Property valuation in the UK: material uncertainty and COVID-19

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Abstract

Purpose – An understanding of uncertainty has always been an integral part of property valuations. No valuation is certain, and the valuer needs to convey to the user of the valuation in the degree of uncertainty pertaining to the market value.

Design/methodology/approach – This practice briefing is a short overview of the importance of understanding uncertainty in valuation in normal markets and the particular difficulties now with the material uncertainty created by the COVID-19 pandemic.

Findings – This paper discusses how important it is for the valuer and the client to communicate and understand the uncertainty in the market at any point of time. The COVID-19 has had a significant impact on property values and the importance of clarity within valuation reports.

Practical implications – This paper looks at the importance of placing capital and rental value changes due to material uncertainty in valuation reports.

Originality/value – This provides guidance on how professional bodies are advising their members, around the world, on how to report valuations and market value in the context of material uncertainty.

Keywords – Uncertainty, Property valuation, Market value, Comparables, Material uncertainty and Market sentiment

Paper type – General review

Introduction

Previous work by French and Gabrielli (2004, 2005) has argued that, as valuations are professional price estimates made at the time of the valuation, market values are not certain. This has always been the case; there has always been uncertainty in valuations. However, the current situation with the COVID-19 pandemic, triggering the Global Downturn of 2020, has meant that the valuation profession has been forced to look at the market through the eyes of material uncertainty; uncertainty that is over and above that experienced in “normal” markets.

Such uncertainty doesn’t reflect on the ability of the valuer but from a lack of comparable information in the market at a particular point of time. Since February 2020, in some markets there have been no transactions at all and existing comparables, pre-Covid, do not reflect the impact on the global downturn on asset values. The valuer therefore has fewer (or no) comparables to act as “signposts” to help determine the market value of the subject property. Instead, the valuer needs to rely upon, and look at, any other signposts in the market that may provide an indication of where market prices may be at that point in time. These could be other forms of market data such as asking price information of similar assets or enquiry details of potential purchasers or a host of other indicators within a hierarchy. Not all comparison is equal and the property profession recognises that some evidence is more useful than other information. In a normal transparent market, market transactional evidence is always preferred as the principal signpost but in more opaque markets, there will be a need to give greater emphasis to these other market signposts. But, as the information used moves away from the relative veracity of transactional evidence, then the certainty of the valuation will become less. In extreme cases, such as the current COVID-19 crisis, that uncertainty can
increase to such a level that it becomes incumbent upon the valuer to inform the client of the situation. In the UK, the Royal Institution of Chartered Surveyors (RICS) refers to this a “Material Uncertainty” and has established protocols for informing the client of the valuations that “less certainty – and a higher degree of caution – should be attached to the valuation than would normally be the case”.

This briefing looks at uncertainty in valuations, material uncertainty and the importance of conveying to the client, not just the market value figure, but the economic context and the meaning of market value.

What is market value?
Market value is purely an exchange price estimate, and it does not have a shelf life. The valuation of any asset represents the valuer’s professional opinion of the price that the asset would achieve were it to be sold in the open market on the day of the valuation. The RICS defines market value within a Valuation Practice Statement (VPS) in the RICS Valuation – Global Standards (Red Book–VPS 4.4, RICS, 2020a) as:

Market value is the estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.

This is a “price” definition and can easily be modified to read as “price” [changes in bold]

Price is the amount for which an asset exchanges on the date of sale between a willing buyer and a willing seller in an arm’s length transaction after proper marketing wherein the parties have each acted knowledgeably, prudently and without compulsion.

How to determine market value
There are three recognised approaches to valuation and they are the cost approach, the income approach and the market approach (Red Book–VPS 3, RICS, 2020a, b), and all approaches, to a lesser or greater extent, use comparison as a lynchpin to determine market value.

The whole valuation process is a heuristic procedure of rigour where the valuer looks at the veracity of each data source to help identify the likely price in the market at the date of the valuation. This relies upon experience, expertise and intuition. A valuer takes comparable information and adjusts these historic figures using other market information to estimate the price in the market today. No good valuer would simply replicate the numbers from comparables sales without further analysis. It may be that the market is static and thus prices will not have changed since the comparables sold but this will be stated in the valuation report as placing the valuation in an economic context is central to a good valuation. Conversely, the market may have risen or fallen in the interim period since the comparable sales and the valuer will adjust the valuation, the estimate of price in the market today, accordingly. Comparables are the start of the valuation process and not the sole contribution. The interpretation and intuitive analysis of comparable information is a complex process. Its apparent simplicity belies the real complexity involved. A valuer is an applied economist who is estimating price today from a raft of market data.

