

Observations on Trends in Institutional Property Valuations

■ ■ ■ **Dr. David Parker**
 FAPI, FRICS, FSA
 Portfolio Manager Property,
 Suncoast Metway Ltd
 Adjunct Professor,
 University of Queensland

Abstract

In the following article, Dr Parker reflects on changes in the nature of the institutional investor and the resulting effects on property valuation practices. With change the only constant, Dr Parker notes the trend towards the use of generic software for institutional property valuations and advocates a pro-active focus by the valuation profession on research into the application of new valuation methods.

The pace of change is quickening and there is no such thing as a business insulated from change. Business process re-engineering, outsourcing and restructure have become commonplace across corporate Australia, encompassing both large and small enterprises.

The business of institutional property investment has changed dramatically over the past two decades, creating consequent changes in its requirements from the businesses of its numerous service providers. As the eighties was the decade of the developer, the nineties was the decade of the listed property trust. Over the last twenty years, the nature of the institutional investor has changed radically.

The eighties was the decade of the institutional property development as a statement, bigger and better than ever before. If the short term returns were lacklustre or non-existent, that mattered little as it was a contribution to the nation's infrastructure for the next millennium when it's full return potential would be realised. There was little emphasis on measuring returns or on relating these to other investments.

Institutions in the Nineties - Portfolios for the Short Term

In the nineties, there was a fundamental sea change in the nature of institutional property investment. Its principal outward manifestation was the rise of the listed property trust. From a market capitalisation of \$4.8 billion in 1991, the listed property trust sector grew to a market capitalisation of more than \$300.0 billion in 1999, with the number of trusts incorporated in the LPT index doubling from 22 in June, 1994 to 45 in late 1999 (Pridham, 2000).

Merger, acquisition and transformation saw the disappearance of City Mutual and the redirection of Norwich Union. Further, the decade saw the departure of the majority of the British property companies, including Capital and Counties, Hamnerston and MEPC. As the British departed, other foreign groups sought to globalise with National Mutual subsumed within AXA and Mercantile Mutual within ING. There was then the rationalisation where numerous smaller institutions were taken over or disappeared, with Legal and General and Prudential absorbed into Colonial and GIO into AMP (Parker, 2000).

But there were also other, less visible outward manifestations. Insurers progressively sought to reduce their exposure to direct property by moving it off balance sheet into other vehicles or by simply selling. From a high of 17.8% in the late 1980's, the proportion of direct property in the portfolios of life insurance offices declined to a current level of 4.3% (Toward, 2000). Superannuation funds, whilst cumulatively growing enormously in size, individually dramatically reduced their weighting to direct property (from a high of 15.5% in the late 1980's to a current level of around 5.5% (Toward, 2000)) in exchange for an increased weighting in listed property trusts. By March 2000, the real property component of superannuation fund portfolios totalled approximately \$16.92 billion (ABS 5655.0) - just over half the size of the listed property trust sector.

The industry of professional investment management grew exponentially during the nineties with funds under management increasing by approximately 65% in the last five years alone to \$523 billion at March, 2000. Interestingly, of this total, approximately 77% was managed by funds managers whose head office is located in New South Wales (ABS 5655.0).

In addition to the outward manifestations, there also came more significant change in numerous less visible aspects. There was a clear shift from bricks and mortar to an emphasis on cash flow. Now property was no longer special, it was just another asset class that should be treated the same way as equities or bonds. If the modern portfolio theory techniques did not work too well and the asset allocation to property was diminished, that was a problem for the property people not for the Chief Investment Officer.

The emphasis shifted from the long term to the short term and from the individual property to the property portfolio, with an increasing focus on performance measurement.

Nature of institutional investor has changed drastically

The PCA developed its highly regarded indices and so exposed the performance of direct property to the full glare of the funds management industry. An asset that may take years to establish itself and so dilute the portfolios' returns against benchmark for the next quarter may find it no longer had a role in the portfolio of the institution of the new millennium.

Institutions of the Noughties - International Cash Flow Managers

The new millennium masters of institutional investment are relatively few, relatively large and global. They invest diversely by both sector and geography, offer a multi-product range (including any combination of wholesale fund, listed property trust, syndicate and so forth), are a significant property market participant and employ a highly qualified, highly skilled and globally portable property team. They are ambivalent as to whether they have an exposure to CBD office in Melbourne, Minneapolis or Milan, it is simply a function of relative risk and return. Institutional direct property investment has become an environment of alphas and betas, attribution, returns, indices and relativities.

