

Dealing with Valuation Uncertainty

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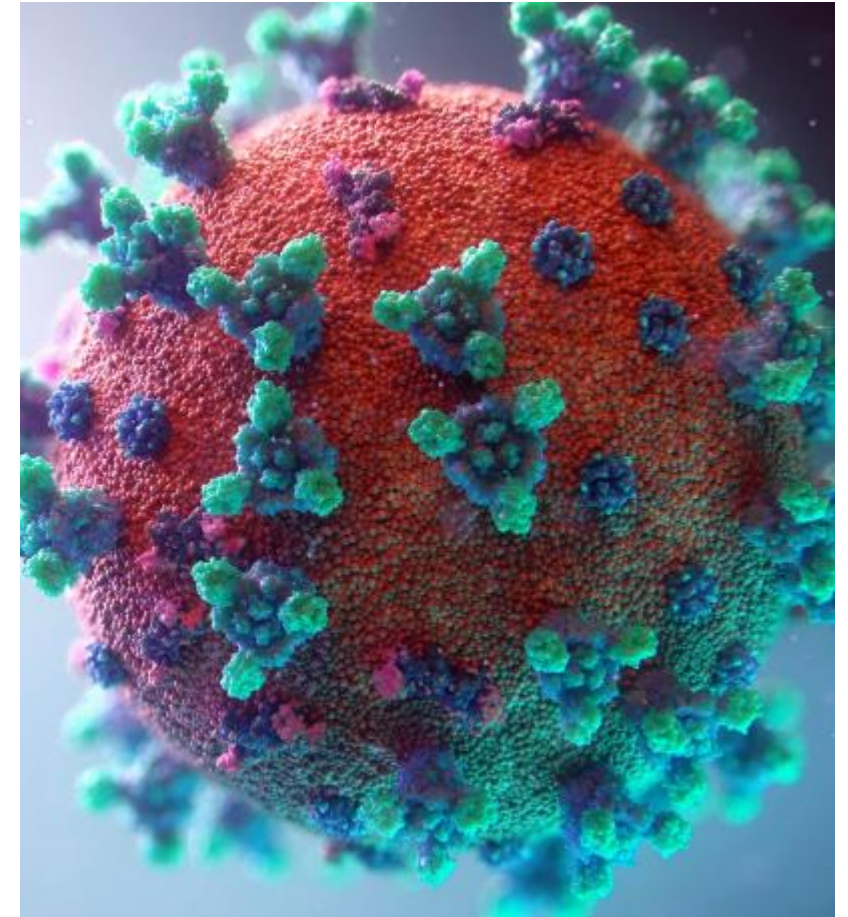
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Overview

- The underlying value of all assets underpins economic activity in any given cycle
- Rapidly evolving economic circumstances - unprecedented and profound
- Administering investment real estate has many new challenges
- Managing the revaluation process is also going to be a significant challenge
- Stakeholders are all in this together
- There is a gilt-edged guarantee from all of this ... students of economics will be studying what transpires in the COVID 19 Economy for decades to come
- The paper is not intended to be the panacea of valuation ideology in the COVID 19 economy – It is intended to start a robust discussion aimed at uniform approaches

Today's Discussion Points

- Importance of Accounting and Valuation Standards in the COVID 19 economy?
- IVSC paper on valuation uncertainty
- Key COVID 19 economy dates and durations
- Commonwealth Code on Commercial Leasing & State based Legislation / Regulation
- Landlord /Tenant Questionnaire - what do we need to know?
- Outcome of Tenant Code negotiations not yet known
- Classifying Tenants and Risk Rating Propensity for Tenant Default
- Limited Sales and Leasing Transactions – Where is the market?
- Cash flow impacts of the Code & valuation application
- Capitalisation rates and discount rates
- Two Valuations – 1) but For the COVID 19 Economy; and 2) Impacted Valuation for the time being
- The necessary maths
- Impact of the treasurers FIRB Announcements
- Key takeout's



Importance of Accounting & Valuation Standards in the COVID 19 economy?

