PLA Conference

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Valuation: what is it and what can it achieve?

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Peter qualified in 1972, after obtaining an Honours Degree in Economics.

Until 1987, he was senior partner of a firm of estate agents in the north-west London area. Having sold that business, he made an ill-timed foray into property development in 1987, and worked for Kemp & Hawley (now part of Stiles Harold Williams) from 1991 to 1997.

He is now senior partner of Beckett and Kay, a firm specialising in landlord and tenant work, with particular emphasis on damage to the reversion, leasehold enfranchisement, value investment, and recovery. The firm is based in Savile Row in central London. Peter lives in Harrow (in north-west London).

Dilapidations

He was the landlord's valuer in the leading cases on dilapidations, Shortlands Investments Ltd v Cargill plc¹, Simmons v Dresden² and Bruntwood v BT³. He was a member of the RICS Dilapidations Working Group, responsible for producing the fifth edition of the RICS Guidance Note on dilapidations.

Leasehold enfranchisement

He was a member of the Leasehold Reform Working Group of the RICS responsible for Valuation Information Paper no 7 on leasehold reform. In the Lands Tribunal, he was one of the valuers in Sportelli⁴, the leading case on deferment rate, and Arrowdell⁵ and Nailrile⁶.

¹ Shortlands Investments Ltd v Cargill plc [1995] 1EGLR 51
² Simmons v Dresden [2004] EWHC 993 (TCC)
³ Bruntwood 2000 First Properties Ltd v British Telecommunications plc [2008] (unreported)
⁴ Earl Cadogan and anor v Sportelli and anor and other cases: LRA/50/2005 and other references
Beckett and Kay

which addressed leasehold relativity. He was a member of the RICS Leasehold Reform Working Group which, at the behest of the Lands Tribunal in Arrowdell, produced the RICS Research Report "Leasehold reform: RICS graphs of relativity" in July 2009.

Recovery

He is an RICS Registered Property Receiver and on the Council of NARA - the Association of Property and Fixed Charge Receivers. He drafted their Guidance Note 19 on the Receiver's role as landlord, and is drafting Guidance Note 12 on leasehold property.

Investment

He is a proponent of value investment principles in property, and a small investor.

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A note on zoning

5 Flats 36-65, Coniston Court, Holland Road, Hove - Arrowdell Ltd v Coniston Court (North) Hove Ltd [2006] (LRA/72/2005)
6 Nailrile Ltd v Earl Cadogan and anor and other cases [2008] (LRA/114/2006 and other references)
Market value

The estimated amount for which a property 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.7

Value compared to worth8

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PRINCIPAL MESSAGE: To avoid confusion, greater care should be taken over the use of the words price, value and worth. In the context of real estate, value should always be related to price (Value in Exchange) not worth (Value in Use). Price/value are market driven whereas worth is subjective and based on the particular requirements/circumstances of the individual.

....

- Price is the actual observable exchange price in the open market.

- Value is an estimate of the price that would be achieved if the property were to be sold in the market.

- Worth is a specific investor's perception of the capital sum which he would be prepared to pay (or accept) for the stream of benefits which he expects to be produced by the investment.

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7 RICS Appraisal and Valuation Manual ("The Red Book") - fifth edition
8 Taken from Calculation of worth - an information paper (RICS Books 1997): full text at the end
Quality and relevance of comparable evidence

The relevance, quality and ranking of comparable evidence is of paramount importance in valuation, so much so that it's been given a good deal of judicial thought. For example, per the judgment in the Living Waters case:

