Divining real estate valuation signals

An extract from European IMRE News March 2009

PricewaterhouseCoopers

Divining real estate valuation signals

Establishing a set of valuation signals to support valuations in today's volatile markets requires intensive research.

Robert Ruggles
PricewaterhouseCoopers (US)
+1 973 236 4776
robert.ruggles.iii@us.pwc.com

Commercial real estate market participants' search for 'true' value of a property or portfolios given the challenges of the current economic and financial environment is similar to Juan Ponce de León's valiant search for the legendary Fountain of Youth in the early 1500s.[2] Is it possible to find, estimate, and support the fair market value of commercial real estate properties? If so, what rational methodologies exist to support market valuations for office, hotel, retail, warehouse, development and other property types? Where are today's valuation signals, internal and external to the real estate industries, that shine a light into a global capital market best described as volatile?

Direct vs. indirect signals

International economic and financial trends are having a profound effect, direct and indirect, on commercial real estate valuation. The direct effects include the obvious facts and trends such as number and volume of market transactions, albeit limited as they are, on the reasonable valuation of commercial real estate properties. The valuation of a property is much easier when there is sufficient number and volume of transactions and more difficult under other conditions. For example, total global commercial real estate transaction volume in 2008 declined approximately 60% from 2007 levels according to Real Capital Analytics[3]; U.S. volume alone declined 74% in 2008. Thus, using the industry standard sales approach to commercial real estate valuation is taxing when sales are essentially minimal, especially in smaller geographic areas. There are also challenges to the valuation of commercial real estate mortgages as total international volume for commercial mortgage backed securities (CMBS) has fallen from $303.5 billion in 2007 to a miniscule $29.3 billion in 2008. At the same time spreads over US Treasury bills have increased from 200 to more than 1,000 basis points.[4]

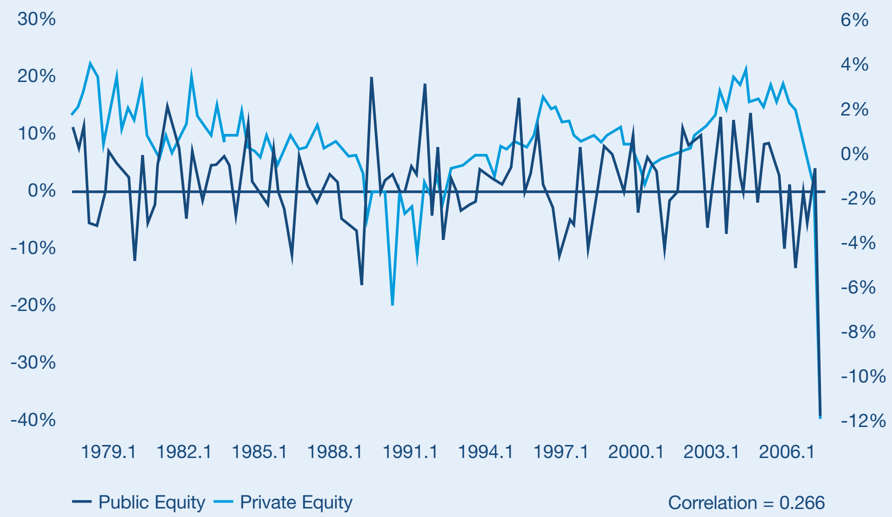
The indirect factors affecting commercial real estate include a multitude of assumptions, expectations, and biases supporting investment and valuation decisions of principal market or most advantageous participants. Perhaps market participants expect private real estate valuations to follow the public real estate valuations. Although history shows there is a significant correlation between the two quadrants, the correlation is still low at 0.266 (see exhibit). The estimation of fair value today implies assumptions regarding occupancy rates, rent growth and cap rates over the next few years.

2 The Spanish conquistador who, according to legend, discovered Florida in 1513 while searching for the Fountain of Youth.