- Lenders, regulators and auditors will heighten the scrutiny of valuations based on the requirements of the accounting and valuation standards in the COVID 19 economy
- The main Australian accounting standards that relate to investment real property include:
 - AASB 13 - Fair Value Measurement
 - AASB116 - Property, Plant and Equipment
 - AASB 140 - Investment Property
- The valuation standards universally adopted in Australia by API and RICS are the IVSC's valuation standards (republished effective 31 January 2020)
- Common principles in both the accounting and valuations standards include:
 - Valuation approaches (Market Comparison, Income (DCF and Capitalisation) and Cost)
 - Need to validate and corroborate inputs (AASB 13 – Fair Value – Level1, 2 and 3 inputs)
 - Need to apply lease incomes for investment real estate
 - Methods of corroborating and validating discount rates and capitalisation rates
 - Need for well articulated and corroborated application if inputs and approaches
- The standard discusses the comparison approach, the cost approach in the income approach (Capitalisation and DCF)
- Validation by Level 1, 2 and 3 observable inputs

Specifics in the Standards for the times we are in

- AASB 13 - Appendix B to AASB 13 gives guidance to valuation approaches as well as Fair Value assessment where there is **risk and uncertainty**
- AASB 140 Paragraph 40 AASB 140 - an entity shall ensure that the fair value reflects, among other things, **rental income from current leases** and other assumptions that market participants would use in **pricing investment property under current market conditions**
- AASB 140 - Paragraphs 53-55 refer to an **inability to measure fair value reliably because of market circumstances**
- IVSC 2020
 - Valuation approaches and methods – pp. 29- 49
 - Income approach from page 36 (DCF from p. 37)
 - Type of Cash Flow, Cash Flow Forecasts, Terminal Value, Gordon Growth Model, Discount Rate Selection method – pp. 37-44



IVSC Paper on Valuation Uncertainty

- March 2020 - IVSC Paper discussing valuation uncertainty
- Mirrors a similar document prepared during the GFC by the IVSC
- **Does not consider the propositions put in the Commonwealth's Commercial Leasing Code**
- Imperative that valuation reports in this time of significant uncertainty properly consider observable valuation inputs
- Where inputs are not observable, that assumptions are well applied and articulated
- The paper makes the distinction between valuation uncertainty and market risk
- Discusses measuring valuation uncertainty noting that any quantitative measure should always be accompanied with a narrative describing the cause and nature of the uncertainty

Key COVID 19 Economy Dates & Durations



State / Territory Ratification of the Code

NT

Not completed at date of preparation

QLD

Introduced to QLD parliament 22 April 2020
COVID-19 Emergency Response Bill 2020

WA

Enacted 23 April 2020 - Commercial Tenancies (COVID-19 Response) Act 2020

NSW

Regulation adopted 24 April 2020 -
Retail and Other Commercial Leases (COVID-19) Regulation 2020

SA

Enacted 9 April 2020 - COVID-19 Emergency Response Act 2020

ACT

Not completed at date of preparation

VIC

Enacted 24 April 2020 - COVID-19 Omnibus (Emergency Measures) Bill 2020

TAS

Enacted 9 April 2020 – COVID-19 DISEASE EMERGENCY (MISCELLANEOUS PROVISIONS) BILL 2020

Commonwealth Mandatory Leasing Code

Leasing Principles – Non-Cash Flow Principles

1. Landlords are precluded from terminating leases due to non-payment of rent
2. Tenants must remain committed to the terms of the lease subject to any amendments to the rental agreement
10. No fees, interest or other charges should be applied in respect of rent waived or deferred
11. Landlords must not draw on a tenant security for non-payment of rent
12. Tenants should be provided with an opportunity to extend its lease for an equivalent period of the rent waiver and/or deferral period (NB Variation of lease rent provisions OR unsecured loan?)
14. Landlords may not apply any probation on levy penalties if tenants reduce opening hours or cease to trade due to the COVID 19 pandemic





Commonwealth Mandatory Leasing Code (cont.)

