Valuation Update 2017
Valuing Sustainability & Valuing In Uncertain Times

Since the BREXIT "yes" vote, the Trump USA presidency, the UK election debacle and problems in the Eurozone, property markets are more volatile.

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1. Introduction - Standards

1.1 In 2017, the International Valuation Standards Council (IVSC) released its new standards, the "International Valuation Standards 2017" (IVSs). The IVSC is a non-profit making group of professional valuers who are dedicated to developing and sustaining a single set of globally accepted valuation standards. The IVSC sets International Valuation Standards for all the world markets where valuations are carried out. These are the generally accepted principles of valuation and procedures for the undertaking of valuations The IVSs apply to ALL asset classes and not just property.

1.2 Most importantly, the IVSC does NOT enforce usage. This is the responsibility of professional or state authorised bodies. Nor does it provide or give professional accreditation. That is the role of the indigenous professional bodies such as (in the UK and elsewhere) the Royal Institution of Chartered Surveyors (RICS). The RICS has fully adopted the IVSs and, as such, the new edition of the IVSs have instigated a new edition of their won standards, the "RICS Valuation – Global Standards 2017" which were issued in June 2017 and became effective from 1st July 2017. The RICS standards are colloquially known as "the Red Book". The RICS has also issued a extra text called "Basis for Conclusions" which explains the rationale behind the more significant changes made in the final version of the Red Book 2017. It purely assists the reader and does not form part of the standards. The new Red Book and accompanying explanatory notes are available as free downloads on the RICS website (www.rics.org).

2. Acknowledging uncertainty in valuations - RICS guidance

2.1 One of the main changes of the new RICS standards is that it is now mandatory to have regard to the guidance in the Red Book. Previously, guidance notes were contained in annexed Valuation Practice Guidance Application (VPGA) and their legal standing was, at best, ambiguous. The view of this author is that good practice implies that all standards and guidance from a professional body would be considered to be mandatory. Surely, if a valuation were challenged in court, the judge(s) would not make a distinction between the two categories; they would expect both to be read and applied. Thus, the change to categorically state that all material in the Red Book is now mandatory makes perfect sense and, to accommodate this, all existing guidance material has been moved into the mandatory standards.

2.2 In the context of "Uncertainty", the text of the existing VPGA 9 (valuation certainty/uncertainty) has been moved into to Valuation Practice Statement (VPS) 3.

2.3 VPS 3 is the Practice Statement that relates to Valuation Reports. Again, in the context of uncertainty, it states that where a valuer is undertaking valuations in markets which are susceptible to change: certainty and uncertainty, they should:

"If appropriate, the valuer should draw attention to, and comment on, any issues affecting the degree of certainty, or uncertainty, of the valuation"

and

"To encourage best practice in the reporting of valuations, with specific reference to conveying a clear picture to users concerning the degree of certainty and risk attached to them"

2.4 Indeed, the main statement relating to uncertainty says;

"All valuations are professional opinions on a stated basis, coupled with any appropriate assumptions or 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."

2.5 This is a very important statement as it allays some of the confusion in the market about uncertainty. There is a misunderstanding that uncertainty refers to the difference between the valuations of the same property by different valuers. This is NOT uncertainty, it is variance. UNCERTAINTY refers to the degree of certainty that ONE valuer ascribes to their valuation. That is to say, how confident is that valuer that there valuation would equate to the price in the market on the date of the valuation. Given that all valuations are professional opinions, the degree of confidence (certainty) will vary according to the property itself and the market conditions. The valuation of a non-specialised property (maybe an office) in a buoyant market, where there is a lot of good recent comparable information, will be more certain than the valuation of the same property in a poor market. Likewise, the more unusual or specialised the property, the less certainty that will pertain to that valuation.

2.6 To help valuers with the requirement to "draw attention to, and comment on, any issues affecting the degree of certainty, or uncertainty, of the valuation", the RICS has issued a guide for users of valuations called "Reflecting Uncertainty in Valuations for Investment Purposes" available from the RICS website (www.rics.org). This is a really useful document that identifies the drivers for uncertainty in valuations and directs the valuer to comment, in their own words (not with caveats), on the impact of each for the valuation in question.

2.7 Ultimately, all valuations are trying to determine "Market Value" (MV - an estimate of price in the market - see below). The reference to uncertainty is to ensure that all MVs are placed in context of the current market. In simple terms, valuations are more certain in strong robust markets with a lot of transaction activity and less certain in poorer markets.

