Valuing Investment Property under Construction

EPRA Recommendations to IVSC

Introduction

In May 2008, as part of its annual improvement process, the IASB approved changes that brought investment property under construction into the scope of IAS 40 *Investment Property*. From 2009, entities reporting under IFRS will be required to re-classify investment property under construction (IPUC) to investment property. This means that any entities who measure their completed investment property at fair value – and this is almost universal practice - will also need to measure their IPUC at fair value (subject to fair value being reliably determinable).

Even if an entity measured its investment property using the cost model (the other measurement option available in IAS 40) it would still need to obtain the fair value of the IPUC (unless it was for the reason that a reliable fair value is not available), since IAS 40 requires the disclosure of the fair value of investment property when the cost model for accounting is applied.

The valuation of IPUC is complex and judgemental and yet, there appears to be little detailed guidance on the subject - bodies such as IVSC and RICS limit themselves to providing some general principles. There is also considerable diversity observed in the methods and principles used in estimating the fair value of IPUC in Europe. For example, an appraiser in the UK would typically use a different model from mainland Europe. In the UK, it is usual for developments to be appraised using the hypothetical developers method otherwise known as the 'residual method' of valuation, which deducts costs of construction, finance and anticipated profit (a percentage of cost) from an exit value; the Gross Development Value of the completed project. In mainland Europe, if IPUC is valued, a discounted cash flow approach is more common whereby use is made of (project) risk adjusted discount factors.

We therefore consider that guidance is needed to ensure consistency among preparers of financial statements, advisers and investors.

The framework

It is clear that there are no genuinely active markets for IPUC - the primary market would be those sold during a 'fire sale' and which fetch low prices. Valuations are therefore typically based on value to the developer, rather than how much would be realised on their sale in their current condition.

The RICS implicitly makes this point clear in UK Practice Statement 1.1 para 3.8 that sets out that *"Where land and buildings in course of development are to be re-valued, they are to be included in the financial statement at their current value."* Current value is then defined by reference to UK accounting standards and the value to the business concept which is similar to the concepts used in IFRS.

We have called this a 'mark to model' approach and, as the name suggests, it necessitates the use of a valuation model. It is the principles behind such models that are the focus of this recommendation.

Project gains

The gain associated with realising a project, and discussed in this paper, comprises the full gain that will accrue to the developer from the initial planning consent until the property is complete. In certain jurisdictions, development activities are separated from asset management and investment property activities - typically a development company develops the property, and on completion transfers it to the investment company to manage. An issue that might then arise is which part of the gain is attributable to the development company - for example a substantial part of the project gain is due to the letting process, and that might be said to be either an asset management activity or a development activity. Although important, this paper does not attempt to distinguish between the two and assumes the development takes place in one single entity or from a consolidated perspective.

Moreover, an increase in value of a project over time may be the result of a whole variety of reasons, including but not limited to development activities, macro and micro economic circumstances, occupier fundamentals and changes in the capital markets. Therefore, even if a project has increased in value over time it will not be possible to isolate the gain realised from development activities from the other factors referred to above.

Project losses

In some circumstances the development process may not realise a project gain. Project values may decrease during the development process due to (i) economic circumstances, changes in market conditions or changes in occupier fundamentals reducing the projected value of the completed property and/or (ii) development costs exceeding budgets/forecasts.

The principles set out below assume that a project gain will be achieved. Situations where project losses arise have not been dealt with in this paper.

Redevelopment projects

Finally, we note that the principles outlined below would also be applicable to valuing existing investment property undergoing major refurbishment.

The principles

At the recent EPRA meeting in Stockholm, held on September 03, 2008, a series of 14 principles were presented to a roundtable of representatives from the real estate industry including European listed property companies, investors, advisors and appraisers.

The principles that were agreed in that meeting are listed below:

1. The starting point of any valuation of IPUC should be a completed property. Such a valuation should be based on current valuations applicable to similar existing completed properties with comparable encumbrances to property rights. In practice, property is not usually fully let on completion, but an appraiser will still be able to value the IPUC and should normally be able to demonstrate possible scenarios.
2. The gain which may be attributable to realising project objectives is the difference between the value of a completed building and its construction costs - including the cost of the land, finance costs incurred during construction and any directly attributable costs.
3. Project risks are all risks associated with realising the project objectives. The existence of unmitigated project risks is a key factor in arriving at the fair value of IPUC. The significant project risks associated with the development should be identified.
4. When project risks are minimised or eliminated, a degree of project gain may have been achieved and the value of the project increased. However, project gain should only be recognised in a valuation of an IPUC when a substantial amount of the project risks have been reduced or eliminated. An appraiser should disclose the significant judgements used in determining the stage at which a substantial amount of the project's risks have been eliminated (see also 7 below).
5. The above notwithstanding, if the land has increased in value - perhaps via the issue of government permits - and comparable prices exist for land in that condition in an active market, then that part of the project gain should be recognised.
6. Valuations should be based on project cash inflows and outflows, taking into account the time value of money and remaining project risks. The cash outflows must include all construction and other project costs still to come, based on contracted terms and current best estimates.
7. Transparency of the valuation estimate is important. The appraiser should include a description of their valuation methodology and the key assumptions used in their report to the client. In particular, the appraiser must also identify how the remaining risks of the project have been dealt with in the valuation - any contingent element, deductions or risk adjusted discount rates should be quantified and explained with reference to the remaining project risks.