3 Real Capital Analytics, Global Capital Trends, December 2008 (see http://www.rcanalytics.com [31 January 2009])

4 Ibid.

Private equity vs. Public Equity Real Estate Quarterly Appreciation Returns 1979Q1 through 2008Q4



Source: National Association of Real Estate Investment Trusts, National Council of Real Estate Invest Fiduciaries, PricewaterhouseCoopers

The industry recognises that cap rate compression is over. Are cap rates, the inverse of a price-earnings ratio, increasing, and if so, how much? The absolute average of the year-over-year change in cap rates from January 2002 to November 2008 is 44 basis points. Is it therefore reasonable to assume an increase of 100 or 200 basis points for cap rates in 2010 when valuing a property today?

Market participants are acutely aware of employment trends such as the announcement on 26 January 2009 by major employers of layoffs totalling over 70,000 in one day. Are rents going to decline as occupancy rates decrease due to lower demand, and if so, by how much? For example, over 700,000 jobs in the financial activities and professional business service sectors have vanished in the U.S. from August 2007 to December 2008, according to the U.S. Bureau of Labor Statistics.[5] What is the rational probability of office tenants renewing leases, and what is the effect of retailers becoming bankrupt and closing stores?

Finding and challenging signals

Psychologists understand how fear affects humans and behavioural finance researchers are pushing the body of knowledge trying to explain investors' behaviour under varying scenarios. Real estate cycle research indicates that collective mania means buyers and sellers are most diverse in valuation assumptions at the peak and bottom of the cycle. Thus, a herd mentality will exist in the marketplace until participants confirm a sustainable recovery has started.

As FAS[6] 157 and other future regulations (including updates to IFRS[7]) impact the valuation process and reporting standards of commercial real estate properties, it is imperative to: (1) apply healthy scepticism to overly pessimistic and optimistic valuation assumptions, (2) seek out the details behind any industry benchmarks, e.g., the use of smaller geographies vs. national returns, or property type returns vs. all property types, (3) research, read, and review capital market activity reports and investor surveys and, finally, (4) enlarge your sample size for peer group analysis[8] that determine market participant assumptions.

The valuation of a property is much easier when there is sufficient number and volume of transactions and more difficult under other conditions.

5 See U.S. Bureau of Labor Statistics, http://www.bls.gov [31 January 2009]

6 Financial Accounting Standard (FAS)

7 International Financial Reporting Standards (IFRS)

8 PricewaterhouseCoopers' Real Estate Business Advisory Service's appraisal management services provide a proprietary and confidential database of over $70 billion in institutional real estate investments.

Investment Management and Real Estate contacts

IMRE News is produced by experts in their particular field at PricewaterhouseCoopers, to address important issues affecting the investment management industry. If you would like to discuss any aspect of this document, please speak to your usual contact at PricewaterhouseCoopers or one of those listed on these pages.

Global Investment Management and Real Estate Leadership Team

Marc Saluzzi
PricewaterhouseCoopers (Luxembourg)
Global Investment Management
and Real Estate Leader
+352 49 48 48 2511
marc.saluzzi@lu.pwc.com

Kees Hage
PricewaterhouseCoopers (Luxembourg)
Global Real Estate Leader
+352 49 48 48 2059
kees.hage@lu.pwc.com

Barry Benjamin
PricewaterhouseCoopers (US)
Americas Investment Management
and Real Estate Leader
+1 410 783 7623
barry.p.benjamin@us.pwc.com

Pars Purewal
PricewaterhouseCoopers (UK)
UK Investment Management
and Real Estate Leader
+44 20 7212 4738
pars.s.purewal@uk.pwc.com

Brendan McMahon
PricewaterhouseCoopers (Channel Islands)
Global IMRE Private Equity Leader
+44 1534 838234
brendan.mcmahon@je.pwc.com

Robert Grome
PricewaterhouseCoopers (Hong Kong)
Asia Pacific Investment Management
and Real Estate Leader
+852 2289 1133
robert.grome@hk.pwc.com

David Newton
PricewaterhouseCoopers (UK)
Global Investment Management
Tax Leader
+44 20 7804 2069
david.newton@uk.pwc.com

Tony Artabane
PricewaterhouseCoopers (US)
Global Hedge Funds Leader
+1 646 471 7830
anthony.artabane@us.pwc.com

If you would like to receive copies of this newsletter or would like further information about PricewaterhouseCoopers Investment Management and Real Estate publications, please contact Denise Cook at denise.cook@uk.pwc.com

Editor: Rupert Bruce

pwc.com