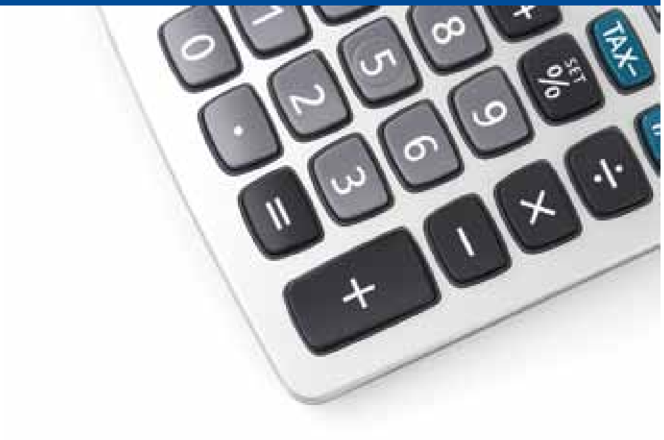
Comment

OPINION

Are property values too conservative?



There's a gulf between a property's price, worth and value, and conservative estimations are right in the eye of the beholder, writes ARAP's *Greg Campbell*

"I would suggest that even though you may think current property valuations are too conservative they are not."


Greg Campbell

Property valuers are currently perceived as being one of the bad guys in the industry because they're "valuing" our properties for less than what we think they are worth or the "value" we require to procure finance; yet most property valuers do not estimate a property's value at all.

Is it really worth what somebody is willing to pay?

The basic principle behind property valuations is that "something is worth what somebody is willing to pay for it" because that is what property valuers' real clients, the banks, want to know. (Don't think because you paid for a valuation you are the client; the bank that issued the instruction and on whose panel the valuer sits is the valuer's real client.)

Roger Montgomery, in my opinion one of Australia's best value investors, tells the story of a company that changed its name from Professional Recovery Systems Ltd to NetBanx.com Corp at the beginning of the .com boom period. As Professional Recovery Systems, their shares were trading at less than 50c and their SEC filing at the time read: *"The company is not currently engaged in any substantial business activity of any description and has no plans to engage in any such activity in the foreseeable future... it has no day to day operations at the present time . Its officers and directors devote only insubstantial time and attention to the affairs of this issuer at the present time, for the reason that only such attention is presently required."* As Roger tells the story "the company was a shell offering the promise to do something maybe one day". At its peak in the .com boom the shares traded at nearly $9. Along with many other .com companies the shares eventually delisted.

Was a company that did nothing and wasn't planning on doing anything ever worth $9? The price may have been $9 but its worth was zero or maybe less depending on debt. Clearly something is not "worth" the price somebody may be willing to pay.

How do we assess a property's real value?

Establishing an investment property's worth is easier than establishing the worth of our home. The first, if done properly, is reasonably objective and rational, the other can be highly subjective and often emotive.

Assessing the value of an investment whether it's residential, retail, industrial or commercial property should be based on discounting the current and future cash-flows distributed by that property at an appropriate discount rate. Predicting with confidence the likelihood of the future cash-flows requires industry knowledge and experience. The choice of discount rate is often thought of as being a reflection of risk tolerance, however if the assessment of cash-flows is realistic and therefore in itself contemplates risk then the adopted discount rate need only reflect a rate that satisfactorily compensates the investor after taking into consideration inflation and the possibility of future interest rate rises. For straight out investments I require a minimum 10%, whereas for development projects my discount rate is much higher. Note this is not a return on total cost or margin, it is effectively the annual rate of return required on the investment.

What we see today in most commercial type property valuations is simply the capitalisation of net income where the capitalisation rate is determined by market evidence and the result is compared to recent sales evidence. In other words, two different methods in forming an opinion on market price, not worth. Residential valuations are determined by sales evidence, again market price not worth.

Market price, not value

The definition of market value from one of Australia's most reputable property valuers is:

The estimated amount for which a property should exchange for 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 each acted knowledgeably prudently and without compulsion".

Whereas the dictionary definition of valuation talks about worth and makes no mention of price, the property valuer's definition for market value has nothing to do with worth and everything to do with price. Market value as defined in property valuation is an estimate of what a property might sell for in present market conditions, an opinion on price, not worth or value.

Property valuations are, in reality, market price opinions done for banks and financiers not because they want to know what something is worth (they have no real interest in owning the property) - they want to know what the relative market price is so they can relieve themselves of the property and recover their loan if the borrower defaults. It has nothing to do with the intrinsic worth of the property. There is nothing wrong with that but let's call it what it is.

Are property valuers too conservative?

One of the most common complaints about valuations is that the valuation is less than the replacement cost. Whether you believe a property valuation is an opinion on market price or an estimate of worth, replacement cost is irrelevant. Just as one man's trash can be another's treasure the opposite can be just as true.

If the property is a residential home, then worth is relative to what we want in a home, however, if the property is an investment then the only consideration is what net income the property is capable of generating.

Remembering that value is the worth of something compared to its price. With the exception of distressed sales, we are still not seeing a lot of good value in the market. I would suggest, therefore, that even though you may think current property valuations are too conservative they are not and, on the basis that valuations are really a reflection of price, then prices are only just starting to approach worth.

Greg Campbell is the director of ARAP, which assists clients facing mortgage default overcome their difficulties through an 'Agreed Risk Adjusted Purchase'.