What is market value in a global downturn?
It is the same as in a normal market. It is an estimate of price in the market. The difference is that there will be very few transactional comparables and the valuer will need to look at other signposts to determine value. The lack of market activity means there is little transactional evidence on which to base values it does not mean that there is not a value at which the property
would transact. That requires the valuer to rely more on sentiment and less on comparables. That makes the valuation less certain. Uncertain inputs lead to uncertain outputs.

The valuer makes a best judgement on the respective variables but, particularly in a downturn, the lack of transaction evidence can lead to uncertainty. In such case, the valuation is more reliant on the valuer’s interpretation of the market rather than transactional evidence. Indeed, immediately after the last crash of 2007/2008, a number of commentators alluded to the need for valuers to value more on “sentiment” than comparison.

(1) “The full extent of the market problems has not been mapped in to current valuations” (Peto, 2008)

(2) “The days of waiting for evidence are over. In the absence of evidence, valuers should be required to value on sentiment” (Mason, 2008)

Market value and worth
In every downturn, the market reacts to lower valuations by arguing that it isn’t the right figure as “we would never sell at that price”. This illustrates a fundamental misunderstanding that still continues in the market place. Many clients don’t understand market value. As shown above, market value is an estimate of the price that would be achieved for an asset if it were it to be sold in the current market conditions in a hypothetical sale. The fact that, in reality, an owner would not sell at that figure is not the issue. That could always be the case. There is a difference between price and worth. Worth is a subjective assessment of the benefits of ownership of the asset. For an investor, if they believe the asset is worth more than its current price, they retain its ownership. If the worth is less than its price then, all other things being equal, they would consider its sale. That is true at any point in the market. It is frustrating that in downturns, owners argue that the market value is too low but in upturns, they never suggest that the market value is too high. In terms of economics, worth can be considered as value in use, whereas price or market value can be considered as value in exchange.

Indeed, in the current downturn the RICS has reported that there are anecdotal reports suggesting that this misunderstanding of the difference between the market value (Red Book, VPS 4.4, 2020a) of a property and the worth of it to a particular owner or occupier (Red Book, VPS 4.6, 2020a) is happening in the current downturn. In the Valuation Practice Alert (RICS, 2020b) on their website, its states:

… a client’s unwillingness to transact at a certain level should not influence the assessment of market value. The assessment of worth does not require a hypothetical transaction but is a subjective judgement of the benefits of ownership by the investor

The definition of worth to which they refer (Red Book, VPS 3.6, 2020a) is:

Investment Value (Worth) - The value of property to a particular owner, investor, or class of investors for identified investment or operational objectives’. 

As the definition implies, and in contrast to market value, worth does not envisage a hypothetical transaction but is a measure of the value of the benefits of ownership to the current owner or to a prospective owner, recognising that these may differ from those of a typical market participant.

Normal market uncertainty
As noted above, there is uncertainty in all valuations at any point in the market. And, by uncertainty, we mean “the probability that the valuer’s opinion of market value would exactly
coincide with the price achieved were there an actual sale at the valuation date”. (Red Book, VPS 3.2, 2020a). In a buoyant market, with lots of comparable transactional data, the uncertainty will be relatively low. In a downturn, the uncertainty will be greater. But this range of uncertainty can be considered as “normal” uncertainty.

The RICS’ full definition of uncertainty (Red Book, VPS 3.2, 2020a) is:

All valuations are professional opinions on a stated basis, coupled with any appropriate assumptions or special assumptions (see VPS 4 paragraph 2, Assumptions, and VPS 4 paragraph 3, Special assumptions). A valuation is not a fact, it is an opinion. The degree of subjectivity involved will inevitably vary from case to case, as will the degree of certainty – that is, the probability that the valuer’s opinion of market value would exactly coincide with the price achieved were there an actual sale at the valuation date.

There is also a RICS Guide to Uncertainty (RICS, 2011) for users of valuations that supports VPS 3. What should be remembered is that the presence of uncertainties should not be used to qualify the valuation in any way and instead should be used to clarify the valuation. Uncertainty in valuations is universal and by expressing to the client that there is uncertainty is not abdication of professional judgement by the valuer. Indeed, it is the opposite. Valuation reports need to be transparent and clear and uncertainty is one element of the valuation that should be reported in full.

So to summarise, the expertise of the property valuer is to take market evidence of previous similar sales and interpret these sale prices relative to the current market sentiment of possible or potential investors in that type of property. You cannot value effectively with comparables alone and the adjustment of these historic sales by market sentiment is integral to the valuation process. Even in a market with lots of transactional evidence and lots of “chatter” about investment sentiment, the estimated figure will have a degree of uncertainty. The RICS emphasis this point in its standards (Red Book, VPS 3.2, 2020a):

... a valuation is not a fact. Like all opinions, the degree of subjectivity involved will inevitably vary from case to case, as will the degree of 'certainty' ... even if all the circumstances envisaged by the market value definition and the valuation assumptions were identical to the circumstances of an actual sale.