We have included in Appendix I the rationale for these agreed principles. A number of other principles were not adopted during the meeting and these are listed in Appendix II.

The attendees at the meeting are listed in Appendix III.

Conclusion

The principles recommended in this paper are supported by EPRA, and with the support of the IVSC, should provide the following industry benefits:

- a consistent approach
- transparency
- a clear link between IAS 40 and the valuation practice
- explicit recognition that key projects risks underlying the valuation must be identified and addressed
- guidance on what constitutes a 'reliable' valuation

It is true to say that more detailed or prescriptive guidance would lead to more standardisation – but a balance must be achieved between (i) the need for a consistent approach; and (ii) professional consideration of the unique circumstances and risks that attach to each project. We consider that the principles set out above do achieve the right balance, and we therefore recommend both that IVSC adopts these principles and incorporates them in their formal valuation guidance.

Attachments

I Principles agreed upon

II Principles rejected

III List of attendees

Appendix I - Basis for conclusions

	Principle	Rationale
1.	The starting point of any valuation of IPUC should be a completed property. Such a valuation should be based on current valuations applicable to similar existing completed properties with comparable encumbrances to property rights. In practice, property is not usually fully let on completion but an appraiser will still be able to value the IPUC and should normally be able to demonstrate possible scenarios. Reference to EPRA Meeting: Principle 1.	Whatever model is used to estimate the value of IPUC, it is necessary to start with an estimation of the value of the finished property. There are many different models to do this, including a yield approach or a DCF. The selection of a model will often depend on market practice. Any estimation of a finished property will involve judgement or estimates; for example of the market rent and discount rate/yield on completion. An appraiser should therefore be able to estimate the value of the finished property under different assumptions taking into account estimated vacancy costs.
2.	The gain which may be attributable to achieving and realising project objectives is the difference between the value of a completed building and its construction costs - including the cost of the land, finance costs incurred during construction and any directly attributable costs. Reference to EPRA Meeting: Principle 2.	The gain which may be attributable to achieving and realising project objectives is the most subjective area of the valuation. In particular, the question of when such a gain - and the quantum thereof - should be recognised in a valuation. It is therefore important to first define what is meant by a value increase of the project. Some attendees believe that such an increase in the value of a development project should simply be referred to as a development gain. However, the nature and reason of any value increase is a complex and judgemental area. *Inter alia* project values may have increased due to, for example: - development activities; - economic circumstances; - changes in market conditions; - changes in occupier fundamental; - synergies with other projects or existing investment properties. Hence, one cannot say or even prove that if a project has increased in value that, by definition, such value increase is solely and exclusively attributable to the development activities. Therefore, these principles avoid the description ‘development gain’ - rather, the neutral wording ‘project gain’ is used. Some attendees believed there could be confusion about directly attributable costs. For instance, IFRS does not allow capitalisation of selling costs, general overhead and research costs etc. However, fair value of IPUC is an exit value. Costs are taken into account in the valuation process to the extent deemed necessary to arrive at that exit value.

	Principle	Rationale
3.	Project risks are all risks associated with realising the project gain. The existence of unmitigated project risks is a key factor in arriving at the fair value of IPUC. The significant project risks associated with the development should be identified. Reference to EPRA Meeting: Principles 3 and 5.	Project risk and reward are inextricably linked. Every project has a number of generic and unique risks. To the extent these risks have not been eliminated, they are a key driver in determining the fair value of any IPUC. Therefore when considering project gain, it is necessary for an appraiser to identify those project risks which are significant to the project and its fair value at the valuation date.
4.	When project risks are minimised or eliminated, a degree of project gain may have been achieved and the value of the project is increased. However, a project gain should only be recognised in a valuation of an IPUC when a substantial amount of the project's risks have been reduced or eliminated. Reference to EPRA Meeting: Principles 4 and 6.	IAS 40 only allows IPUC to be carried at fair value if the valuation is sufficiently reliable. This implies that sufficient risks have been eliminated. As the objective of any guidance paper is not to be prescriptive, we consider that guidance that a 'substantial' amount of risk be eliminated is appropriate. It is deliberate that no further guidance has been provided as the appraiser will need to consider the individual facts and circumstances of a development in making this judgement. Not only might they differ from project to project, but also from market to market and can be dependent on the economic climate. However, it is important that an appraiser discloses how this judgement is made. For example, if certain hurdles are set prior to project gain being recognised - for example a percentage of the development physically complete or a percentage of the building successfully let – then these should be disclosed.
5.	The above notwithstanding, if the land has increased in value - perhaps via the issue of government permits - and comparable prices exist for land in that condition in an active market, then that part of the project gain should be recognised. Reference to EPRA Meeting: Principle 13.	As noted, the valuation of IPUC is typically carried out on a 'mark to model' basis. However, if there is an opportunity to use a 'mark to market' method for an element of the IPUC, then it would be appropriate to do so. This implies a two-stage recognition approach may be appropriate: the incremental value resulting from zoning and permits and the remainder of the development process. For example, it may be that the appraiser does not consider it appropriate to include any project gain in the 'construction asset' if the development has not yet progressed sufficiently (i.e. the appraiser may still consider the fair value of that part to be the same as cost). However, if in this situation, the land element of the development has an identifiable fair value by reference to market transactions, then that should be taken into account. Some attendees believed this is not in line with paragraph 51 of IAS 40. Indeed, future capital expenditure that will enhance the benefits may not be taken into account in determining the fair value, nor may the income that might arise from this expenditure. However, it is common for the value of land to reflect its potential future use, and the value of land may increase in the event that the owner obtains

