Submissions in response to the
Independent Review of Real Estate Investment Valuations – Call for Evidence

The Commercial Real Estate Finance Council (**CREFC**) Europe is a trade association promoting a diversified, sustainable and successful commercial real estate (**CRE**) finance market in Europe that can support the real economy without threatening financial stability. Our membership includes a range of different bank and non-bank lenders (including credit funds), intermediaries and advisory businesses, and real estate firms that use debt to finance their activities.

We are responding to this call for evidence principally from the point of view of lending firms that provide credit secured on commercial real estate acquired or held (or developed to be held) as an investment. We have obtained feedback from member firms informally but also through collective engagement with individuals responsible for instructing and reviewing valuations at more than a dozen different lenders of different types.

General comments

Members expressed disappointment that there is no representation of secured CRE lenders on the Review Panel, notwithstanding the importance of CRE lenders as a client base for real estate investment valuations. General concerns were expressed about valuation in illiquid markets, when the traditional weight placed on often dated comparables does not work and valuations are often felt to be largely worthless, as not reflecting current market conditions.

Questions were also raised about the need for some form of long-term or sustainable value approach (not least given the extensive work carried out pursuant to Recommendation 4 of the 2014 report A Vision for Real Estate Finance in the UK, and against the backdrop of changes to the approach to collateral value proposed to the European CRR pursuant to the finalisation of Basel III), and about the need for valuations to integrate ESG considerations.

Overall, doubts were expressed about whether the RICS is adequately equipped and resourced to lead and regulate valuation industry professionals – felt by some to be struggling to keep up at a time of rapid change in the market – and to provide the quality assurance clients require.

Detailed responses to questions

Valuation Methodology

1. Should RICS be more prescriptive in the requirements it places on members to employ certain valuation methodologies in particular circumstances?

- There was little support for greater prescriptiveness among CREFC Europe consultees, but most felt that discounted cash flow (**DCF**) should be used more widely in the mainstream market, especially in the context of shopping centres and retail assets (and potentially, looking ahead, office assets). Suitable training, not prescription, is required for the broader use of the DCF approach. Prescriptiveness would tend to work against nuance, flexibility and judgment, which are key elements of good advice. Where greater prescriptiveness would help is in relation to better targeted CPD (see below).

2. Would any increase in prescription on methodology lead to a reduced obligation on the professional valuer to reflect a particular market characteristic?

- There was a sense that valuers sometimes use a particular methodology because that is what they are comfortable with, rather than because it is the most suitable methodology for the relevant asset and purpose. Prescription on methodology is not the answer to that problem, however – better training and oversight by the professional body are.

3. Do the current applications of valuation methodologies meet market requirements – i.e. do valuations provide sufficient information to clients and others who rely on them about the factors that have influenced the valuation opinion?

- There is a strong case for DCF to be used more widely. It is more transparent, and better at dealing with fluctuating rents (based on turnover or top-up) and forward look. The fact that DCF has been tried and tested in the hotels, PBSA and other alternative segments is helpful and relevant, given that other, traditional parts of the commercial real estate market are becoming increasingly operational in nature. Having said that, it is important that the value selects a methodology which is both appropriate (having regard to the subject property and the purpose of the valuation), and one the valuer has the expertise to use, and that the selection and the reasons for it are explained to the person instructing the valuation. It will often be appropriate for the valuer to run more than one method as a check (for example, notwithstanding our comments regarding the attractiveness of the DCF approach, it may not be the best approach for reflecting obsolescence risk and longer-term cap ex requirements).

- Regardless of methodology, valuers should clearly articulate the analysis and methodology that supports reported valuations, adding evidence and narrative (and perhaps reducing some of the more repetitive and 'standard form' verbiage commonly included in valuation reports).

- Valuations often rely excessively on the outputs generated by Argus Enterprise software which can be difficult for end users to review and interrogate, allowing errors to go unnoticed.