First, to describe a particular property as a "comparable" in the context of a rent review arbitration, as in relation to any other property valuation issue, is to refer to another property that can be used as a reference point to give some indication of value of the property in question. The closer the other property stands on the scale of characteristic proximity to the property in question the more helpful an indicator it will be of the value of the property. Thus, if all material characteristics going to value are the same, one would expect the value of the property in question to be very close to that of the other property. In such a case much weight would be attached to it as "a comparable". There might, however, be other cases where a number of properties of similar characteristics had one or more characteristics materially different from the property in issue, but could still be used as the basis for a general indication of the value of that property because an experienced valuer would know what adjustment to make to the value of that property by reference to the material differences in characteristics in order to obtain a general indication of the value of the property in question. In such a case it would no doubt be appropriate to describe the other properties as imperfect or even poor comparables. That would simply mean that their value could not be transposed to that of the property in question, but it would not mean that they were evidentially irrelevant to that value. At the extreme end of the scale would be properties that were so different in material characteristics from the property to be valued that they had no evidential contribution to make and therefore be treated as irrelevant. Accordingly, the term "comparable" has to be treated as wide enough to cover any other property that has any evidential contribution to make to the assessment of the value of the property in question, whether that contribution is substantial or only relatively small because of differences in material characteristics.

Second, information as to the material characteristics of the other properties, said to be comparables, may be complete or relatively incomplete. The less complete it is, the less weight can be given to that property as a comparable. Special circumstances relating to the negotiation of the rent at a particular property may render it a poor comparable or not a comparable at all, whereas, if there were no knowledge of those circumstances, that property might appear to be the perfect comparable.

So closeness to the subject matter is critical in assessing value.

Remoteness of comparable evidence from the subject matter to be valued makes it "so different in material characteristics from the property to be valued" that its use would be a sign of desperation. It would imply that there is absolutely no comparable evidence of any
kind available of a "scale of characteristic proximity to the property in question" to be useful.

Lotting


Duke of Buccleuch v. IRC [1967] AC 506

Re Castlebeg Investments (Jersey ) Ltd's Appeal (LRA/3/1984), reported in EG of 3-Aug-1985

Carl v Grosvenor Estate Belgravia [2000] LRA/33/1999

[Attorney general of Ceylon v Mackie]

Wellcome Trust v Romines [1999] 3 EGLR 229

Marriage value

Stokes v Cambridge [1961] 180 EG 839

The piggyback effect

...... in the 1980's, a combination of a comparative shortage of new lettings and a large number of rent review settlements resulted in such settlements constituting the biggest single group of rental transactions. This predominance resulted, in some cases, in such settlements becoming self generating, with errors being compounded. Subsequent open market transactions did not confirm the levels of those earlier rent review settlements and these situations have confirmed the dangers of over-reliance on other rent reviews. 

Provision for loss of capital

Net income for this purpose will be the profit rent, as has been shown above. However, when an investor purchases a leasehold interest there is one factor which will not be met in a freehold interest, namely that one day the purchaser's interest must cease and the purchaser will have no further interest in the property: if the purchaser obtains a further lease in the property at market rent to follow the expired lease that will be a new investment.

Reynolds and Fetherstonhaugh: Handbook of Rent Review - para 9.6.1
The investor knows therefore that one day its interest will cease and it will have no capital asset remaining. The investment will therefore decline from whatever was paid to nothing. Such an investment is known as a wasting asset since the asset wastes away naturally and inevitably.

The investor faced with such a situation must therefore take steps to deal with the loss of capital. This can be done by investing funds which grow to compensate for the capital lost. The sensible approach is to finance these funds out of the income produced by the wasting asset so that it is self-compensating. Various methods are available but the conventional approach is to assume that part of the rent will be invested each year out of the profit rent in an annual sinking fund. Since there is a need to guarantee the replacement of the capital, the investor must seek a medium which is as certain as possible to guarantee that the sums invested will reach a specific and certain figure at the end of the term. The only such medium is normally an insurance policy. Naturally the returns offered by insurance companies must be based on long-term rates of interest which ignore abnormal movements in interest rates and which give a reasonable guarantee that they can meet their obligations. Consequently the returns offered will be low and an average yield of around 2.25%-3% has been found to be realistic. Only for the purposes of our examples we have used 3%. The appropriate rate will be dictated by market conditions at the time of the valuations but in the case of Nailrile Ltd v (1) Earl Cadogan [LRA/114/2006] (a Leasehold Reform Act case) the Lands Tribunal determined in December 2008 that the appropriate sinking fund rate was 2.25%.

