STUDENT FOCUS

Lessons for NAMA from Valuation Practices

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One wonders if Oscar Wilde had valuers in mind when he quipped that "nowadays we know the price of everything and the value of nothing." Certainly the National Asset Management Agency will need to reflect on the valuation practices of valuers if they are serious in addressing their fundamental objective of maximising the return to their shareholding taxpayer. At some stage in the future NAMA will want to raise the most money it can from selling the assets under their control, mindful that they will lose money if they undervalue their assets. Similarly, potential purchasers will be concerned about asset values because they don't want to pay more than they are worth.

Predicting how much purchasers will be willing to pay for those assets is tough. Investors in assets of all types use a variety of techniques to value the assets they buy. They will try to assess which asset has the greatest potential for gain, assess the risk factors involved, look at accounting data and assess where the market is heading. Scientific valuation precision is nigh impossible because valuation is both art and science.

Nevertheless despite the limitations of assessing scientific value, going back to first principles is an appropriate starting point. What is relevant is intrinsic value. The intrinsic values of all assets are found the same way. The current intrinsic value of all assets is the expected cash flow (not profits) those assets will generate both now and in the future. What these assets generated in the past is of no consequence to their current values. Unfortunately this is the main weakness of accounting based valuation methods, such as profits methods of valuation, because such methods are, by definition, historical. Indeed the Mallison Report, which was published following the UK property market crash in the late 1980s, suggested that one reason for the overvaluation 'bubble' was valuers using historical (comparable) evidence to estimate current values. However, if future cash flows based on economic values are declining, intrinsic values can lie considerably below market price. This is the classic property asset bubble which we are now experiencing.

Unfortunately, by adopting accounting values and not economic value, valuers contribute to property market inefficiency. The reaction to this global financial and real asset meltdown is for tighter regulation. But the difficulties now being experienced in global asset markets are not new– it's just that the problem is much bigger. The common denominator is accounting based valuations.

It may be a tad unfair to practicing valuers to criticise them for slavishly adhering to this method of valuation given that their bible, the Red Book, takes its cue from the international accountancy standards. Perhaps the solution, in addition to tighter regulation, is a move to long term economic value, which, thankfully, is what NAMA is alluding to.

Appraising commercial property is composed of several methods of valuation. The dominant valuation method used is the income approach using terminal value. The price paid is a reconciliation of the income approach and other valuation methods. But sometimes assets will sell for amounts other than the present value of expected future cash flows because not everyone can agree on what the future cashflows are going to be. Competition for valuable assets will lead to price adjustments which are the best estimate of what the asset price is. The assets will sell to those investors who see the least risk and/or anticipate the highest cash flows. But here lies the heart of the problem.

Remember the objective of valuations, if we are to avoid asset bubbles, should be to find a **market price** that sits comfortably with **intrinsic value**. There are two important inputs here. First, cash flow expectations should be based on realistic economic

forecasts. Sadly this is not always the case. For example, looking at the balance sheet of Anglo Irish Bank the net asset value (book / accounting value) of their commercial property portfolio is circa €4.5bn. If you were to believe this you believe in the tooth fairy. Clearly the valuations placed on those commercial properties, now being acquired by the taxpayer, expected these properties to generate wholly unrealistic cash flows. Again this violates first principles in financial economics – the GIGO effect – garbage in garbage out.

Secondly, in addition to having realistic cash flow expectations, the risk attached to those cash flows is paramount. This risk is reflected in the discount rate. Inter alia, how these commercial properties are funded determines the discount rate. In the valuation of these commercial properties, gearing levels of 80% was not uncommon. The principal characteristic feature of debt is its fixed income repayment regardless of the cash flows. This substantially increases the commercial property's financial risk. Was this adequately priced into the valuation? The evidence would suggest not. Furthermore, valuers must come to use an appropriate cost of capital instead of simply relying on the cost of debt. Again the reason for this is that valuers take their cue from their accounting cousins who simply deduct the cost of debt in arriving at a profit figure and ignore the biggest cost of all – the cost of equity, which of course is included when teasing out economic value.

The taxpayer will become NAMA's biggest shareholder and maximising the shareholders long term economic value is the primary goal. To do this it should avoid bad valuation practices. The valuation method used to value the target assets should be the economic equity residual method. This method assesses the residual free cash flows (FCFs) left over for the acquiring company's shareholders – the taxpayer. Maximising these FCFs maximises the taxpayers' return.

The valuation profession needs to return to basic economic theory that will inform them of how to undertake competitive market analysis using pro forma cash flow analysis, its economic drivers and investment risk in assessing property values.

IAVI YOUNG MEMBERS NETWORK

The IAVI Young Members Network was established to provide social, educational and networking opportunities for members under the age of 37. It also provides feedback to the IAVI at National Council level in relation to the issues affecting young members. Working Committees have been established in Dublin and in the South East region and meetings are organised on a monthly basis by the IAVI Communications Officer. We recently undertook an online survey to find out what young members needed from the committees and how best to deliver on that. As a result, there have been several young member events held in Dublin to date, including the very recent 'IAVI Summer Social' at the School House Bar in Ballsbridge which was very well attended and provided a great opportunity for IAVI property professionals and students to meet each other and to develop contacts on an informal basis.

Given the high proportion of young members that comprise the IAVI membership, we are actively encouraging young members to become more involved and to give us their feedback, ideas & suggestions for development and improvement of the Young Members Network. We are in the process of establishing working Committees in the other regions. If you would like to get involved, please contact Conor O'Donovan, IAVI Communications Officer, on (01) 661 1794 or ***conor@iavi.ie***

L-R Conor O'Donovan (IAVI Communications Officer) & the Dublin Young Members Committee; Ivor Ashe (MFO), Ciara Davin (Treasury Holdings), Caroline Freyne (Danninger), Marcus O'Connor (MFO), Astrid Lyons (Bennetts), Michelle Healy (Lisney), Fergus McCarthy (Fitzpatrick Property).

Socialising at the Young Members event.