- In an illiquid market environment (such as during the pandemic), valuers can be too reliant on recent comparable evidence which pre-dates the illiquidity and fails to reflect changes in sentiment or likely downward value movements that have not yet been revealed in transactions. The resulting lag in valuations reflecting perceived current market conditions is bad for confidence. It should be possible to infer what is happening from previous cycles and periods of market stress to inform valuations even in such conditions.

4. Do the requirements of the Red Book / IVS create an adequate global/national framework for provision of high-quality valuation advice?

- UK value movements (from year to year) are quite extreme compared to Continental Europe, leading to a perception that there is no consistent standard across the industry. Are values in fact more volatile in a liquid market, or does liquidity simply reveal volatility?

- There does not appear to be sufficient experienced resource to manage and author the numerous professional guidance notes and standards. Red Book updates and guidance notes are regularly delayed (numerous examples of this!). The Red Book should be the <u>single reference point</u> with all standalone guidance notes and standards linked to from an online version of the Red Book.

- There is also an international dimension. Valuers across continental Europe are often, but not always, RICS qualified – and the fact that many investors and lenders active in the UK market are international means that other valuation practices are sometimes applied to UK assets. It might be helpful if methodologies commonly employed in other jurisdictions were recognised by the RICS framework, fostering broader acceptance of the RICS framework and driving greater consistency.

5. Is there a need for additional guidance, training and data to RICS valuers to support the provision of high-quality valuation advice?

- To address concerns expressed elsewhere about a lack of confidence in valuer expertise, especially in less liquid market segments and smaller regional markets, CPD requirements should be tailored, with targeted CPD for valuers in their area of valuation expertise.

- There should be a greater emphasis on educating valuers in financial modelling and analytics, at an earlier stage in their career as well as through CPD. Valuer training should also cover the way the buyers and sellers of assets price them, with a view to making it easier for them to explain their methodologies in a commercially helpful way to their clients.

- Too many reports make very broad assumptions. For a proper secured lending valuation the requirement for the valuers to take account of cap ex required over the next ten years should be tightened. For example, many valuers currently assume that fire safety and energy upgrading works are in order, rather than investigating or even simply recognising what is known from available technical due diligence reports. Valuers should be better at understanding and assessing cap ex requirements – both to reflect ordinary refurbishment and to address sustainability-related obsolescence risks.

- Real estate is in part a financial product, so its price is linked not only to property market fundamentals and the characteristics of the relevant asset, but also to the cost of capital and the capital structure for each asset (and valuers generally reflect that in their reports and potentially associated analysis). However, it is important to recognise in particular the degree to which (and price at which) an asset is financeable. While valuers look at unlevered returns, investors will often look at the levered IRR of an asset. The exit price in the future is defined by the market rent over the cap rate and the cap rate is a function of the asset risk compensation (equity) <u>and</u> the cost of debt. The availability or otherwise of debt can materially affect the price of an asset.

- Valuers traditionally rely heavily on trading comparables. This can be entirely appropriate if sufficient transactions with comparable assets have taken place in say the last 3-6 months. However, where that is not the case, valuers should look at other data sources to inform and justify their opinions. For example, the public markets (most obviously REITs, securities representing single assets, including on IPSX, and CMBS) provide an interesting angle (credit spreads, etc.) and should be looked at more closely by valuers.

6. Can professional valuers make better use of technology to deliver high quality valuations?

- Quite possibly, but technology needs to be used intelligently. See comments above in relation to the use of Argus Enterprise software and outputs. Methodology selection should not depend on the most familiar options offered by such software, any more than it should be constrained by a valuer only feeling comfortable with a limited range of methodologies.

7. Any other comments relating to valuation methodology.

- Methodology should always be clear and transparent. Consideration to be given to sustainability and long term value
  - Methodologies should be flexible and move with the times. A range of methodology is acceptable
  - Some student accommodation would be best valued on an operating concern basis if there is service provision and a Discounted Cash Flow (DCF) model for higher value H&L sector given the slow return to normal or new normal trading profits and cash flow.