Within such an environment, the forecasting of returns from property investments through cashflows is paramount. Both income returns and capital returns require forecasting, with reducing degrees of reliance from one year through to five or ten years. Income returns need to consider every tenancy/suite and income/expense line separately with explicit assumptions for vacancies, rent reviews, lease expiries and so forth. Capital returns likewise need to consider capital expenditure, refurbishment/redevelopment and changes in capital value. This is an environment where a change in forecast return for the next quarter of 0.1% is significant.

Clearly, the valuation of institutional direct property has an impact upon the level of capital returns and thus total returns of both the individual property and the portfolio. In the unlisted pooled fund environment, total returns are the principal measure of performance and so the role of periodic direct property valuations is important.

Changing Focus in Capital Valuations

However, in the listed property trust environment, income returns are the principal measure of performance with the valuers periodic view of the capital value of the physical property secondary to the stockmarkets daily pricing of the listed property trust unit.

Thus, for a large portion of the institutional property industry, the determination of capital value by valuation is a regulatory requirement rather than a management preference.

The need for periodic valuation may also be contended to be likely to diminish as the structure of the property market changes in the first decade of the new millennium. Greater constraints in debt funding and a change in the perception of development risk from attraction to tolerance may be expected to smooth the traditional boom/bust cycle. This may have a corresponding effect of dampening the traditional periods of massive rental growth and decline within sub-sectors and the resulting volatility in capital values.

The answer is directly related to the assumptions in the inputs and is always calculated in the same way and is always mathematically correct. There is no capacity in such software for subjective adjustment.

Generic software facilitates a clear focus on the key aspects of returns through cashflows, being quantum, direction and timing and their respective sensitivities. With explicit inputs and clear outputs, such generic software offers the institutional investor a high level of transparency.

Evolution of DCF

The implications for the property valuation process of the adoption of such generic software by institutions is potentially both significant and formative.

Investment industry worth \$253 billion by March 2000

For multi-tenanted properties over, say, \$10 million, leased on dissimilar lease structures, valuation would usually be by capitalisation and discounted cash flow (DCF). Whilst the institutional investor may consider the DCF to be the principal form of valuation, this may not, necessarily, be the view of the valuer.

For the Australian valuation profession, the adoption of DCF as a valuation technique has been a long, slow and painful process. Following the collapse of numerous groups including Estate Mortgage and Tricontinental, the demise of the unlisted trust industry, the report of the Property Economic Task Force (Norman, 1992), the widespread incidence of leasing incentives and the paucity of major investment sales transactions in the early 1990's, the valuation profession was effectively forced by its clients into the reluctant use of DCF techniques (Parker and Robinson, 2000).

Indeed, the evolution of the acceptability of DCF has included an Information Paper (AVLE, 1993), AP Research Note (Foxward, 1993), Practice Standard (now withdrawn) (AVLE, 1996) and draft, rewritten Practice Standard and Guidance Note (Parker and Robinson, 1998) together with numerous seminars and an excellent chapter in "Valuation Principles and Practice" (Webster, 1997).

Research by Newell (1999), found a significant increase in the use of DCF, rising from inclusion in 36% of external valuation reports in 1989 and 68% in 1994 to a dominant position of 84% in 1998. DCF is now well established as an orthodox valuation methodology, the alleged inappropriateness claimed to arise from a misplaced emphasis on certain of the words of Jacobs, J in the High Court of Australia (Albany and Ors v The Commonwealth of Australia (1976)) having now long been overcome.

Consistency, Transparency and Accuracy

Whilst DCF is widely accepted and discussed, the method has never been codified. There is no prescriptive guidance current in Australia concerning the preferred, industry standard treatment of each of the numerous variables within the DCF such as acquisition costs, rest periods, discount rate selection and so forth.

For the institutional investor, the use of DCF by the valuer has numerous benefits. It is a cash flow methodology allowing comparison with the cashflow of return forecasts. Further, it is transparent with the institutional investor able to clearly observe and focus on each assumption explicitly made by the valuer.

The method is widely understood, both in its strengths and weaknesses and in its lexicon of terminology. It not only fits nicely into the institutional investors' portfolio management process, but it also provides the institutional investor with an insight into the valuers thinking and logic.