Leasing Principles – Cash Flow Principles

3. Proportionate reductions in rent payable in the form of waivers and deferrals based on trade reduction
4. Waivers must constitute no less than 50% of the total reduction in rental payable
5. Rental deferrals - amortised over the balance of the lease term or for a 24 months whichever is the greater
6. Reduction in statutory charges (land tax, council rates or insurance) will be passed on to the tenant (NB what about net, semi gross and gross leases?)
7. A landlord should seek to share any benefit it receives due to deferral of loan payments
8. Landlords should where appropriate, seek to waive recovery of any other expense or outgoing payable by a tenant under the lease term during the period the tenant is not able to trade
9. Repayment should occur over an extended period in order to avoid placing undue financial burden on the tenant. No repayment should commence until the earlier of the **COVID 19 pandemic ending (as defined by the Australian Government) or the existing lease expiring and considering a reasonable subsequent recovery period**
13. Landlords agree to a freeze on rent increases except for retail leases based on turnover rent

Dealing with the cash flow Impacts of the Commonwealth's Code in DCF Valuation (Income Approach)

- Likelihood of limited transactions given the speed of entering the COVID 19 economy high?
- Understanding negotiated tenant rent relief cash flows (Code or otherwise) a temporary conundrum
- Transactions settling recent weeks since the onset of the pandemic most likely contracted beforehand and just settling
- The DCF approach will be the primary and most useful valuation approach to deal with the changed nature of rental cash flows
- It is a given that the COVID 19 economy plus the Code, may have a sudden and profound impact on rental cash flows (for particular tenants)
- This will in turn impact the underlying value of the asset predicated on based on pre COVID 19 cash flows
- At the date of writing approximately 850,000 Australian businesses had registered for the JobKeeper support thus entitling them to apply for rent relief under the Code



Classifying Tenants has become a necessity

Immediately necessary to classify tenants based on:

1. The nature of their business
2. Government OR non-government
3. > OR < \$50m Turnover threshold
4. SME Jobseeker eligibility
5. If Non-Government and outside threshold of JobKeeper eligibility – likelihood of seeking rental relief anyway?
6. Outside JobKeeper for now but may slide into it
7. SME tenants who have suffered significant losses in turnover and therefore meet the JobKeeper thresholds immediately

- Obviously, certain classes of tenant's businesses will fall into the above classifications more so than others
- Tenants will need to be classified based on likelihood of cash flow impact
- May become necessary to risk rate likelihood of tenant rental default
- Cash flow adjustments need to be compared to pre COVID 19 economy cash flows

Dealing with the cash flow Impacts of the Commonwealth's Code in DCF Valuation (Income Approach)



Adjustment duration **not only the period of the COVID 19 pandemic** but also an **undefined period of recovery according to the Commonwealth's Code.**

The key cash flow impacting principles once they are negotiated and known include:

1. Establish whether or not each tenant will seek relief under the Code
2. Reductions in rent in alignment with reductions in SME tenant turnover
3. Rental waivers (amount and duration)
4. Rental deferment amortisation (amount, waiver repayment commencement date and duration – 24 months to remaining lease term)
5. Pass through of statutory charge reductions to tenants (NB net versus semi-gross versus gross lease considerations)
6. Freeze on the rent increases during the COVID 19 pandemic period and any recovery period (Impact of no rental growth for this period)
7. Waiver of recovery of outgoings where tenant is significantly impacted

Dealing with Unexpended Lease Incentives (Income Approach)

- Code is silent on dealing lease incentives
- Forward cash flow implications of lease incentives will need to be carefully considered
- Most valuers apply a capital deduction in their capitalisation methodologies for the present value (at the valuation date) of the unexpended proportion of incentives in the form of rental abatements and rent free periods on a tenant by tenant basis
- A similar logic to calculation of the present value of the Commonwealth Code SME rental adjustments will need to be adopted to adjust for the impact of term-based cash flow reductions (i.e. as a capital deduction) where pre COVID 19 cash flows are capitalised



Landlord or Tenant Questionnaire

COVID-19 Australian Commercial Leasing Code Landlord and Tenant Questions

On 7 April 2020, the Commonwealth Government announced a Code of Conduct on Commercial Leasing Principles during COVID-19. In order to undertake our valuation, it has become necessary for us to understand how, if at all, your lease rental and outgoings will be affected if the Code's principles apply to you as tenant.