Property valuations are always uncertain; it is the degree of uncertainty that will vary in line with market volatility.

Abnormal market uncertainty
For the majority of times, markets may rise and fall but will stay within the parameters of being normal. However, it is recognised that there will be times where negative market volatility extends beyond those normal boundaries. This is what is happening with the COVID-19 pandemic, there is now unprecedented uncertainty and this is impacting real estate markets worldwide and, specifically, the impact of that uncertainty on the market value of property (and other assets). All valuations in normal markets have a degree of uncertainty. So the question is how do valuers deal with the massive uncertainty caused by the COVID-19 pandemic or, more specifically, with the mitigating measures taken around the world that has triggered the current global downturn?

Material uncertainty – professional guidance
The RICS, like many other professional bodies around the world, recognises that there will be times when the uncertainty in the market is greater than normal. This is called material uncertainty and, again to quote the RICS, it is where the addition of the word “material” means that the degree of uncertainty in a valuation falls outside any parameters that might normally be expected and accepted.
Now, within the academic and professional literature there is a mire of different definitions for uncertainty and material uncertainty, different terminology, incompatible definitions and a plethora of myopic disciplinary perspectives. That discussion is outwith the ambit of this briefing as it is clear that, regardless of definition, that the world is experiencing unprecedented levels of uncertainty due to this significant unforeseen event.

Although, this briefing is concentrating upon the guidance and standards of the RICS, other professional bodies around the world have been issuing similar guidance. This may be at a national level or regional/world level. Some refer to material uncertainty, some others, abnormal uncertainty or similar terms.

The RICS adopts and applies the International Valuation Standards (IVS) published by the International Valuation Standards Council (IVSC). They have made comment via their website about valuation during market unrest (IVSC, 2020) and reiterated the analysis above:

One of the main issues when dealing with valuation uncertainty is that a valuation is not a fact, but it is an estimate of the most probable of a range of possible outcomes based on the assumptions made in the valuation process. Market valuations are estimates of the most probable price that would be paid in a transaction on the valuation date. An element of uncertainty is inherent in most market valuations as there is rarely a single price with which the valuation can be compared.

Likewise, the European Group of Valuers’ Associations (TEGoVA) issued an umbrella statement via their website (TEGoVA, 2020) saying:

The pandemic has rendered real estate valuation work in most countries difficult to undertake in the absence of market activity (transactions are rare if not non-existent) as postulated by the definition of market value. In the circumstances many valuers have included disclaimer clauses in their reports highlighting the uncertain nature of the valuations reported.

With both the IVSC and TEGoVA commentaries, it is advised to read the statements in full on their respective websites but the excerpts above give an idea of the global professional response to reflect the current level of uncertainty affecting all market valuations. These are comments by international/regional organisations but the exact application of the recommendations will be within the gift of each national body. Most national bodies operate within the geographical boundaries of their respective countries, however the RICS has a global reach and their standards, which themselves come from the IVSC, can be used around the world in accordance with any overriding national regulations.

The rest of this briefing is looking at the RICS Standards as they apply in the UK.

Material uncertainty – RICS guidance

As of mid-March 2020, the RICS issued advice to its members, and in particular to valuers, that it may be warranted to declare within their valuation reports that there is material uncertainty. The Red Book (VPS3, 2020a) clearly states:

... in some cases there may be a greater degree of uncertainty concerning the valuation figure reported than usual, and where that uncertainty is material – which should be expressly signalled in the report – further proportionate commentary must be added in order to ensure that the report does not create a false impression. Valuers should not treat such a statement expressing less confidence in a valuation than usual as an admission of weakness – it is not a reflection on their professional skill or judgment, but a matter entirely proper for disclosure.

In my opinion, it would be odd for a valuer NOT to declare material uncertainty at this current time albeit, the decision to do so, or not, still lies with the valuer. Indeed, the RICS has recently issued a statement (RICS, 2020b) that says:
RICS Regulated Members and firms may therefore be considering whether a material uncertainty
declaration is now appropriate using the Red Book Process. If material uncertainty is declared, this
should be explicitly stated, and RICS has suggested today, a form of wording that can be used.

