the properties are being effectively marketed. Obtain full information from reliable contacts with letting or selling agents.

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4 Material valuation uncertainty

RICS members should be fully aware of RICS Red Book Global Standards VPGA 10 and VPS 3 in the decision-making process. If material uncertainty is declared, you are reminded that this should be explicitly stated.

Whether material uncertainty exists remains the decision of the RICS member. Insight indicates many markets are uncertain and a continued lack of empirical data could support this conclusion.

Declaration of material uncertainty is not in itself an indicator or reason to move an assessment of value. RICS members must still meet the requirements of Red Book Global Standards, drawing particular attention to VPS 4.

Further details around material uncertainty can be found in our [practice alert and supplementary guide](#). UK Valuers should also refer to the latest recommendations of the [Material Uncertainty Leaders Forum](#).

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5 Value and worth

RICS members must be aware of the difference between the market value of a property (VPS 4 section 4) and the investment value or worth of it to a particular owner or occupier (VPS 4 section 6).

In uncertain times where economic trends are an unknown, there may be evidence of unusual pricing in the immediate aftermath of a market reopening.

RICS members should be alert to whether the transactional information reflects the tone of value or is merely reflecting the needs of an individual buyer and/or seller, who could be seen as a special purchaser. In this circumstance, the transaction may be proceeding at a figure to reflect the worth of the asset, taking into account the buyer and/or seller's motivation to buy and sell but not at a figure that is reflective of the value of the asset.

Market value may coincide with its worth but a client's unwillingness to transact at a certain level based on their own needs should not influence the assessment of market value. Note that the assessment of worth does not require a hypothetical transaction but is an assessment of the worth of an asset to an individual.

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6 Economic activity, macro and micro

RICS members should be alert to micro and macro economic indicators and activity. Having an awareness and knowledge of macro economic performance and fiscal policy is important.

Valuation requires local knowledge, and markets will be influenced by national, regional and local economic activity. Markets will also be influenced, possibly more so, where a local economy is sustained by a single or small number of employers and/or type of activity.

Any change can affect supply and demand.

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7 The income approach to valuation during COVID-19 (including with reference to individual trade related properties)

For certain assets and markets the income approach to valuation is the most suitable. The current COVID-19 health crisis has caused uncertainty around future income streams and therefore particular professional considerations around the use of the income approach. Income uncertainty might be a short-term issue or, where there are predicted knock-on behavioural, regulatory or economic effects, a longer-term consideration. The more unknown these effects are and the longer the expected duration of uncertainty, the greater challenge there is with the use of the income approach.

The use of the income approach is only appropriate where the valuer has the experience and competence to be able to apply it to the class of asset being valued within the relevant market. Where the valuer is not familiar with the income approach and it is the principle approach relevant to the market for the asset being valued, they should consider whether they are able to undertake the valuation.

Evidence in respect of the income approach may be taken from various sources relevant to the particular market. For example, the rent roll and rent collection details where undertaking a discounted cashflow investment valuation of a portfolio. Sometimes the income approach requires a forensic review of the accounts for the occupier of the asset being valued and may also refer to benchmarking details relating to other operators and assets.

7.1 Further reading

The following content refers to current RICS and other related standards, and highlights where these may be effective in valuing using the income approach in the current market.

[Discounted cash flow for commercial property investment](#) (1st edition), RICS guidance note. Although published in 2010 the document provides an excellent framework.

RICS Valuation – Global Standards (Red Book Global Standards) VPS 5 paragraph 2 refers to the number of different forms the income approach may take:

‘based on capitalisation or conversion of present and predicted income (cash flows) ... to produce a single current capital value. Among the forms taken, capitalisation of a conventional market-based income or discounting of a specific income projection can both be considered appropriate depending on the type of asset and whether such an approach would be adopted by market participants’.

This covers the income approach for valuation across a wide range of real estate asset classes, including reference to the specific ‘profits’ methodology used in relation to individual trade related properties, referred to at VPGA 4 of *Red Book Global Standards*. The method should only be used in the appropriate circumstances set out in VPGA 4 and in section 7.3.

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Some valuations may refer to a combination of the market approach and income approach, such as the valuation of market rent where a turnover element is included or as a cross reference. The valuer is advised to follow the appropriate standards for each approach as well as standing back and looking at the valuation conclusion.

Where there is an absence of comparable transactions, some valuers have resorted to the income approach for valuing assets for which it has not been traditionally associated. While in some circumstances this may be valid, valuers are advised to proceed with caution and with regard to the content below and criteria of competence and experience expressed above.