The Code applies to SME's that have a turnover less than \$50million per annum and who are eligible for the Commonwealth's JobKeeper support (i.e. they have suffered a turnover loss of 30% or more as a result of the economic impact of the COVID 19 Pandemic).

It would be appreciated if you could answer the following key questions to assist us in preparing our valuation of the property.

Information Required

1. Do you have a turnover of less than \$50 million?
2. Do you or does the tenant qualify for the Commonwealth's JobKeeper support?
3. If your answer to 2. above is yes what has been your reduction in business turnover (%)?
4. What date did you qualify for JobKeeper?
5. If you haven't yet applied for JobKeeper payment, do you intend to do so in the future?
6. Have you begun to receive Job Keeper payments from the Commonwealth Government?
7. What is your Current Net Rental Per Annum?
8. How much outgoings do you pay per annum in addition to net rental?

The Necessary Time Value of Money Maths

(Waiver and Deferral)

Waiver

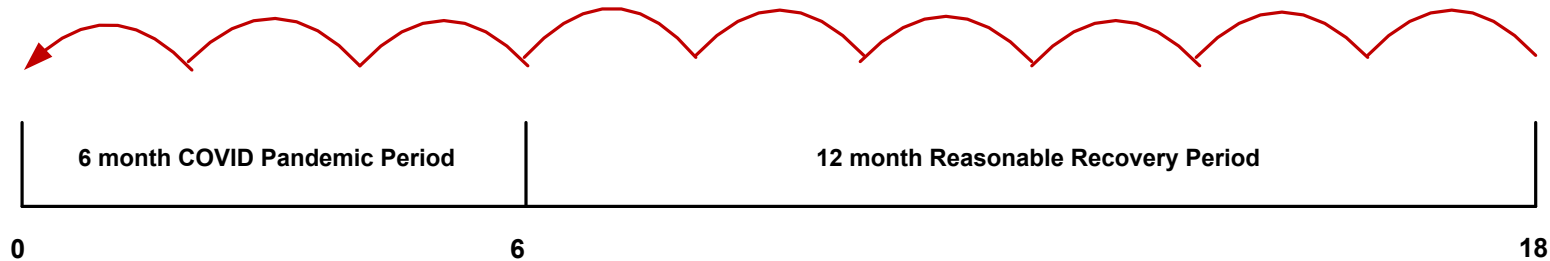
- Amount \$
- Commencing Date
- Duration
- Expiry Date

Deferral

- Amount \$
- Commencing Date
- Duration
- Expiry Date
- Unsecured Loan or Deferred rental payment (arrears) under lease – may depend on remaining lease term?



