

DCF 2 – Impacts on Valuers of Trends in Property Fund Management

By Dr David Parker

Introduction

The new millennium masters of property fund management are relatively few and comparatively large, having a global presence.

PIR 2003 estimate that the Australian property fund management industry controls gross assets in Australia and overseas of AU\$163 billion in 694 funds managed by 194 property fund managers on behalf of over one million investors.

As a sizeable component of the client base for the valuation profession in Australia, the requirements of and approaches to valuation methodology by property fund managers are significant influences on professional practice for Australian valuers.

In a major research project funded by the Cooperative Research Centre for Construction Innovation, Parker 2003 found that 92 per cent (by funds under management (FUM)) of the property fund manager sample surveyed used generic software packages for portfolio management (including valuation) with 60 per cent using DYNA, 32 per cent using Cougar and eight per cent using Excel.

Accordingly, with such a large proportion of the property fund management industry using such packages for various purposes including valuation, generic software packages have become a significant conduit between the valuation profession and the property fund management industry.

Parker 2001 has previously noted that both DCF and capitalisation are accepted valuation approaches in Australia for multi-tenanted properties over, say, \$10 million with dissim-

ilar lease structures and that a growing trend is evident for property fund managers to require such valuations to be undertaken in their preferred generic software package.

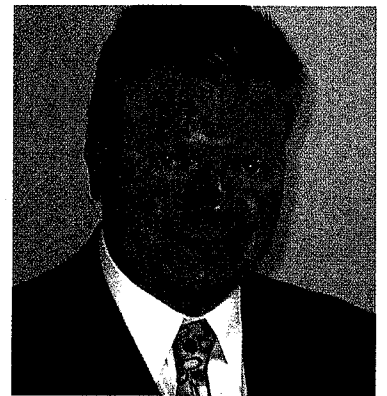
It may, therefore, be contended that Australian property fund managers may not only require DCF to be used as a valuation methodology of choice but also to require the use of that approach to DCF codified in their preferred generic software package.

In the first paper in this series, Parker 2004 considered the inter-relationship between property fund manager decision making processes and valuation practice, analysing property fund managers' priorities for, inputs into and outputs of generic software packages to inform the valuation profession.

This second paper in the series considers the impact on the role of valuers of the following trends in property fund management:

- the application of generic software packages;
- the implementation of standardised formats;
- the use of electronic data transfer; and
- the compatibility of IT systems.

This paper is also based on the findings of a survey of eleven Australian property fund managers (with on-shore funds under management of greater than A1.2 billion) using a pre-tested survey instrument in a structured, face to face interview environment (as detailed in Parker 2004). Whilst this is acknowledged to be a statistically small sample, this is reflective of the level of consolidation that has occurred within the Australian property fund management industry.



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The paper concludes by prompting issues for debate by the valuation profession concerning the potential impacts of enhanced transparency and fully integrated client IT systems on the valuation profession. In a world of inter-

national generic software packages, the paper further prompts debate on the need for a Practice Standard for DCF and the role of national professional bodies in standard setting for DCF.

Application of Specific Generic Software Packages

As noted above, Parker 2003 found that 92 per cent (by FUM) of the property fund manager sample surveyed used generic software packages for portfolio management with DYNA found to be the dominant package used.

The survey sought to determine those purposes for which respondents were applying generic software packages, with the results detailed in Table 1.

Table 1: Application of Specific Generic Software Packages

	DYNA	Cougar	Other	Average
Valuation	100%	80%	100%	91%
Return				
Forecasts	100%	40%	100%	73%
Risk Analysis	100%	60%	100%	80%
Acquisition/ Divestment				
Analysis	100%	100%	100%	100%

There is a clear trend to the use of generic software packages for the four identified elements of the property portfolio management process. With an average of 91 per cent of respondents using a generic software package for valuation and 100 per cent for acquisition/divestment analysis, 80 per cent for risk analysis and 73 per cent for return forecasts, that valuation undertaken in the generic software package is inextricably intertwined within the portfolio management process.

Significantly, those respondents using DYNA were found to be using the software for all four identified elements of the property portfolio management process. Effectively, when DYNA was found to be used, it was found to be used for all identified elements of the property portfolio management process.

Conversely, Cougar was found to be used less frequently by respondents for valuation, return

forecasts and risk analysis with only common use for acquisition/divestment analysis.

Having identified the application by property fund managers of generic software packages, the survey sought to ascertain whether the respondents specified that package to be used by an independent valuer when preparing a valuation of a property within their portfolio, with the results detailed in Table 2.