7.2 The income approach – IVS definition

Red Book Global Standards requires that valuers apply International Valuation Standards (IVS), which state in IVS 105 paragraphs 40.1 and 40.2 that:

‘40.1 ... the income approach provides an indication of *value* by converting future cash flow to a single current value. Under the income approach, the *value* of an asset is determined by reference to the *value* of income, cash flow or cost savings generated by the *asset*.

40.2 The income approach *should* be applied and afforded *significant weight* under the following circumstances:

- (a) the income-producing ability of the *asset* is the critical element affecting *value* from a *participant* perspective, and/or
- (b) reasonable projections of the amount and timing of future income are available for the subject *asset*, but there are few, if any, relevant market comparables.’

IVS 105 paragraph 40.3 sets out circumstances where it may be valid to use the income approach but where an alternative might also be considered to weight and corroborate the value indicated. These circumstances include:

- ‘(a) the income-producing ability of the subject *asset* is only one of several factors affecting *value* from a *participant* perspective,
- (b) there is *significant* uncertainty regarding the amount and timing of future income-related to the subject *asset*,
- (c) there is a lack of access to information related to the subject *asset* ...
- (d) the subject *asset* has not yet begun generating income, but is projected to do so.

40.4 A fundamental basis for the income approach is that investors expect to receive a return on their investments and that such a return *should* reflect the perceived level of risk in the investment.’

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7.3 Red Book Global Standards VPGA 4 – Valuation of individual trade related properties

Red Book Global Standards VPGA 4 paragraph 1.3 refers to properties that are ‘normally bought and sold on the basis of their trading potential’. It refers to the following asset classes where a ‘profits’ basis is commonly used: ‘hotels, pubs and bars, restaurants, nightclubs, fuel stations, care homes, casinos, cinemas and theatres, and various other forms of leisure property’ and also in some cases ‘car parks, garden centres, caravan parks, crematoria’. Whether an asset meets the VPGA 4 criteria ‘will be a matter for valuer judgment having regard to the specific type, form and use of the property and market circumstances prevailing, and evolving, at the time’ (paragraph 1.4).

The ‘essential characteristic’ of such ‘trade related’ property is that it has been:

‘designed or adapted for a specific use, and the resulting lack of flexibility usually means that the value of the property interest is intrinsically linked to the returns that an owner can generate from that use. The value therefore reflects the trading potential of the property. It can be contrasted with generic property that can be occupied by a range of different business types, such as standard office, industrial or retail property.’ (paragraph 1.3)

VPGA 4 paragraph 1.5 advises that valuers who prepare valuations of trade related property:

‘usually specialise in this particular market. Knowledge of the operational aspects of the property *valuation*, and of the industry as a whole, is fundamental to the understanding of market transactions and the analysis required.’

Where calculating market value, the Fair Maintainable Operating Profit (FMOP) is a judgement made by the valuer based on the Fair Maintainable Trade (FMT) of the Reasonably Efficient Operator (REO). Judgements around trading potential are made with reference to the actual trading figures of the asset, relevant comparable evidence and other relevant economic indicators.

Trading potential is defined in VPGA 4 paragraph 2.13 as the future profit that a Reasonably Efficient Operator (REO) ‘would expect to be able to realise from occupation of the property’.

The immediate trading position of a property, which in some cases during the health crisis may have substantially declined or completely evaporated, may not be the only data relevant to the valuation. VPGA 4 paragraph 2.13 refers to trade evidence that could be:

‘above or below the recent trading history of the property. It reflects a range of factors (such as the location, design and character, level of adaptation and trading history of the property within the market conditions prevailing) that are inherent to the property asset.’

A very important distinction is made at VPGA 4 paragraph 6.1 between the market value of a trade related property and the investment value – or its worth – to the particular operator.

‘The operator will derive *worth* from the current and potential net profits from the operational entity operating in the chosen format. While the present operator may be one potential bidder in the market, the valuer will need to understand the requirements and achievable profits of other potential bidders, along with the dynamics of the open market, to come to an opinion of value for that particular property.’

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Adopting an income approach and profits method does not preclude the use of comparable information, which may be 'derived from a wide variety of sources, not just transactional evidence' (VPGA 4 paragraph 1.6). Information may also be drawn from 'different operational entities with regard to the component parts of the profits *valuation*' (VPGA 4 paragraph 1.6).

Given the uncertainty and challenging trading conditions surrounding some markets it may be appropriate to consider alternative uses. VPGA 4 paragraph 1.7 states that:

'where it is clear that the property may have an alternative use that may have a higher value, an appropriate comment should be made in the report. Where such an alternative use value is provided, it should be accompanied by a statement that the valuation takes no account of the costs of business closure, disruption or any other costs associated with realising this value.'

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