Waiver Component



Present Value (PV) of waiver amount to valuation date

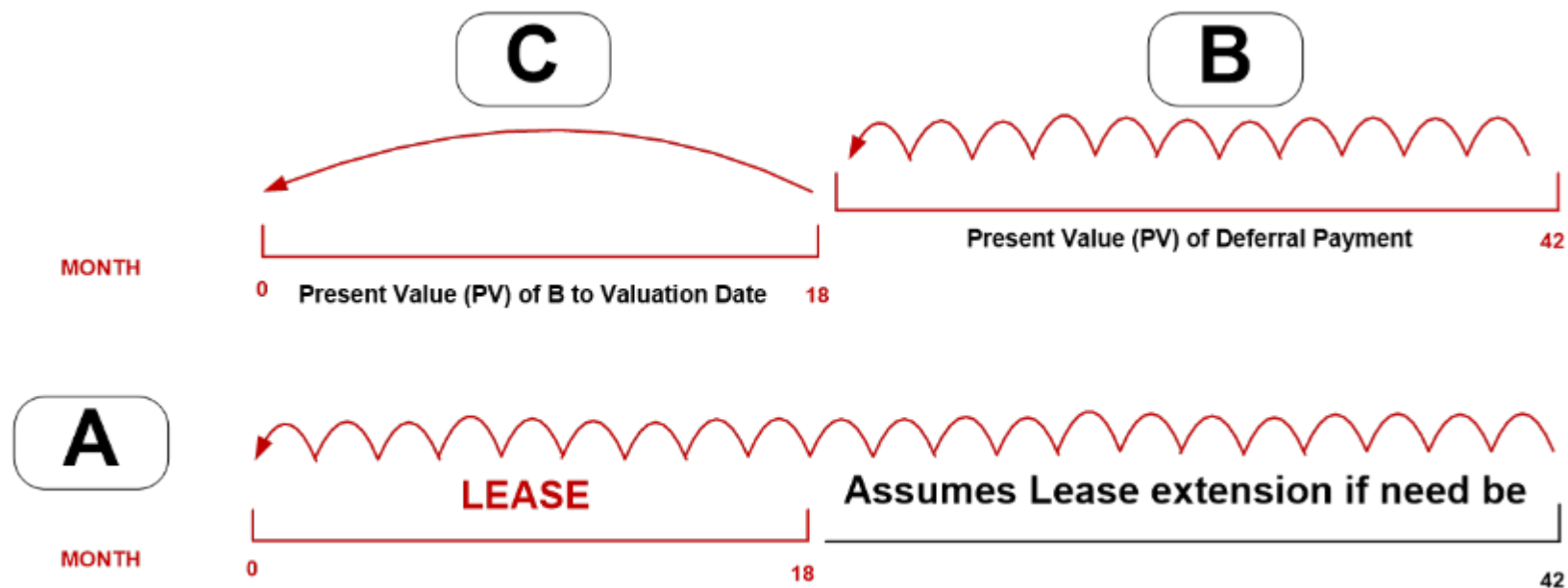
Assume

1. Capitalise Lease Contract Rents in first instance;
2. 6 Months COVID Pandemic Period;
3. Plus 12 month Reasonable Recovery Period

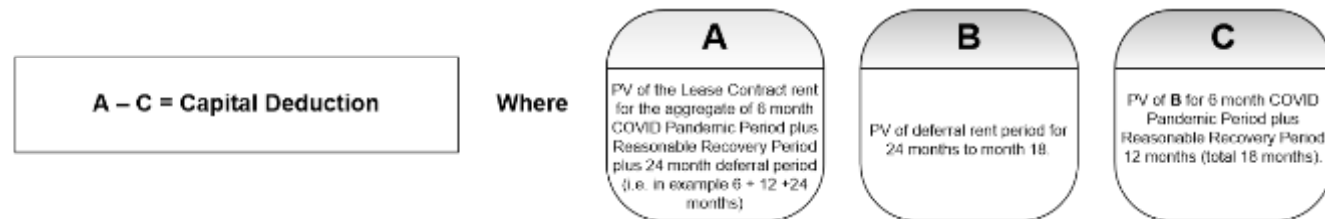
Calculate

1. Present Value of foregone rental income at capitalisation rate as a capital deduction

Deferral Component



Present Value (PV) of Lease Contract Cash Flows



Assume

1. Capitalise Lease Contract Rents in first instance;
2. 6 Months COVID Pandemic Period;
3. Plus 12 month Reasonable Recovery Period;
4. Assume 24 month deferral Amortisation;
5. Assume Lease extension if need be to cover 6 + 12 + 24 months

DCF Impact - Example

Example Assumptions

- 6-month COVID 19 Pandemic period
- 12 month recovery period
- 24 month deferral amortisation interest free
- Total Waiver & Deferral Period 42 Months
- Lease extended to 42 plus months
- Tenant honors lease and no default
- \$100,000 PA lease rent
- 30% JobKeeper Turnover reduction
- No double dip of cash flow adjustment and