Property Risk Analysis

8. Is there a potential conflict of interest for the valuer in providing a valuation figure for regulatory purposes and advice on future market changes?

- Not clear why there should be. Lawyers and accountants have long juggled the different purposes for which their advice is required. The fees and liability caps sought by valuers should reflect the degree to which their advice has been expanded for such purposes.

9. Are valuations appropriately instructed?

No specific comments.

10. Are valuations provided in a manner which gives clients sufficient, forward-looking quantitative analysis on risks and their impact on investment worth, in addition to the objective opinion of current value?

- A market value valuation provided as at a specified date remains the most certain position for a number to be provided, subject to points made elsewhere about the importance of a longer-term, sustainable view. For secured lenders in particular, a 'horizon view' is useful, given the importance of the position on loan exit/maturity.
- Uncertainty can be reduced through better use of data (both historic and forward-looking), greater transparency and visibility regarding comparables and use of indices (although where an index is used, insight into its composition should be provided as assurance of its relevance). Assumptions should be removed where they can be replaced by known relevant information, for example by appropriately integrating information from third party reports (such as building surveys in relation to cap ex requirements).
- The RICS market value assumes a trade between a willing buyer and seller at arm's length with sufficient capital (including debt) being available. In distressed situations where the market is dysfunctional (such as can be observed today), those assumptions are of little relevance, so the narrow definition of market value is of questionable meaningfulness. From a lending perspective, we should be interested in a longer term (going concern) value rather than the Red Book market value, as the relevant exchange of the asset is likely to happen a few years down the road. Alongside market value, a sustainable (hence less volatile) value would provide a sense of sustainable value in a stable environment, allowing clients to look through market peaks and troughs.

- Secured lending valuation reports should focus on the actual valuation rationale (how they have arrived at their valuation number, how the comparables used as evidence actually compare to the subject Property, which methodology was used and why, etc.).

- In line with comments elsewhere in this response, when valuing assets in stressed and illiquid markets, valuers should use insight and provide context from previous market downturns.

11. Can more be done to ensure clients understand how to instruct additional supporting, bespoke risk analysis?

- Among CREFC Europe consultees, a lack of expertise in instructing valuations was not cited as a concern. However, it was noted that RICS training specifically aimed at those in client organisations with responsibility for reviewing valuations would be useful.

12. Do valuers have the tools to deliver this sort of analysis?

- There appears to be considerable scepticism among CREFC Europe consultees as to whether valuers consistently have the tools to do this. An overriding theme in feedback has been a concern that valuers do not consistently have the skills and expertise they ought to have and that the RICS is not providing the leadership, training framework and oversight required to help valuers improve and adapt in a rapidly changing market environment.

13. Any other comments relating to property risk analysis.

- Valuers should look at the credit quality of tenants, both on granular portfolios and where there is a reliance on one or a very small number of tenants.

- The RICS needs a simple but robust rating framework for assessing ESG considerations. It is recognised that the governance component may be difficult at the level of a real estate asset, but environmental and social aspects should be feasible. Currently, the best approach for taking account of such considerations is through yield and ERV, but a more proactive approach from the RICS is needed to guide the industry. With EPC B and performance-based energy/emissions ratings for larger commercial buildings looming, clear guidance is needed in relation to the brown discount / green premium of existing stock.

Independence and Objectivity

14. Are current RICS requirements in respect of valuer independence sufficient? This will focus on valuations for financial reporting (including investment portfolio performance measurement).

- A requirement for regular rotation of valuers (at signatory, team and firm level) would be appropriate, in line with good practice for auditors, where valuations are to be used for a regulated purpose.