If the investor places some of the net income in such a sinking fund it can be satisfied that its original investment capital will be available at the end of the lease for further investment. In that way the investment can be continued indefinitely so that the return received after allowing for sinking fund costs will
be perpetual. The effects of inflation on such an arrangement will be considered later.¹⁰

Types of purchaser

Potential purchasers are persons who propose to tie up a certain amount of capital in land or in land and buildings and there are three main angles from which they may view the transaction. First, if they wish to occupy the property they will be concerned with the benefits, commercial or social, which they anticipate they will derive from that occupation. Secondly, they may regard the property as an investment capable of yielding an annual return in the form of income. Thirdly, their motive may be profit; that is buying at one price now, in the hope that they may sell at a higher price at some time in the future, perhaps having injected further capital, and thus making a gain. These motives are not, however, mutually exclusive and a transaction may be entered into with more than one motive in mind. ...

Development appraisal and residual valuations

How detailed should the appraisal be?

113 ... It is simply a question of degree. As we have said, the correct approach is to consider the lengths to which a developer would reasonably go in identifying what it would cost him to undertake the project, building in as he would, sufficient contingencies to reflect risks and unknowns, and this is what we have attempted to do in our following conclusions.¹²

Residual valuations are a last resort:

293 ... This Tribunal has repeatedly stressed its reluctance to use this valuation method. Its enforced use in this reference does not mean that its faults are any

¹⁰ Modern methods of valuation - tenth edition: Shapiro, Davies and Mackmin (EG Books)
¹¹ Ibid
the less; it remains a valuation method of last resort which is inherently very sensitive to even small changes in the input variables.\textsuperscript{13}

Preference of the Court for comparables over residual valuations

*In our opinion the following propositions may be deduced from the authorities:*

(a) *The value of an interest in land compulsorily acquired is the amount which that interest, if sold on the open market by a willing seller, might be expected to realise at the date ...*

(b) *In assessing this value the best evidence is comparison with figures from other sales of comparable property.*

(c) *The land acquired must be valued not merely by reference to the use to which it is being put at the time at which its value has to be determined, but also by reference to the uses to which it is reasonably capable of being put in the future: Gajapatiraju v The Revenue Divisional Officer, Vizagapatam [1939] AC 302.*

(d) *... .*

(e) *Where there are no comparable sales resort may be had to the residual value method. This should be reserved for exceptional cases and will not be applied where the open market value is otherwise ascertainable by such assessments as a spot valuation: Cripps on Compulsory Acquisition of Land, 11\textsuperscript{th} ed (1962), para 4-200. As the Lands Tribunal stated in Perkins v Middlesex CC (1951) 2 P & CR 42:*

"... a spot valuation based upon experiences of the market is more likely to be right than calculations which depend upon many assumptions and forecasts." \textsuperscript{14}

\textsuperscript{13} Ibid

\textsuperscript{14} Mon Tresor Ltd & Anor v. Ministry of Housing and Lands (Mauritius) [2008] UKPC 31
Hope value

(f) A spot valuation can take into account the existence and amount of hope value. Its assessment depends upon an amalgam of factors, the likelihood (ranging from complete certainty to a very slight possibility) of the requisite planning permission being granted, the demand for the suggested development, the time which such development would take and the projected costs. The resulting figure represents the premium over existing use value which a developer may be thought willing to pay in order to acquire the land in the hope of turning it to profitable account.15

54. Mr Beckett accepted that there were risks attaching to the development of the roof of Phase 2. He sought to reflect those risks by making a deduction of 50% from the value with planning permission and free of the restrictive covenant. We note that having assumed that, on 1 July 2005, the unrestricted value with planning permission was £300,000, Mr Beckett has not made a specific deduction to reflect the increase in values over the seven months following the valuation date. On the other hand, in arriving at his starting figure of £300,000, Mr Beckett decided to deduct 14.25 per cent from the price which was actually paid for Phase 1, based only on a short-hand residual valuation. That seems to us to be a cautious approach. Taking everything into account we consider that both Mr Beckett’s starting figure of £300,000 and his 50 per cent deduction for lack of planning permission are reasonable and we accept them.16