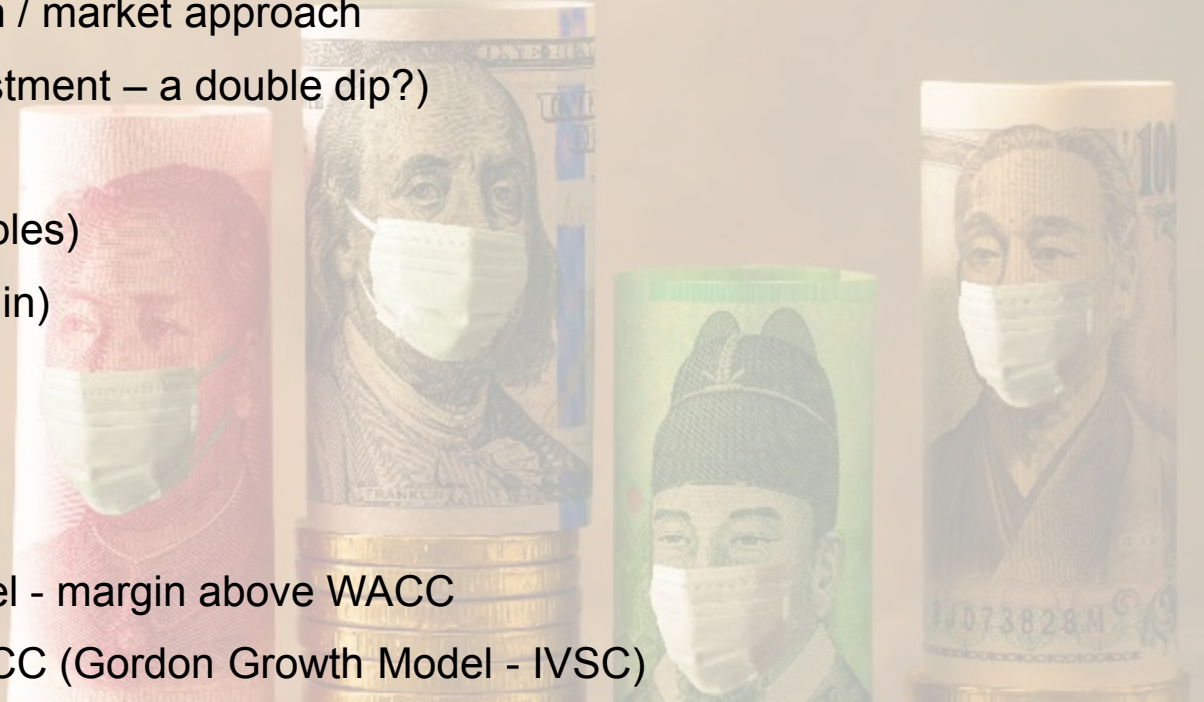
Cap Rate/ Discount Rate adjustment

Reduction approximately 1.54%

EXAMPLE ONLY						
NB Assumed COVID 19 Pandemic Period - 6 Months						
NB Assumed Reasonable Recovery Period - 12 Months						
NB Assumed Rental Deferral Component Period 24 months						
TENANT AND LEASE PARTICULARS	PRE COVID 19 CASH FLOW	POST COVID 19 ECONOMY CODE ADJUSTED				ADJUSTED CASH FLOW
	Lease Rental Cash Flow	Lease Cash Flow No Growth COVID 19 Pandemic and Reasonable Recovery period)	Waiver	Deferral		Adjusted Cash Flow
Tenant	Smith					
Area M2	200.00					
Annual Rental	\$100,000					
Monthly Rent	\$8,333					
Rental PM2 PA	\$500					
Fixed Rental Growth	3.50%					
Turnover Reduction			30%			
Total Rent Relief to Waiver and Deferral PA			\$30,000			
Waiver Percentage (50%)			50%			
Waiver Amount PA			\$15,000			
Waiver Amount PCM			\$1,250			
Deferral Percentage (%)				50%		
Deferral Amount PA				\$15,000		
Deferral Amount PCM				\$1,250		
Month No	Month					
1	01-May-20	\$8,333	\$8,333	-\$1,250	-\$1,250	\$5,833
2	01-Jun-20	\$8,333	\$8,333	-\$1,250	-\$1,250	\$5,833
3	01-Jul-20	\$8,333	\$8,333	-\$1,250	-\$1,250	\$5,833
4	01-Aug-20	\$8,333	\$8,333	-\$1,250	-\$1,250	\$5,833
5	01-Sep-20	\$8,333	\$8,333	-\$1,250	-\$1,250	\$5,833
6	01-Oct-20	\$8,333	\$8,333	-\$1,250	-\$1,250	\$5,833
7	01-Nov-20	\$8,333	\$8,333	-\$1,250	-\$1,250	\$5,833
8	01-Dec-20	\$8,333	\$8,333	-\$1,250	-\$1,250	\$5,833
9	01-Jan-21	\$8,333	\$8,333	-\$1,250	-\$1,250	\$5,833
10	01-Feb-21	\$8,333	\$8,333	-\$1,250	-\$1,250	\$5,833
11	01-Mar-21	\$8,333	\$8,333	-\$1,250	-\$1,250	\$5,833
12	01-Apr-21	\$8,333	\$8,333	-\$1,250	-\$1,250	\$5,833
13	01-May-21	\$8,625.0	\$8,333	-\$1,250	-\$1,250	\$5,833