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

3. Energy Performance Certificates Letting Restrictions

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3.1 In a free market, sustainability will only have an impact if the occupiers of properties consider that the "sustainable elements" make a contribution (perceived or real) to the bottom line. Occupiers will only pay for specifications that impact positively upon their businesses. That is to say that if, at the date of valuation, the market does not differentiate "sustainable" and "non-sustainable", there will be no impact on value.

3.2 In the early 2010s, there was a feeling that the UK real estate market would start demanding more energy efficient buildings. The cost of energy on the world stage was rapidly increasing with demand outstripping supply. The price of gas, electricity and oil was on an upwards spiral and this was beginning to impact on the bottom line of occupying commercial buildings. It would be a natural conclusion that the "market" would adjust and buildings with high energy efficiency ratings would be sought in preference to energy inefficient buildings.

3.3 In the UK, Energy Performance Certificates (EPCs) became a regulatory requirement in April 2008 for all commercial properties that are either being sold, built, or rented. The EPC must be provided to a prospective buyer or tenant free of charge. Thus, it was likely that tenants and purchasers of owner-occupied buildings would be influenced by the rating (A to G, with "A" being the best) of the certificate and choose highly rated properties in preference to lesser ratings. This would lead to energy efficient buildings being occupied more than the less efficient buildings. In theory, the poorly rated properties would either be retro-fitted or redeveloped and the low ratings of (say) F and G would disappear from the main markets due to the laws of supply and demand.

3.4 Indeed, this may have happened if the world hadn't succumbed to Financial Economic Crisis in 2007/2008. That changed all the fundamentals of the markets and, coupled with the fall in energy prices as the world economies stalled, the use of poorly rated, energy inefficient, properties in the UK (and elsewhere) continued. Other factors were now more important to the occupiers of buildings than sustainability. Thus the only way to instigate an improvement of the commercial property stock is to introduce legislation that restricts occupation of poorly rated properties.

3.5 This came about with the Energy Act 2011, that announced that, from April 2018, it will be unlawful to let commercial (or residential) with an EPC Rating of F or G (i.e. the lowest 2 grades of energy efficiency).

3.6 The deadline of April 2018 will only apply to lease renewals and new lettings, however from 1st April 2023 it will apply to all current leases.

3.7 The new legislation is referred to as "The Minimum Energy Efficient Standards Legislation" (MEES) and it aims to:

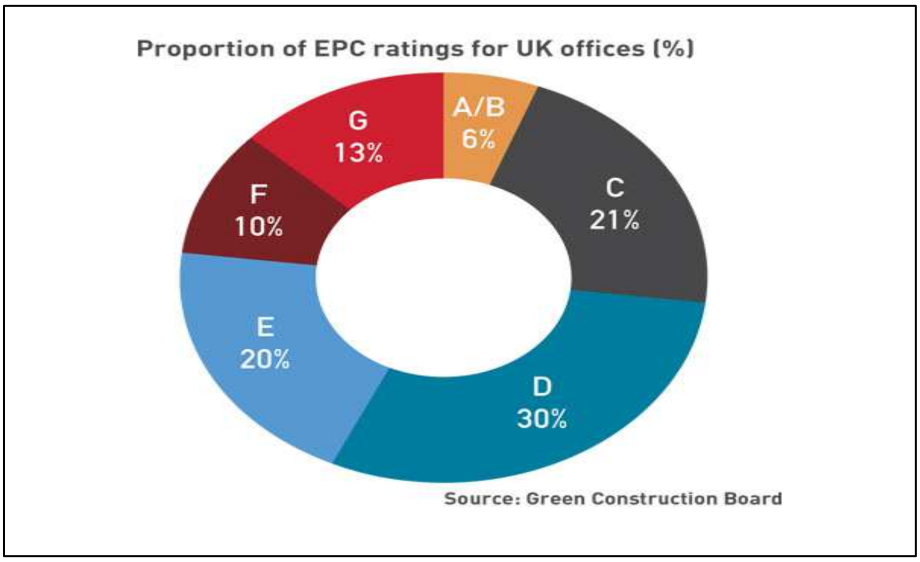
- Improve the energy efficiency of properties with an EPC rating of 'F' or 'G'
- Help to tackle the traditional barrier to the implementation of energy efficiency works in buildings (aka the 'split incentive') where the landlord foots the bill for improvements that benefit the tenant
- To encourage the retrofitting or redevelopment of energy inefficient buildings
- It is expected that the government will review the standards and likely raise them to cover all properties with a rating below a 'D' in 2025