Table 2: Specification of Generic Software Package to be used For Valuation

	DYNA	Cougar	Average
Specified	60%	0%	30%
Preferred	20%	60%	40%
Not Specified	20%	40%	30%

Significantly, an average of 70 per cent of respondents either specified or expressed a preference for that generic software package to be used by an independent valuer. Those property fund managers using DYNA were more specific about the use of DYNA by the independent valuer (60 per cent specified plus 20 per cent preferred) than those using Cougar (60 per cent preferred).

With a clear trend to the use of specified generic software packages for valuation and other associated elements of the portfolio management process, the impact on the role of valuers is clear. It is effectively essential for valuers wishing to practise in the institutional property fund management sector to use such software packages (both generally and as specified) and to implicitly accept the process of undertaking DCF programmed therein.

Having identified a specification for use of generic software packages, the survey continued to investigate whether property fund managers were confident that valuers could operate the specified generic software package properly, with the results detailed in Table 3.

Table 3: Confidence in Valuers Operation of Generic Software Packages

	DYNA	Cougar	Average
Confident	60%	50%	55%
Some Confidence	40%	25%	33%
Not Confident	0%	25%	12%

Overall, an average of 88 per cent had a level of confidence in valuers' ability to operate a particular generic software package. A higher level of confidence was evident by those using DYNA than by those using Cougar.

The impact of client confidence in valuers is significant as, when confidence in the operation of the process is achieved, both client and valuer can focus on the key assumptions and judgemental variables in the valuation which are potentially better uses of valuers time and of greater benefit to the client.

Implementation of Standardised Formats

With the generic software package being central to the property portfolio management process and a clear trend towards the use of specified generic software packages, it may be anticipated that property fund managers would require valuation service providers to present data in a prescribed format consistent with that generic software package being used.

Accordingly, the survey sought to determine whether property fund managers required valuation service providers to present data in a prescribed format with the results detailed in Table 4.

Table 4: Requirement for Presentation of Data in Prescribed Format

	DYNA	Cougar	Average
Prescribed Format	75%	25%	50%
Non-Prescribed Format	25%	75%	50%

Significantly, the proportion of property fund managers using DYNA and requiring data to be presented in a prescribed format was the exact reverse of that for fund managers using Cougar.

The trend would, therefore, appear to be that those property fund managers using DYNA are potentially integrating their valuation service provider in to the property portfolio management process to a greater extent than those using Cougar.

For valuers, the impact would appear to be that those with property fund management clients using DYNA are more likely to be working on a common valuation model which is capable of development by both the valuer and the client and exchange between each. This may be likely to increase the propensity for integration of the valuer in the various elements of the property portfolio management process, creating a level of confidence that may potentially result in the use of the valuers services for other portfolio management activities (such as due diligence in acquisition/divestment).

The survey also sought to investigate whether property fund managers required valuers to undertake both DCF and capitalisation in the same generic software package. The survey found 86 per cent of respondents required both methods of valuation to be undertaken within the same generic software package, indicating that a valuation by capitalisation undertaken in a separate package was unlikely to be acceptable.

The impact on valuers of such a requirement may be a significant step forward in ensuring that assumptions adopted in each method of valuation are consistent and transferable, increasing the focus on the assessment of key judgemental variables in each by the valuer.

Use of Electronic Data Transfer

As the fund management industry generally has embraced electronic data transfer, the survey sought to investigate the use of electronic data transfer by the property fund management industry in the valuation process.

For example, for large, multi-tenanted properties with extensive tenancy schedules, the provision of data electronically by the property fund manager client to the valuer is compellingly logical for efficiency, accuracy and speed.

The survey sought to ascertain whether the property fund manager provided the valuer with data electronically, with the results detailed in Table 5.

Table 5: Use of Electronic Data Transfer

	DYNA	Cougar	Average
Provided Electronically	80%	50%	67%
No Provided Electronically	20%	50%	33%

The results indicate a trend towards the electronic provision of data, with an average of 67 per cent of respondents providing data to valuers electronically. Significantly, again, there was a marked difference between those respondents using DYNA (80 per cent providing data electronically) and those using Cougar (50 per cent providing data electronically).

The impacts on the valuer of an increased use of electronic data transfer may include a significant reduction in the time taken to undertake a valuation (as data entry time is eliminated and data checking time remains constant), less distraction by clerical issues allowing greater attention to valuation issues and a reduced risk of inaccuracy and error.

Compatibility of IT Systems

The efficient provision of data electronically requires some compatibility of IT systems between the valuer and the property fund manager. Accordingly, the survey sought to determine if compatibility of IT systems was a determining factor in the respondents' choice of valuation service provider, with the results detailed in Table 6.

