Draft Approach to Determine Long-Term Sustainable Value (L-TSV)

I. Introduction

The method by which the value of a property is determined depends upon the purpose for which the valuation is required. In the case of a property transaction, for example, the vendor and purchaser are interested in finding Market Value, i.e. a "spot value" or market assessment of value at any one given point in time, which corresponds with the current market equilibrium between supply and demand having regard to comparable transactions for any specific type of property.[1]

There are other purposes, however, where value should be treated from a different perspective, either exclusively or as additional information to Market Value.

> E.g. a bank has to optimally secure their charge against the "value" of the property. It is therefore essential to estimate the sustainable value of the mortgaged property over a longer period of time. This is effected by determining the Long-Term Sustainable Value (L-TSV). Other valuation bases, such as Market Value, do not adequately address the suitability of the property as security for long term lending purposes.

L-TSV is designed as a risk management tool. The concept seeks to mitigate risk exposures in a value-based manner. Therefore it differs from the market value, which requires accompanying regulation by bank and/ or national authority when using for risk management purposes.

II. Underlying Principles

L-TSV is derived by reference to long term observations of market movements and data at the time of the valuation, based upon the durable characteristics of the asset and its environment. It reflects a price which should in any event be achieved under normal market conditions over a long period of time into the future. L-TSV needs to reflect a long term stable equilibrium and appropriate alternate uses and specifically excludes the following:

- Factors specific to certain parties,
- Short term factors which would affect value such as market disruptions and
- Speculative factors.

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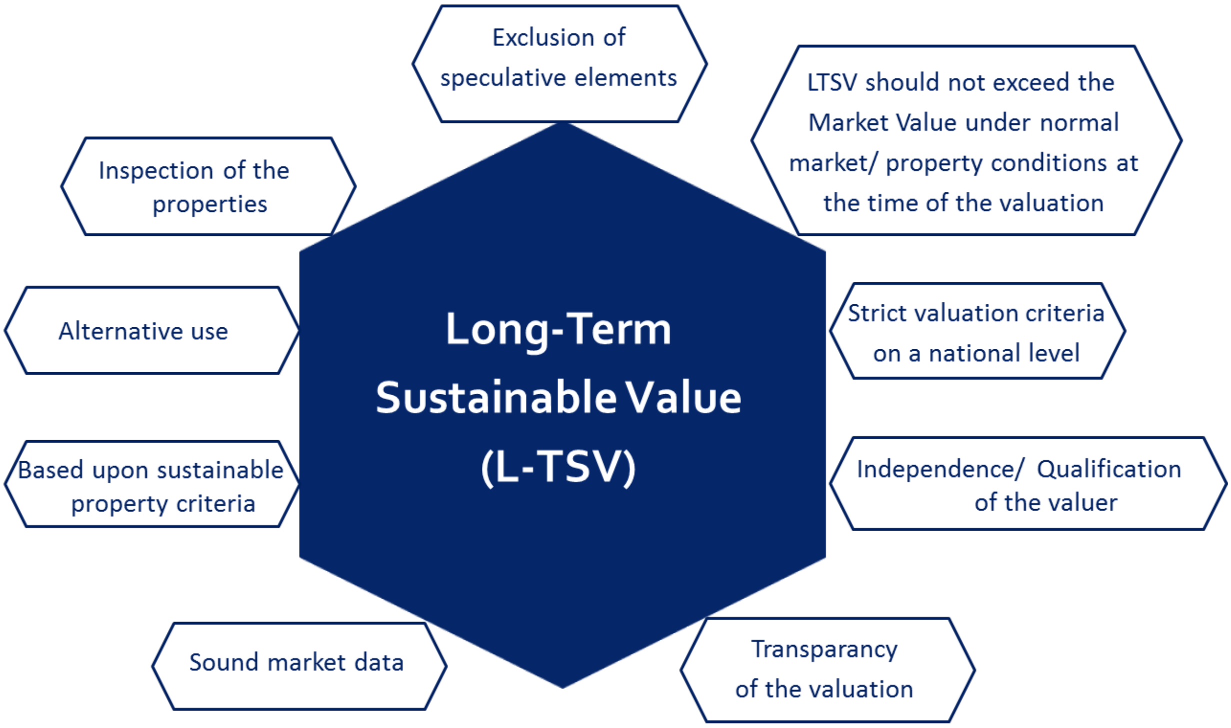
[1] The Red Book (VPS 4), International Valuation Standards (IVS 1), European Valuation Standards (EVS 1) and Capital Requirements Regulation (Art. 4 (76) CRR (Regulation (EU) No 575/2013) define the Market Value as the estimated amount for which the property should exchange on the date of valuation 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 being under compulsion.