Conversely, the way in which DCF is currently being applied by the valuation profession creates numerous problems for the institutional investor. There is now a wide range of proprietary models, with each major valuation practice having its own model and its own conventions and protocols for the use of their model. As proprietary models they effectively become black boxes, lacking transparency to the institutional investor who is not privy to the hidden formulae.

It also appears evident that there are shortcomings in the use of such proprietary models. These may range from gaps in the logic of discount rate selection relative to growth rates, capitalisation rates and their respective inter-relationships through to subjective adjustment and include DCF's giving exactly the same result as the capitalisation method but at a discount rate precise to two decimal places (see, for example, the reference to 14.79% in Parker, 1997).

The absence of prescriptive guidance permits the application of considerable subjectivity in the DCF process. This leads to inconsistencies within the DCF valuation itself, which may contribute to the potential for inaccuracy.

This problem is further compounded, from an institutional investor's viewpoint, by the inconsistencies in structure between the proprietary DCF models of the various valuation practices.

It would, therefore, be possible for two valuers in the same firm to use the same model or for two practices to each use their own model to value the same property and each arrive at a different, but equally defensible, valuation.

For the institutional investor using numerous independent values simultaneously, this is a sub-optimal result as the lack of accuracy, consistency and transparency has the potential to adversely affect the forecasts of return, for which the sensitivities are very fine.

Resolving the Differences

Accordingly, as the valuation industry has, justifiably, rejected prescriptive guidance, the institutional investor needs an alternative approach to satisfy its requirements for accuracy, consistency, and transparency. It is not surprising, therefore, to observe the growing trend of institutional investors now requiring a valuation to be undertaken in their preferred generic software application.

Such an approach allows the valuer control over the key variables such as discount rate and growth rate selection whilst providing the institutional investor with all of their valuations undertaken on the same basis in an accurate, consistent and transparent manner.

Having begun such a move towards accuracy, consistency and transparency, it is unlikely that the institutional investor would retreat such that a rear guard action by the valuation industry may be potentially futile.

The impact, however, on the role of the valuer is significant. It potentially finally shifts the focus of the valuer away from location, bitumen sealed dual carriageways and tenancy schedule data entry to a detailed, analytical consideration of the key variables being entered into the model. As the property market variables become less important and the economic, financial and capital markets variables become more important, such generic software imposes a discipline on the valuer to consider the relativities and interactions between each.

Generic software offers high level of transparency

As such, it is a much higher order use of the valuer's skills, knowledge and expertise. Conversely, it is the second time in less than a decade that the clients have led the valuation profession into the next phase of property valuation methodology rather than vice-versa.

Pro-active Research into New Methods

Given the existence of Webster's excellent chapter for the DCF novice (Webster, 1997), the use by larger valuation practices of proprietary software for mid-market valuation assignments and the trend by institutional investors towards the requirement to value using generic software, the need for a Practice Standard would appear diminished and that for a Guidance Note enhanced (Parker and Robinson, 2000).

Historically, it has taken an extended period for a new valuation methodology to become established - Greaves (1972) and Ratcliffe (1972) having been the pioneers of DCF applications. It is, therefore, perhaps now time to shift the debate and research focus away from DCF and on to alternative valuation methodologies.

As institutional investment is now firmly rooted in the capital and financial markets, it is logical to explore the applicability of other valuation techniques from such markets to direct property. For example, Brown and Ong (2000) explore the use of option pricing theory to value direct property and find considerable theoretical and conceptual relevance, capable of development into practical application with further research.

However, the short-term focus of institutional investor clients and the availability of other groups of service providers may make such clients reluctant to wait the requisite extended period for the property valuation profession to embrace such other capital and financial markets valuation techniques. It is contended, therefore, that the property valuation profession should invest its resources in the requisite research now in order to allow it to lead the receptive, institutional investor client into the next phase of property valuation methodology.

Biography

As Portfolio Manager Property for Suncorp Metway Limited in Brisbane, Dr Parker is responsible for the strategic direction and periodic valuation of an \$850 million property portfolio.

Dr Parker is a member of the National Education Committee and the Queensland CPD Committee, having previously been a Divisional Councillor in NSW and Victoria and past winner of the Institute's Ronald Collier, Peter Barrington, Ian Melville and Harry Thomas Awards.

Having contributed over 25 papers to property journals, Dr Parker is a regular conference speaker both in Australia and overseas and contributes a periodic column to the "Australian" newspaper on property funds management.