Analysis v Experience

In Marson v Hasler [1975] LT, criticism was made by one of the parties of the "academic" approach of the valuer for the other party: it was said reliance on analysis could be described as a mere juggling with figures. The valuer who made that criticism said that he did not belong to the "Analytical School" of

15 Ibid
surveyors, but regarded himself as belonging to the “Forty-years-man-and-boy school”. In that case the Tribunal said:

“It had every respect for able and practical surveyors who belong to the latter 'School', but the fact should be recognised that when a member of this 'School' finds himself unable to agree values with an equally able and practical member of the 'Analytical School' then on a reference to the Lands Tribunal, the latter surveyor is apt to have the easier passage. The reason for this quite simple, the Tribunal reaches its decisions on the evidence presented and although it does of course draw on its own skill, that skill is applied not to the valuation of the subject property but to weighing the evidence given - a process conveniently described as 'valuing the valuations' (and which may involve also 'valuing the valuers'). Opinion evidence, if it is to be certain of carrying weight, needs not only to be based on factual evidence but also to be demonstrably so based. Factual evidence bearing on the value of any land commonly takes the form of comparables: and the purpose of analysing the comparables is to enable unlike features to be identified and distinguished and to enable like features to be compared.17

[Notes from this point on are the author's and are not directly derived from authority].

Valuation compared to participation: a limited function

What property valuers do is a limited thing, entirely different from what investors do, or even from what thinkers about investment do.

Normally when one is discussing the value of properties or of investments, it's a fascinating topic. One can ruminate on the future. Will house prices carry on rising? Will investment returns decline? What is the effect of a rate of return on one kind of investment on another kind of investment? and so on. These are actually much more challenging and intellectually stimulating issues than those the property valuer deals with. What he does may be difficult at times, but intellectually it's fairly humble.

17 Compulsory purchase and compensation - fourth edition: Barry Denyer-Green (Estates Gazette)
The principles are rooted in fundamental - one might almost say first-year undergraduate - principles of real estate valuation. These principles apply to deferment rate as surely as they do to any other type of property valuation. Valuing the freehold interest with vacant possession in a house for mortgage purposes is no different in principle to the assessment of deferment rate. If the house next door was recently sold and it's very similar, that gives an extremely good guide to the value of the house the valuer is assessing. This says nothing about what he thinks the future of house prices will be, whether the house is "good value" in the sense of representing a high degree of utility for the purchaser, or whether he feels (as I do) that the present level of house prices is alarming. Indeed, it says nothing about any general principles at all.

This is a straightforward example of how valuers proceed. They actually don't deal in the interesting questions of "how?" and "why?", nor social, economic or personal merit. They simply apply the results of an actual market transaction to the subject matter of their valuation, without getting into what might well be more stimulating intellectually.

Valuers may also be investors, dealers, speculators or occupiers, or indeed social or economic thinkers, but that's irrelevant; they're not then being valuers. Valuers merely observe, analyse and apply. There are robust, practical reasons for this, implanted at the very earliest stages of a valuer's education. Investors may regard a given market price (that's to say what valuers confusingly call "value") high or low relative to their perception of its true or intrinsic value; they may become sellers or buyers accordingly. For valuers to think this way is inconsistent with their function (pace the "worth" concept of the Red Book). Valuers must keep judgement to a minimum - using it mainly in the area of adjustments.

In particular, speculative comparisons of other asset classes with property are inconsistent with their function.

**The place of comparable evidence**

It follows, as night follows day I think, that comparable evidence is the core concept in property valuation. What the valuer does is to collect comparable information, analyse it and apply it to the subject problem. This may be more or less difficult in any given case, but that is the universal technique, and for sound reasons.

In many situations, were the valuer to substitute his personal attitude to the property for that technique, he would be likely to get the valuation wrong and, in an extreme case, could expose himself to a claim for professional negligence.

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**Collection of data**

Of course, in practice data can often be quite difficult to come by. The more unusual the kind of property - the more specialised the class of property being valued - the more difficult
it may be to produce comparable evidence. The sources of such evidence are many, particularly in central London. There are many web sites which collect data from other sources: LonRes from agents for example; myhouseprice.com from the Land Registry; the Land Registry itself; other agents known to the valuer; and the transactions of which the valuer is aware in his or his firm's capacity as agent.