Table 6: Compatibility of IT Systems as a Determining Factor in the Choice of Valuation Service Provider

	DYNA	Cougar	Average
Determining Factor	80%	25%	55%
Not a Determining Factor	20%	75%	45%

Interestingly, the respondents were approximately evenly split on average but, again, for those property fund managers using DYNA, the compatibility of IT systems was a greater

determining factor in the choice of valuation service provider than for those using Cougar.

The trend would, therefore, appear to be towards the increasing importance of compatibility of IT systems as a determining factor in the choice of valuation service provider. The impact on valuers of such a trend is significant, as valuation businesses seeking to practice in the property fund management sector will need to be cognizant of their potential clients IT environments in designing their own.

Significantly, however, the sample surveyed had not reduced the number of valuation service providers since adopting their nominated generic software package. This would suggest that, to date, valuers have evolved their service delivery to accommodate their client's requirements.

Summary

The survey of property fund managers found clear evidence of the following trends:

- toward the use of generic software packages for valuation and other associated elements of the portfolio management process with a level of confidence in valuers ability to operate the package apparent;
- toward the specification by the property fund manager of that generic software package to be used by the independent valuer with no apparent reduction in the number of valuation service providers;
- amongst DYNA users, to require data to be presented in a prescribed format;
- in the requirement for both the DCF and capitalisation methods of valuation to be undertaken within the particular generic software package;
- toward the use of electronic data transfer by property fund managers, in common with the wider fund management industry;
- toward the compatibility of IT systems becoming a determining factor in the property fund managers choice of valuation service provider; and
- that, to date, valuation service providers have evolved their service delivery to accommodate their client's requirements.

Conclusions

With a clear trend towards the use of generic software packages for valuation and other associated elements of the portfolio management process, the future of proprietorial models (being those developed by valuation firms for their own use) and other localised software packages in an, effectively, duopolistic market is debatable.

By specifying that an independent valuer use an international generic software package, the property fund manager is effectively dictating that process of undertaking DCF to be adopted by the valuer, which may be contended to significantly limit the need for a Practice Standard for DCF. Such constraints on the role of a Practice Standard are effectively constraints on the role of the standard setting function of a national professional body, the desirability of which is debatable.

The common ground that has been created between the property fund manager and the valuation profession by generic software packages provides an ideal opportunity for the profession to cease debate and accept the process of DCF as programmed in the software, focusing the future attention of the profession on issues associated with judgement in the selection of those key variables within the DCF valuation.

The client requirement for the valuer to present data in a prescribed format is contended to be a significant step forward in the transparency of (and in the perception of transparency of) the valuation process. Whilst the valuation

process may have always been transparent to the valuer, it may not have appeared so to the client, which may have contributed to past losses of confidence in the valuation process by the client.

Such transparency is very significantly aided by the client requirement to undertake the DCF and capitalisation methods of valuation in the same generic software package, which ensures consistency of assumptions if the same answer is to be achieved.

By both valuer and client having common methodology, data and process, some of the mystique of the valuation process may be taken away, potentially resulting in greater confidence by the client in the valuation process.

Conversely, such transparency places the onus on the valuer to ensure consistency in assumptions for growth rates, capitalisation rates and discount rates in order to reconcile the answers from different methods with limited scope for legerdemain, the desirability of which for the valuation profession may be debatable.

The use of electronic data transfer places an even greater focus on the role of IT in the property valuation process and of IT infrastructure in the operation of a property valuation business. For those valuers seeking to practice in the valuation of major, multi-tenanted properties for property fund manager clients, a long term and ongoing commitment to the significant installation and maintenance costs of IT will be fundamental. It is foreseeable that, in time, the cost of maintenance and continual upgrade of IT may become comparable to, or of greater cost than, labour for the valuation business.

As property fund managers' IT systems become fully integrated (such that the property management package, facilities management package, accounting package, portfolio management generic software package and so forth all "talk" to each other electronically), compatibility of IT systems may become the sole determining issue in selection of a valuation service provider.

Rather than valuation skills or expertise, it may be the compatibility of a valuation practices IT system with that of the property fund management client that determines whether or not that practice is instructed to undertake a valuation assignment. Effectively, the compatibility of IT infrastructure could become the principal determinant of a valuation practices client base.

With IT costs looming as an increasingly major business cost for valuers with clients in the property fund sector, the impact of such costs on valuation fees, the profitability of valuation businesses and the profile of their ownership are each worthy of significant further debate.

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