Editorial

Property valuation: pricing and the market

"A Cynic is a man who knows the price of everything, and the value of nothing.
Oscar Wilde, Lady Windermere's Fan, 1892, Act III"

I know that the quote above is semantically looking at the words "price" and "value" in a deeper and wittier connotation than I will be discussing in the context of property valuation, but it does highlight the importance of precision in language. As a veteran academic, I have travelled far and wide in the UK and around the world listening to property investors, lenders and valuers and I am constantly bemused at how few people actually understand "value".

There are three words in common parlance in the English language (and other languages) can commonly be used interchangeably. These are "price", "value" and "worth". Yet in the context of property (and economics), the words have distinct meanings.

(1) Price is the actual observable figure at which a property asset is sold in the open market. By definition, it is an historic fact and can only be observed once the sale has been made.

(2) (Market) Value is an estimate of price where there is no actual sale. It is a proxy. An estimate of the figure that would be paid for the property asset in the open market were the property to be sold (after marketing) on the date of the valuation.

(3) Worth is a not a market-based figure. It is a subjective assessment of the financial benefit of that asset to a particular owner or potential purchaser at a particular moment in time.

In simple terms, an investor may look at the cash flow that a property investment generates and calculate that the property is worth "X" to them at their internal discount rate and based on their forecasts of the future. The Open Market Valuation for the same property, however, is "X-1" based on market evidence. Thus the investor will be interested in purchasing the property; the difference being a reflection of the divergence between their forecasts and market expectations. Conversely, if an investor thinks that that a property that they own is worth less than the market value, then they would consider selling that asset.

Worth is the driver that stimulates offers in the market; value is an estimate of the sale price in that market and price is the actual amount paid. These are three different concepts. But, all of them are a specific point in time. Just as prices fluctuate in the market according to economic conditions, so will value (as an estimate of price) and worth. Valuations do not have shelf life. Values, as prices, go up and down.

The distinction between "price", "value" and "worth" is of paramount importance. But sadly for every valuation user who understands the distinction, there is the same number or more that think that value is worth or that value is an inherent number below which the property will never be sold.

If I got a pound for every banker whom I have had to disabuse of that last statement, I would be mortgage free and setting up my own bank. Value is an estimate of the price in the market TODAY. Tomorrow it will be a different number. Just like with shares in the stock market where prices fluctuate by the minute. Yet, property is seen as something different. Maybe part of the problem is that, with property, it is not possible to observe prices changing in real time on the screen as you can with the stock market? Maybe, it is because, property values are seen to be something other than an estimate of "price"? Maybe, it is that as a tangible asset, people think that the economy impacts on property differently to other assets? I am not sure why. But, the bottom line is that too many educated and intelligent professionals think that property valuation is something separate from price. It is not.

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Of course, another contributing element is that as a valuation profession, we are not good at communicating to our clients about the definition of value. In a valuation report, we must define "Market Value" but, all too often, this is a mechanical exercise rather than a real exposition to the valuation user.

In fairness, I know that there are some well-informed clients who understand the distinctions exactly. Likewise, there are many wonderful valuers who provide robust and comprehensive valuation reports that fully explain market value. But these are the individuals who do not get the headlines. It is where something is considered wrong, where there is considered to be a negligence claim, that a misunderstanding of "value" can have severe consequences. If a valuer values a property at "*X*" in a buoyant market and subsequently, the market crashes and the sale price (say) two years later is "*X-Y*", that does not make the original valuation wrong. The loss of "*Y*" should be down to the vagaries of the market but, all too often, claims arise because the user of the valuation considers that the original valuation provided some kind of guarantee. It does not.

It is also sometimes argued, erroneously in my opinion, that valuations, because they rely upon historic price information (comparables), are backwards looking. Indeed, in a recent RICS report, it was said:

> A market value basically looks at the past and can create a lagging effect. A market value basically looks at the past and can create a lagging effect. This can lead to an underestimation of current market value in upward market movements, and an overestimation in a downward market movement (RICS, 2018) [1].

Whilst I do not deny that the lagging effect can be observed, the reasons for this are much more complex than the valuation method alone. Indeed, to consider calculations of market value as "backwards looking" fails to recognise that prices (comparable information) already capture future expectations. When anyone buys anything, they are buying its future use. Property prices (for investment property) are already reflecting a market expectation of how that property will perform over time. Thus market comparables reflect market expectations. The question for a valuer, when using comparables, is how has market sentiment changed between the comparable sale and the subject property's valuation date. All valuers worth their salt will adjust comparable information to incorporate those perceived changes. Using historic information (there can be no other type) is not the same as "looking at the past". and and

Nick French

Note

1. Sander Scheurwater, The Future of Valuations – The relevance of real estate valuations for institutional investors and banks – views from a European expert group, RICS Insight Paper, November 2017, Royal Institution of Chartered Surveyors, London.