- In smaller regional and international markets (where there are fewer suitably qualified valuers), and in relation to very specialised properties, it can be very challenging to find a valuer with no prior involvement with the property or client. The current flexibility in guidelines can be construed as allowing conflicts despite the obvious risks. In order to address this, stricter conflict management should be enforced (regardless of resistance from parts of the profession). However, valuer rotation requirements would have to be carefully balanced against the further resulting reduction in the availability of suitable, independent valuers. It is also important to balance the benefits of specialisation against those of valuation practices with a broader knowledge of and involvement in the market.

15. Are there any other material threats to objectivity in valuation that RICS should consider?

- Clients (especially lenders) should have a published whistle blowing policy to prevent undue influence/ inappropriate pressure.
- There is much to recommend the US practice for a barrier between the person originating a loan at a lending institution, and the person instructing the associated valuation.

16. Should valuation firms be required to provide details of their valuation governance structure within their terms of engagement?

- Details of internal audit processes and peer reviews would be beneficial, especially if there were published RICS best practice guidance in this area.

17. Any other comments relating to independence and objectivity.

- We observe inconsistency of approach and a general lack of understanding across the industry despite publication of the Conflicts of Interest Global Standards in 2017. That must be addressed if the RICS brand is to command confidence and credibility across the industry. RICS needs better systems for collecting and acting on feedback from clients about issues arising.
- We are aware of concerns around the ability of valuers from the larger surveying practices to be independent and objective where significant fees are earned by other business lines (comparable to concerns that continue to plague the Big Four audit firms).
- Disclosures and confirmations currently work ok for our lender valuations. However, in smaller markets, getting a valuer who is not conflicted can be an issue with a smaller pool of professionals. It is important to strike a balance between complete independence and objectivity and knowledge of the market and players within.
- We understand that there is growing momentum at European Union banking regulators for requiring valuation firms to be rotated every three years (or every third instruction). The RICS should anticipate such trends when considering global valuation standards in the context of valuations for international lenders.

Measuring Confidence

18. How can RICS measure market confidence in RICS valuer performance on an ongoing basis?

- The RICS needs to embrace and resource its regulatory role properly. This is a critical part of the role of the RICS to ensure valuations standards are proactively upheld, valuers have appropriate expertise and experience, and confidence maintained in the RICS brand across the industry and in fast-moving times.
  - Lenders need to be able to easily provide feedback to the RICS when we see poor reporting standards.

    - Lenders required transparency of VRS and the auditing regime undertaken by RICS regulation.
    - The lender perception is that regulation is inadequately funded and resourced, and remains ineffective both nationally and globally.
- CREFC Europe would be happy to work with the RICS to collect regular feedback from lenders.

19. Should insights such as the Valuation and Sale Price Report by undertaken more frequently?

- No specific comments.

20. Any other questions relating to measuring confidence.

- The quality and consistency of valuation reports can vary considerably across different firms of valuers, and even within the same firm across different offices/markets (especially in smaller and less liquid market segments). Experience helps build trust and confidence; it can be difficult to appoint the right valuer in a new market or sector where that experience is missing.
- Lenders do not always have confidence in the level of expert knowledge that valuers have in a particular market segment in which they advise. Valuers need to be actual experts in their field, having regard both to the sector and the location of the asset. Small, regional firms may be unable to match in terms of sector-specific expertise what they have in terms of local knowledge; and large national or international firms may under-invest in the expertise of smaller, local offices. The lender should have confidence that the valuer fully understands the asset being valued and has sufficient knowledge and experience to undertake the valuation.
- Quality issues that are often observed include incorrect inputs and calculations, and the absence of explanation or justification for the approach and metrics adopted (e.g. very variable degree of read-across to comparable evidence).
- Does the RICS currently gather and analyse feedback from the end users of reports? A structured approach to collecting, analysing and responding to feedback in a timely but considered way would improve the consistency and quality of valuations.
- There may be value in extending (or better publicising) access to RICS training designed specifically to meet the needs of those reviewing valuations, such as auditors and lenders.

We would be happy to discuss our submissions further. Please contact me in the first instance.

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