	Principle	Rationale
		any required permissions for a change in the use of that land. It may be, for example, that a permission to change from an industrial to residential use will increase the value of the property as a whole, not withstanding that the existing industrial buildings are still in place. This increase in value is typically attributable to the land, rather than the buildings. If that value increase reflects the market value of the land, i.e. it is what every buyer of the land would incorporate in the price they are willing to pay, it would be appropriate to record any changes in value resulting from the receipt of such permissions in the fair value of the land. But, if the increase in value is entity-specific, for instance, if the benefit of the permission was only available to that owner and not the market generally, then no additional value can be recorded for the land.
6.	Valuations should be based on project cash inflows and outflows, taking into account the time value of money and remaining project risks. The cash outflows must include all construction and other project costs still to come based on contracted terms and current best estimates. Reference to EPRA Meeting: Principles 7, 8 (partially), 10 and 11.	This paper is not prescriptive about a valuation method, but any method must take into account the time value of money and contracted cash flows. Other non-contract cash outflow estimates must be estimated according to market prices.
7.	Transparency of the valuation estimate is important. The appraiser should include a description of their valuation methodology and the key assumptions used in their report to the client. In particular, the appraiser must also identify how the remaining risks of the project have been dealt with in the valuation - any contingent element, deductions or risk adjusted discount rates should be quantified and explained with reference to the remaining project risks. Reference to EPRA Meeting: Principle 14.	As noted previously, the valuation of IPUC is both complex and judgemental. It is therefore important that an appraiser's report informs the user of the valuation method and key assumptions. The appraisers report may be used for corporate governance purposes and to assist in the preparation of the financial statements. We also note, for example, that IAS 40 requires disclosure of the methods and significant assumptions applied in determining the fair value of investment property, including a statement whether the determination of fair value was supported by market evidence or was more heavily based on other factors (which the entity shall disclose) because of the nature of the property and lack of comparable market data.

Appendix II – Rejected principles

	Principle	Rationale
1.	If risk is not explicitly allowed for elsewhere in the valuation process - for example construction costs and GDV - then: a) the discount rate should reflect the market risk premium, and is by definition higher than the rate used for valuing the completed and fully let property; b) different rates may be necessary on different elements - for example a higher discount rate for outgoings (higher risk = lower discount rate) as compared with income (higher risk = higher discount rate). Reference to EPRA Meeting: Principle 8 (partially).	This was found too prescriptive. The attendees, however, agreed with the general principle that project risks should be explicitly allowed in the valuation. It is the appraiser who must identify how he has factored in the remaining risks into the valuation.
2.	The required risk premium should be based on the premium typically required by developers in the subject market at the effective date of the valuation Reference to EPRA Meeting: Principle 9.	As above
3	Project uncertainties which are not reflected in the risk premium must lead to an even higher discount factor, or to a lower project gain, or must be factored in via other techniques such as the Real Options Model or Monte Carlo simulation Reference to EPRA Meeting: Principle 12.	As above.

Appendix III - Attendees at the EPRA roundtable meeting in Stockholm

Ad Buisman (Chairman)	Ernst & Young
Gareth Lewis	EPRA
Peter van Rossum	Unibail Rodamco (Chairman of EPRA Reporting & Accounting Committee)
Bert Jaap Dijkstra	Unibail Rodamco
Olivier Elamine	Alstria
Marcus Post	ING Real Estate
Luciano Gabriel	PSP Swiss Property
Jan Haars	Corio
Graham Roberts	British Land
David Sleath	SEGRO
Dennis De Vreede	RedevCo
Arjan Spruit	RedevCo
Craig Hughes	Ernst & Young
Matt Williams	Ernst & Young
Hans Grönloh	KPMG
Jonathan Thompson	BPF / KPMG
Chris Thorne	IVSC
Andrew Barber	RICS / CBRE

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About EPRA

The European Public Real Estate Association - is the voice of the publicly traded European real estate sector.

With more than 200 active members, EPRA represents over EUR 300 billion of real estate assets and 85% of the market capitalisation of the FTSE EPRA/NAREIT Europe Index. EPRA works to encourage greater investment in listed real estate companies in Europe through the provision of better information to investors, improvement of the general operating environment, encouragement of best practices and the cohesion and strengthening of the industry,