14	01-Jun-21	\$8,625	\$8,333	-\$1,250	-\$1,250	\$5,833
15	01-Jul-21	\$8,625	\$8,333	-\$1,250	-\$1,250	\$5,833
16	01-Aug-21	\$8,625	\$8,333	-\$1,250	-\$1,250	\$5,833
17	01-Sep-21	\$8,625	\$8,333	-\$1,250	-\$1,250	\$5,833
18	01-Oct-21	\$8,625	\$8,333	-\$1,250	-\$1,250	\$5,833
19	01-Nov-21	\$8,625	\$8,333	\$0	\$0	\$9,38
20	01-Dec-21	\$8,625	\$8,333	\$0	\$0	\$9,38
21	01-Jan-22	\$8,625	\$8,333	\$0	\$0	\$9,38
22	01-Feb-22	\$8,625	\$8,333	\$0	\$0	\$9,38
23	01-Mar-22	\$8,625	\$8,333	\$0	\$0	\$9,38
24	01-Apr-22	\$8,625	\$8,333	\$0	\$0	\$9,38
25	01-May-22	\$8,926.9	\$8,625.0	\$0	\$0	\$9,563
26	01-Jun-22	\$8,927	\$8,625	\$0	\$0	\$9,563
27	01-Jul-22	\$8,927	\$8,625	\$0	\$0	\$9,563
28	01-Aug-22	\$8,927	\$8,625	\$0	\$0	\$9,563
29	01-Sep-22	\$8,927	\$8,625	\$0	\$0	\$9,563
30	01-Oct-22	\$8,927	\$8,625	\$0	\$0	\$9,563
31	01-Nov-22	\$8,927	\$8,625	\$0	\$0	\$9,563
32	01-Dec-22	\$8,927	\$8,625	\$0	\$0	\$9,563
33	01-Jan-23	\$8,927	\$8,625	\$0	\$0	\$9,563
34	01-Feb-23	\$8,927	\$8,625	\$0	\$0	\$9,563
35	01-Mar-23	\$8,927	\$8,625	\$0	\$0	\$9,563
36	01-Apr-23	\$8,927	\$8,625	\$0	\$0	\$9,563
37	01-May-23	\$9,239.3	\$8,926.9	\$0	\$0	\$9,864
38	01-Jun-23	\$9,239	\$8,927	\$0	\$0	\$9,864
39	01-Jul-23	\$9,239	\$8,927	\$0	\$0	\$9,864
40	01-Aug-23	\$9,239	\$8,927	\$0	\$0	\$9,864
41	01-Sep-23	\$9,239	\$8,927	\$0	\$0	\$9,864
42	01-Oct-23	\$9,239	\$8,927	\$0	\$0	\$9,864
Sum		\$366,058	\$357,061	-\$22,500	-\$22,500	\$22,500
Less Rental Growth			\$8,997			
Terminal Value @ Terminal Yield		5.00%				\$31,497
Terminal Value		\$2,217,436				\$2,217,436
Discount Rate PA		7.50%				
Discount Rate PCM		0.01				
NPV		\$2,043,186				\$2,011,784
Percentage Change						-1.54%

