Valuations - Explained

Thoughts and Opinions by Dr. Tony Hayek

There has been a huge shift in the way a Bank's business is done today due to the changing financial landscape. Once upon a time (in fact, not that long ago) the banking industry's main objective was to post massive profits, and the term "default risk" was merely a phenomenon. This was due to the overall state of the economy (low level of default) and the fact that commercial banks "banked" on the fact that property prices will always cover the amount of debt owed in the unlikely event of a default. This theory has recently been proven wrong. The emergence of the subprime mortgage crisis has effectively transformed the bank's tolerance of risk. The objective is no longer to just make large profits through care-free lending, rather it is to control the amount money they could potentially lose. This has changed the way in which banks lend money and has had an even greater effect on the valuation industry.

A valuation firm is engaged by a bank to confirm the value of a property they will use as security for a loan given to a customer. This means that valuations provided to the bank is an important part of how much risk the bank is actually taking when they lend out money. In an environment where risk is at the top of the bank's agenda, this poses a problem. Historically, valuers have used a "comparable sale" method to value a property. As a result of the banking system's new intolerance to risk, valuers are now also forced to consider a list of criteria given to them by the bank. One example of this, is that a valuation firm can only use comparables within 1 km of a property and in the case of units/townhouses the valuer cannot compare units within the same complex. So for a new project, often it is difficult for a valuer to reflect the true market value due to lack of comparables, unless, of course, there is an almost identical development recently completed nearby.

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There are number of reasons that valuations are coming in below market value in the current environment. Here they are in no particular order:

1. Scarcity – In my experience, I have found that properties that have a point of difference will more often than not, outperform the local market. When a property is scarce it will often have a premium attached to it because of its superior location, size, finishes, amenities and design. This makes it virtually impossible for a valuer to justify a contract price because there will be a clear lack of comparable sales.

2. Subjectivity – Two properties are very rarely identical. A valuer's subjective opinion, whether they like it or not, will play a part in the valuation process. The point here is that there is no scientific or empirical means for a valuer to remain neutral and unbiased with their valuation. Hence there is a large level of subjectivity that goes into this process.

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3. Time Frame – Valuers generally use historic data to value property and as such they are "past-tense focused". Valuers get their comparable sales data from RP Data's database (RP Data records each property sale nationally) and it normally takes three months for a new sale to register on RP Data. So what happens when a market is shifting? Valuers simply do not have the right information available. Sentiment can change quite quickly in a local market. If there are a couple of months of solid growth, the valuation firm will not have access to this new information and will base their evidence on old sales data.

4. Liability – In the midst of the global financial crisis, banks have sought to take legal action against valuation firms that have been seen not to have taken acceptable due-diligence in preparing their valuation report. This has led to valuations coming in on the conservative side. In other words, valuers have adopted the "better safe, than sorry" approach.

This is not to take away from the way the banks are managing their affairs or the way valuers are conducting their business; their conservative approach is a prudent measure that probably needs to be taken. Moving forward, the distinction needs to be made between fair market value and a bank conducted valuation.

I'll share a couple of experiences I've had that may help show how some of the points I've made above translate into the real world. At the end of 2006, I recommended an in inner city apartment complex in Brisbane. At the time our research process led us to a urban revitalisation type development in Kelvin Grove which is approximately 2 kilometers north west of the CBD. The project was unprecedented in the area. I matched a client to a unit within the complex with a contract price of $320,000.This was a true reflection of the market conditions at the time, however the valuer valued the property at $260,000. A number of factors (including a loss of confidence from the buyer) led to the sale falling through. In today's market, that same property would be conservatively worth $420,000, an appreciation of approximately 31% or 12.4% per annum. That valuation cost the client $80,000 in two and a half years.

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Another example is an inner city Sydney warehouse conversion project we recommended to clients at the beginning of 2007. It is a unique and highly desirable property. The development had six identical 3 bedroom terraces which were priced at $649,000. One of the clients went to their bank and applied for finance. Their valuation came in at $480,000. The client went back to the bank and asked them to re-value it as she felt the valuation was unrealistic. The same lender had the terrace re-valued by the same firm and this time they valued it at $600,000. The client subsequently went to another lender as the other 5 were valuing at contract price. With the new lender, the valuer valued the same terrace at $645,000. The loan was approved and the client purchased the property.

Looking back at the first example, I can understand why the client made the decision. The fear of paying too much crippled them. Courage always comes easier when you have clear, simple information. Know your numbers, do your research and take action.

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