3.8 As with any new legislation, there will be a period of transition and there are a number of exemptions that will apply. The government will create a central register for landlords to apply for exemptions, with supporting evidence, from MEES.. The main exemptions are:

- Landlords will be exempt after all cost-effective improvements have been carried out - A cost effective measure is deemed to have a payback period of seven years or less
- Landlords can apply for exemption from MEES, for five years, where they have implemented all cost effective improvement measures and the minimum 'E' rating has not been met
- Landlords will be exempt, again for five years, if consent to undertake improvements is refused from a third party (e.g. Local Authority), superior landlord or a tenant
- If the improvement works would result in a devaluation of the property by 5% or more the landlord can apply for an exemption.
- MEES does not apply to very short lettings, or to lettings of 99 years or more

Full details of the legislation can be found at Department for Business, Energy & Industrial Strategy in a document called "The non-domestic Private Rented Property minimum standard – landlord guidance" (March 2017). [www.gov.uk/government/publications/the-non-domestic-private-rented-property-minimum-standard-landlord-guidance]

3.9 There has been a substantial amount written and done about the management issues that arise because of the new legislation. Since the announcement in 2011, good landlords have been reviewing and preparing their portfolios to ensure that no properties have a F or G rating. That said, it is still estimated, by the Non-Domestic Energy Performance Register [www.ndepcregister.com] that 23% of office properties will be affected by the legislation.



3.10 However, the purpose of this note is not to look at what can be done to manage a portfolio under the new legislation but to look at the impact on value of such restrictions

4. What will the EPC Letting Restriction mean to the Valuation of Property?

4.1 Obviously, if you are the owner of a property with an EPC of A to E then there will be no, immediate, impact on the value of your property. It can still be let and it can still generate an income in accordance with the prevailing market conditions of the respective market. However, if you have a property that has a rating of F or G, from April 2018, you will not be allowed to let the property legally. The landlord either has to retrofit the property to increase its EPC rating to E or above or the property can not be let. There is a third option of letting the property illegally in the hope that the illegal letting is not spotted. Whilst this is obviously not encouraged, it will happen until the policing of legislation is more apparent. At the moment, the role lies with the local trading standards offices and the fines can be quite substantial. But, the efficacy and efficiency of the policing has yet to established and it may vary between localities. That said, the valuer needs to value on the assumption of legality.

4.2 All valuations of let properties assume cash flows continue for the duration of the existing lease and, normally, for a new (hypothetical or real) lease thereafter. Obviously, in the case of properties that have (or may have) EPC ratings of F and G, the continuing cash flow is doubtful. In this context, the RICS has issued "Illustrative Wording for Valuation Reports" as they consider it prudent to incorporate explanatory text about the upcoming changes within valuation advice. This illustrative wording is intended to provide clarification to the clients of valuations.

4.3 There are three scenarios for current valuations; a) valuations where there is no EPC provided, b) valuations where the EPC is at E or above and c) valuations where the EPC is F or G. Thus the RICS has suggested three forms of words for each scenario.

- **A – no EPC**
We have not been provided with an up to date EPC rating for this property and, as such, our valuation is based on the assumption that the subject property(ies) will meet the minimum requirements laid down by the legislation and that there will be no adverse impact on value and marketability. It is advisable to obtain an expert's opinion to advise whether (an) EPC(s) should be commissioned and if the building(s) is(are) likely to meet with the legislative requirements.

- **B – EPC is OK**
The existing EPC certificate(s) that has(have) been provided indicates that the subject property(ies) will fall within the acceptable energy performance range for the purposes of the Act. Although the legislation is not expected to be reviewed again until 2020, the method of assessment may have changed since the EPC certificate was issued. It is therefore advisable to obtain an expert's opinion on whether the building would still comply with the minimum standard if the building(s) were re-certified under the current methodology.

- **C – EPC below E**
The existing EPC certificate(s) that has(have) been provided indicates that this property may not meet the minimum acceptable energy performance standard for the purposes of this Act. Unless the property qualifies as exempt, capital expenditure may be required in order to upgrade the property(ies) to an acceptable EPC rating standard. Failure to do this may result in renting this property being unlawful, with an associated impact on marketability and value. It is therefore advisable to obtain an expert's opinion on the status of the property(ies). Our valuation assumes the property(ies) is(are) not exempt and reflects the fact that a strategy of improvement will be required in order to bring the property(ies) up to the minimum required energy performance standards.

4.4 These wordings are well drafted and all valuations should be using the appropriate wording for the valuation scenario pertaining to the valuation in hand.