The underlying principles of L-TSV can be set out as follows:



Alternative use	The sustainable qualities of the property to potential occupiers over the longer term, e.g. in terms of its location, build and fit-out quality, layout, have to be discussed, together with its flexibility and potential for alternative use. The sustainability of rental income and the long-term potential for the property to generate revenue depends upon its suitability for use among the widest possible occupier market, or in the case of specialised properties, among a sufficient number of interested parties. If substantial alteration works would be required to change the property from a specialised or obsolete use to a readily marketable one, such cost implications must be addressed in the assessment of L-TSV.
Inspection of the properties	The valuer must undertake a property inspection and undertake research to a sufficient extent to enable a professional valuation report to be produced.

Exclusion of speculative elements	Documentation which pertains to operation by current interested parties, e.g. cost estimates, lease contracts, purchase contracts in respect of site or property acquisition, existing operator's annual accounts, current operating expenses etc. must all be questioned in respect of their sustainability, as it is necessary to "abstract" the relevant parameters adopted in the valuation to a level which would be acceptable to the majority of occupiers, operators, tenants, purchasers etc. No speculative assumptions which may enhance future value may be incorporated in the course of this "abstraction".
The L-TSV should not exceed the market value under normal market/ property conditions at the time of the valuation	As a rule, L-TSV should not exceed Market Value at the time of its determination. However, in practice, this can occur under certain market conditions. In special circumstances at the date of valuation, whereby a higher L-TSV in relation to Market Value results, normal market conditions and/ or factors relating to the state of the property have to be taken into account to adhere to this principle. In case of higher L-TSV in relation to Market Value the underlying reasons should be fully explained in the valuation report.
Strict valuation criteria on a national level	Due to differing characteristics between the property markets of various nations, e.g. the availability of market data, legal background and national valuation standards, a joint European methodology to determine L-TSV can only be based upon broad principles. More precise valuation guidelines should be constituted on a national level to ensure that such national characteristics of property markets and valuation practices are properly accounted for.
Independence/ Qualification of the valuer	The valuation should be prepared by a qualified valuer, who, in respect of his professional training and experience over a longer period, possesses special knowledge and experience in the field of property valuation with a special focus on determination of L-TSV. The valuer must not be involved either in the loan acquisition, lending decision or in the brokerage, sale or letting of the property. Any conflict of interest in this respect must be avoided. The valuer has to ensure and confirm that he is independent of any party interested in the outcome of the valuation.
Transparancy of the valuation	The valuation approach adopted and the main valuation parameters and assumptions must be clearly stated and justified. The recipient of the valuation report must be able to understand the valuer's reasoning as to the choice of parameters adopted and how they have arrived at the L-TSV.
Sound market data	Use of reliable market data sourced from current and previous market activity to provide property benchmarks, which can then be extrapolated to determine long term trends.

A market outlook or forecast, requires knowledge of past market experience, its movements and influences over time, and its cause and effect. The valuer's objective is to identify the factors influencing changes in prices and values among various property types and to use this insight to form an "opinion" upon the future development of markets and values.

Based upon sustainable property criteria

When estimating the L-TSV, the valuer must disregard any factors affecting value that are either of a temporary nature, or related only to specific parties and not to the market as a whole.

III. Draft Approach to Determine Long-Term Sustainable Value (L-TSV)

1. *Definition*

L-TSV means the value of immovable property as determined by a prudent assessment of its future marketability taking into account long-term sustainable aspects of the property, the normal and local market conditions, its current use and alternative appropriate uses.
The L-TSV represents the sale proceeds from the property which, based upon experience, may be expected to be achieved in the market over a long period of time, without consideration of temporary, e.g. economically induced, fluctuations in value in the relevant property market and excluding special assumptions.[2]

2. *Scope and Subject of Valuation*

The subject of the L-TSV is restricted to only the permanent elements of the immovable property and the legal interests to be charged.

3. *The Valuer*

3.1. *Qualification*

The valuation should be prepared by a qualified valuer, who, in respect of his professional training and experience over a longer period, possesses special knowledge and experience in the field of property valuation with a special focus on determination of L-TSV.
The credit institution has to ensure and the valuer has to confirm that the instructed valuer is appropriately qualified for the specific property market. Professionals appointed or certified as appraiser or valuer for the valuation of properties for L-TSV- purposes are assumed to possess such qualifications.

3.2. *Independence*

The valuer must not be involved either in the loan acquisition and decision or in the brokering, sale or letting of property.
Any conflict of interest has to be avoided. The valuer has to ensure and confirm that they are independent of any party interested in the outcome of the valuation.

Reports which have been presented or commissioned by or on behalf of the borrower cannot serve as a basis.