This advice was implemented via a RICS Valuation Practice Alert (RICS, 2020b) on their
website called “COVID-19 (Coronavirus)”. Such notifications are rarely used and its existence
reiterates the importance that the RICS attach to the need to declare material uncertainty.
The RICS stress that any restrictions placed upon the normal access to the property and/or
valuation data and restrictions on the physical inspection of the subject property need to be
made clear and agreed with the client and clearly stated in the report. If the client is not happy
with the provision of valuation on a restricted basis, then the instruction should be declined.
Additional guidance is also available to download on RICS website and this should read in
conjunction with the RICS valuation practice alert.

But, indeed, all RICS valuers will have already read, and digested, its content in its entirety
but I have repeated the salient wording that the RICS suggests should now be included in all
valuation reports where there is material uncertainty.

... As at the valuation date, we** consider that we can attach less weight to previous market
evidence for comparison purposes, to inform opinions of value. Indeed, the current response to
COVID-19 means that we are faced with an unprecedented set of circumstances on which to base
a judgement. Our valuation(s) is/are therefore reported on the basis of ‘material valuation uncertainty’
as per VPS 3 and VPGA 10 of the RICS Red Book Global. Consequently, less certainty – and a higher
degree of caution – should be attached to our valuation than would normally be the case. Given the
unknown future impact that COVID-19 might have on the real estate market, we recommend that
you keep the valuation of [this property] under frequent review.

So to revert to the central tenet of this briefing, all valuations are uncertain due to the nature of
the valuation process; they are expert opinions. But, at the moment the range of that
uncertainty is greater than that experienced in normal markets. Of course, there are still some
transactions happening in the market (particularly in the logistics market) and different
property sectors will be impacted in different ways. There will be some markets where some
degree of certainty does still exist.

But where there is uncertainty, there will be a number of issues that the users of the
valuations will have to consider. This may be the impact on financial statements (where
additional disclosures and procedures that may be required in order to finalise company
reports), the impact of additional disclosures to opinion on banking covenants; less
preferential loan to value ratios and, overall, the lenders views on uncertainties disclosed in
the financial statements. Uncertainty doesn’t just impact on property values but on all forms
of decision making across the property sector.

What does “material uncertainty” mean to the user of property valuations?
So, what does this all mean to the users of valuations? There has been anecdotal evidence that
most of the big funds and lenders are fully aware, and cognisant, of the need to declare
material uncertainty and the consequential additional caution needed when looking at the
valuation figure. But for other users of valuations, who are less conversant with the valuation
process, it can be confusing. What is this “less certainty” in this valuation? Can I ask another
valuer for a more certain valuation?

The answers are all linked to the true nature of a valuation as discussed above. A
valuation is a range of possible values which usually conforms to a normal distribution. That
is a distribution of numerous possible values ranging from a low value to a high value with a
larger grouping of more likely values in-between. Indeed, American valuers often refer to the
“most probable price”. So valuation is NOT a single figure, it is a range of possible figures.
But, that doesn’t work in practice and a valuer has to indicate to the client ONE number. This is the estimate of market value. All valuation reports provide the client with single figure for market value.

But if you ask the valuer how certain they are that they have chosen the “correct” spot figure, they will answer according to the range of possible values in the market at that point in time. If the market is strong with lots of comparable evidence and market activity, that range will be relatively compact. If, however, as now the market has no transactions and no market evidence of bids or other activity, then that range will be significantly wider. That is why it is less certain. Their choice of a spot figure within a wide range has greater uncertainty that the figure chosen will correspond to the actual sale price were the property sold on the date of the valuation.

Likewise, all valuers work within the same environment and thus the lack of certainty will pertain to all valuations by all valuers, it is a market uncertainty and all valuations will have the same uncertainty at any point in time. There is no point of changing valuer as the uncertainty in the valuation figure will be the same.

So, as with everything else in this strange new COVID-19 world, valuations are inherently less certain and it is incumbent upon the valuer to let the client know that at the commencement of the instruction and to explain the uncertainties relating to the subject property and the market within it is being valued. Users of valuations should trust in their valuers. And as discussed above, it is imperative that the valuer and the client converse so the material uncertainty is explained and that the distinction between market value and worth is fully understood.

Conclusion

All valuations are opinions of the price that would be achieved in a transaction at the valuation date, based on the stated assumptions or special assumptions. Like all opinions, the degree of subjectivity involved will vary significantly, as will the degree of “certainty” (that is, the probability that the valuer’s opinion would be the same as the price achieved by an actual sale at the valuation date). These variations can arise because of the inherent features of the property, the market place or the information available to the valuer. Such variations are accentuated in a down market such as the current global downturn trigged by the COVID-19 pandemic. An acceptance of the limitations of the market due the resulting material uncertainty is not a reflection on the professional skill or judgement of the valuer. Put simply, the market is more uncertain, inputs are uncertain and so the market value of the property will also be more uncertain.

References


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