Discount & Cap Rate Justification in the COVID 19 Economy

- Surrogate path to real estate discount rates and cap rates absent sales
- Lack of COVID 19 economy sales for direct comparison / market approach
- Avoid the double dip (cash flow plus discount rate adjustment – a double dip?)
- Be mindful of the classification of tenants
- WACC as the entity's discount rate (NB Spencer Principles)
- Cost of equity (CAPM) and Cost of debt (BBSW + margin)
- Risk free rate a key ingredient to CAPM
- Lower rate environment (BBSW) and debt margins
- Debt /Equity Ratios in the capital stack
- Capital allocation to acquire ... total return @ asset level - margin above WACC
- Interpolation of cap rates from margin above entity WACC (Gordon Growth Model - IVSC)



But for (or before & after) COVID 19 Economy Value Less Adjustments

- A but for COVID 19 Economy valuation will be important - pre COVID 19 cash flows
- Important until sale and lease transactions become available post the onset of the COVID 19 pandemic – then may fall away
- AASB Accounting Standards and IVSC Valuation Standards require valuers to corroborate/substantiate inputs to valuations
- It will also be incumbent upon investment real estate owners and managers to make available details of any negotiated outcomes with tenants
- Bankers, Regulators and Auditors will have a heightened requirement to see investment real estate valuations corroborated and validated
- Careful cash flow consideration until rent relief details are known
- Code cash flow adjustments (and any agreed adjustments) will impair cash flows for an uncertain period, relative to lease contract cash flows

FIRB Changes

- FIRB threshold changes 29 March 2020 - may impact capital flows into investment real estate.
- Reducing to \$0 the monetary screening thresholds the Foreign Acquisitions and Takeovers Act 1975 (the Act).
- Australian Government oversight over all proposed foreign investment during this time.
- Timeframes for review will also be extended (30 days extended to up to 6 months).
- Not an investment freeze. Australia is open for business and recognises investment at this time can be beneficial
- All proposed foreign investments into Australia subject to the Act will require approval, regardless of value or the nature of the foreign investor.
- The extent to which these changes impact capital flows into investment real estate and therefore impact the markets will only be known in the fullness of time.
- At best there is likely to be a time lag in certain FIRB approval matters.

The Main Take Outs

- Intent to start a robust discussion to develop uniform approaches
- Underscore the need for valuers to be able to corroborate and substantiate opinions as to rental forecasts, discount rates and capitalisation rates and ultimately values
- Draw attention to the provisions of the valuation and accounting standards that consider the valuation of assets and the recording of those asset valuations in entities' accounts in these economic times
- Press for a But for COVID 19 economy valuation and a COVID 19 Economy valuation to explain adopted cash flows, cap rates and discount rates until sales are available
- Keep the Standards, Statutes, Regulation and stimulus pronouncements at hand

Sources

References

- My paper on Investment Valuation Uncertainty dated 16-4-2020
- AASB 13 - Fair Value Measurement
- AASB116 - Property, Plant and Equipment
- AASB 140 - Investment Property
- IVSC January 2020
- IVSC Letter on Valuation Uncertainty March 2020
- Prime Minister Scott Morrison – National Cabinet Mandatory Code of Conduct - SME Commercial Leasing Principles During COVID-19 - 7 April 2020
- Federal Treasurer's FIRB Announcement 29 March 2020
- State and Territories Statutes and Regulations enacting the Code principles

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