4.5 Wordings A and B are both straight-forward as the valuation is of an assumed continuing cash flow. However, wording C where the EPC provided is below E, there is an assumption that "a *strategy of improvement will be required in order to bring the property(ies) up to the minimum required energy performance standards".* This is fine in theory but unless the client has provided the valuer with a estimate (by an exert in retrofitting costs) of the capital works required, the valuer will be guessing this cost. This is, normally, outside the expertise of a valuer and raises questions for their Professional Indemnity Insurance, if they are undertaking work that is not normally that of a valuer.

4.6 Also, the use of the wording doesn't provide the valuer with a structure for the valuation model. Indeed, when discussing valuations with colleagues in practice (in January 2017), there seemed to be little consensus on how to reflect the EPC legislation in valuations. In fairness, those consulted (a group of 20 valuers working in London and the provinces in England and Wales) did all agree that implicit valuations (no one is using DCF models) should be used but within this general consensus, there was then a degree of divergence. The models suggested were:

- Value as if the property can be relet at reversion and deduct the (estimated) cost of retrofitting to conform with an “E” (or above) rating (12 respondents)
- Use a reversionary valuation model (layer or term and reversion) and increase the equivalent yield. (5 respondents)
- Use a reversionary valuation model (term and reversion) and increase the yield used on reversion. (3 respondents)

4.7 In conversation with colleagues at the RICS, there was a view that only the first suggested model should be encouraged but, in fairness, in the absence of further guidance, the two other suggested models may have some merit.

4.8 To illustrate the valuation models, this author found a suitable case study (see over).

4.9 It is clear that further guidance is required on appropriate valuation models fro properties affected by the new EPC letting restrictions. The RICS is working on a new "insight" paper to follow in the autumn 2017.

Example. Valuation April 2017[1]
A small office 2 storey property let to one tenant on the M3 corridor
Built in 1968 and let on a 10 year lease in 2010. 5 year reviews
Rent passing – £30,000, Market Rent £32,000 ARY 10%.

The property is in a good secondary location but the specification is a typical 60s' build. Metal single glazed windows, brick built, flat roof (which shows signs of leaking previously). The tenant has fulfilled all obligations and maintained the property well albeit, obviously, in keeping with the condition at the commencement of the lease. The cost of cost of retrofitting to conform with an "E" (or above) rating is estimated to be £40,000 and it will take 6 months to complete the work.

1) Traditional - Implicit ***Value as if the property can be relet at reversion and deduct the (estimated) cost of retrofitting to conform with an "E" (or above) rating***			
Term & Reversion			
Rent Passing		***£30,000***	
YP 3 years @	***10.00%***	***2.49***	***£74,606***
Market Rent		***£32,000***	
YP Perp @	***10.00%***	***10.00***	
PV 3 years @	***10.00%***	***0.75***	***£240,421***
		Capital Value	***£315,026***
Estimated cost of retrofitting			***- £40,000***
		Net Capital Value	***£275,026***
PV 6 months @	***10.00%***	***0.95***	
		New Capital Value	***£262,227***
Less costs @	***6.8%***	***Market Value (say)***	***£245,000***

This would be the RICS' preferred valuation model albeit, the cost of retrofitting is a "guesstimate" and there may be issues relating to the valuer's ability to estimate this cost (see above)

An alternative model would be to avoid any guesstimate and undertake the valuation on the basis that there is an increased risk to the cash flows in the valuation and increase the yield accordingly. This model is shown overleaf.

[1] There are a number of issues with the case study:

- There is an assumption that the existing tenant can be accommodated during the retrofitting either within the existing building or elsewhere and will return to the property. The logistical costs of this have not been factored into the valuation.
- Similarly, there may be statutory compensation issues relating to the non-continuation of the existing tenancy. Again, that has not been accounted for in the valuation.
- There is an assumption that the existing tenant remains. For the type of properties affected, this is a bold assumption and the property, even when retrofitted, may have a void for a duration.

2) Traditional - Implicit ***Use a reversionary valuation model (layer or term and reversion) and increase the equivalent yield. In this case, a 2% increase has been applied***			
Term & Reversion			
Rent Passing		***£30,000***	
YP 3 years @	***12.00%***	***2.40***	***£72,055***
Market Rent		***£32,000***	
YP Perp @	***12.00%***	***8.33***	
PV 3 years @	***12.00%***	***0.71***	***£189,808***
		Capital Value	***£261,863***
Less costs @	***6.8%***	***Market Value (say)***	***£245,000***

This values the property at the same figure as (1).

References and Further Reading

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