[2] A European definition of a sustainable value is set out in Art. 4 par. 74 CRR (Capital Requirements Regulation), here entitled “Mortgage Lending Value”.

4. Valuation Report

The L-TSV must be contained and submitted within a written report.
The report must be prepared by a valuer appointed by the credit institution. Institutions may rely upon reports prepared on behalf of other institutions, provided that these reports meet the following requirements.
The Valuation Report should generally include:

- the assignment;
- the valuer's qualifications;
- the basis and purpose of the valuation;
- the valuation date;
- the inspection date, the person who inspected and the scope of inspection
- the L-TSV of the property
- a description of the property;
- the condition of the property;
- a summary of the legal context (tenure, zoning, planning, building consents, tenancies, etc.);
- a commentary as to the market for the property, i.e. normally including a Market Value;
- a description of the valuation methodology and analysis;
- any assumptions that have been made;
- All legal, contractual, technical, environmental and natural conditions which have been identified must be assessed;
- Comment upon potential factors which could impact on value and/or marketability of the property;
- any limitations on the report;
- signature.

The entire valuation report has to be presented in a self-explanatory and transparent manner.

5. Inspection

The property to be valued must have been inspected as part of the valuation process.

6. Valuation Approach

The assessment of L-TSV can be based upon one or more appropriate valuation approaches:

- Income approach;
- Comparison approach;
- Cost approach.

It is recommended that the most appropriate and most conventionally recognised of these approaches be chosen in order to assess L-TSV depending upon the type of property, jurisdiction and available data. If more than one approach is adopted, due consideration must be given to any wide deviations in the respective results in reaching the final value conclusion.

7. Income Approach

7.1. Sustainable Income

The L-TSV shall be based upon a sustainable income from the property, this being the income that the property is capable of achieving by any reasonably efficient landlord on a sustainable basis assuming proper management and by taking into account the permitted use.
As a general rule overrents above sustainable rental level should be ignored.

7.2. Landlord's Costs

In calculating the sustainable income of the property costs should be taken into account which are likely to be borne in the long term by any reasonably efficient owner. Adequate reserves such as would be necessary to secure the long term income generating capacity of the property have to be considered.

7.3. Sustainable Capitalisation Rate and/or Sustainable Yield

The sustainable capitalisation rate and/or sustainable yield has to be assessed by having regard to relevant long term market data and trends relating to the respective type of property and its relevant market.

8. Comparison Approach

In determining comparative value, regard must be had to sale prices of properties which most closely resemble the property to be valued in terms of its sustainable features, i.e. those which most significantly affect its value, in particular location, external and internal features and use. Comparable prices may be derived from compilations of sale prices or from other market data.
The comparable sale prices should be assessed in terms of their sustainability and be adjusted, where appropriate.

9. Cost Approach

The cost approach consists of an estimation of the land value (9.1) plus the adjusted depreciated replacement costs of the building (9.2.) in relation to costs of comparable property.

9.1. Land Value

The land value is to be derived either directly from appropriate long term market data, i.e. from comparable sales evidence or by adopting alternative approaches using sustainable input parameters.

9.2. Replacement Costs

Replacement costs being the average estimated costs to construct a building of a similar standard as at the valuation date, using modern materials and current standards, design and layout.
Replacement costs include those costs that would usually be expected to be borne by a reasonably efficient developer, including

- Construction costs
- Utilities, site works, landscaping
- Ancillary costs such as: professional and project management fees, statutory and consent charges

Replacement costs do not include demolition costs.
Costs should be assessed having regard to their comparability and sustainability and should be adjusted where appropriate.

9.3. Depreciation

Replacement costs should be adjusted due to the age, condition, functional and economic obsolescence of the building.

10. Remaining Useful Life of the Building

Contrary to the physical life, the remaining useful life covers the period in which the building(s) can still be operated economically assuming proper maintenance and operation. This would include extending the useful life by the inclusion of investment to refurbish the building and its reflection in the valuation.
The impact of the remaining useful life of the building in the context of the income approach has to be explained in a transparent manner taking into account national and local market practice.

11. ***Specific Aspects of Turnover Related Properties***

In case of turnover related properties, such as hotels, leisure, parking and healthcare facilities, where comparable rents are not available, sustainable income may be based upon an appropriate share of the profit e.g. EBITDA that any reasonably efficient operator could be expected to achieve over a longer term from the operation of the property.
When estimating the operating profit, due consideration must be given to an assessment of sustainable factors impacting revenue and costs to ensure the sustainability of turnover and the trading capacity of the property.
The L-TSV for turnover related properties has to be assessed without having regard to fixtures, fittings and equipment (FF&E) or small operating equipment (SOE).