So important is the collection of comparable evidence, that a valuation without any forces the valuer to express considerable doubt about the accuracy and range of his valuation. For this reason, valuers are sometimes compelled to rely on single comparables, even though they're open to the "one swallow doesn't make a summer" criticism, in preference to any theorising about what value might be in abstract.

**Application of the evidence: making adjustments**

The Living Waters case emphasised that where evidence is available "an experienced valuer would know what adjustment to make to the value" in order to arrive at a reasonably reliable valuation. This is actually the valuer's most meritorious function. Making judgements about adjustments to comparables to arrive at the value of the subject property is perhaps the only area in which the valuer exercises a truly intellectual function. The rest is just well-considered evidence-gathering.

Adjustments to valuation data are made as a matter of routine for valuers. It's not necessary - in fact it's usually not possible - to find comparable evidence precisely the same as the subject property. Indeed, the more evidence the valuer has to work with, the more internally inconsistent he is likely to find that evidence. The real world is a messy place. Transactions tend to fit a scatter graph better than a line, and it's this "scatter graph" that the valuer is dealing with in arriving at his figure.

A good quantity of comparable evidence, adjusted by a valuer, even if speculatively or tentatively, is more likely to be satisfactory than wholly speculative theoretical or tentative assessments. A valuer's technique is therefore rooted mainly in fact, rather than in undiluted speculation.
A NOTE ON ZONING

THE ANALYSIS OF SHOP RENTAL VALUES

It is common sense, as well as an established standard of valuation, that the front of a shop - the part seen by passers-by - is worth more than the back. It follows from this that a shop with 15m of frontage and a depth of 8m commands a higher rent than a shop of 8m frontage and depth of 15m.

The method valuers have developed to deal with this is called zoning. The principle of zoning is that the front band of space is valued at one rate, the next band at half that, and so on.

Though all valuers agree on the principle, the detailed analysis can vary from valuer to valuer. My own approach, which I believe to be the commonest, is to take the first three bands - called Zone A, Zone B and Zone C - at 6m depths into the shop, call all remaining areas of the shop Zone D, and value ancillary space on an ad-hoc basis. If the amount of Zone D is relatively small, I would throw Zone D into Zone C.

I treat Zone B as having half the value per square metre that Zone A commands, Zone C a quarter of the value of Zone A, and Zone D one eighth. This idea is sometimes expressed thus:

<table>
<thead>
<tr>
<th>Zone</th>
<th>Value ITZA *</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>B</td>
<td>A/2</td>
</tr>
<tr>
<td>C</td>
<td>A/4</td>
</tr>
<tr>
<td>D</td>
<td>A/8</td>
</tr>
<tr>
<td>Basement</td>
<td>A/10</td>
</tr>
</tbody>
</table>

* meaning expressed "in terms of Zone A"
A highly simplified example

Take a shop with 5m of frontage to the street, and a depth of 25m. There are 4 zones in such a shop, according to my method, and they analyse as follows:

<table>
<thead>
<tr>
<th>ZONE</th>
<th>MEASURES</th>
<th>Actual (m²)</th>
<th>ITZA (m²)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>5.0 x 6.0</td>
<td>30.0</td>
<td>30.0</td>
</tr>
<tr>
<td>B</td>
<td>5.0 x 6.0</td>
<td>30.0</td>
<td>15.0</td>
</tr>
<tr>
<td>C</td>
<td>5.0 x 6.0</td>
<td>30.0</td>
<td>7.5</td>
</tr>
<tr>
<td>D</td>
<td>5.0 x 7.0</td>
<td>35.0</td>
<td>4.4</td>
</tr>
<tr>
<td></td>
<td></td>
<td>125.0</td>
<td>56.9</td>
</tr>
</tbody>
</table>

If I now find that there is reliable evidence from other transactions to support a rate of, say £1,000/m² ITZA, then I value this shop at £56,900 per annum. Of course, I must have analysed the comparables by exactly the same method, or, in a saying common among valuers, "as you value, so must you devalue".