JANUARY 2022

REAL ESTATE VALUATIONS - SYSTEMS, SKILLS AND TECHNOLOGY

WHO, WHEN, AND HOW?

Valuations are an integral part of a real estate investment manager's function, informing them as to whether an investment is on track according to the proposed business plan and whether it will generate the anticipated returns upon sale. However, valuations are not merely the result of numbers in an Excel model with much thought required as to who should decide what an asset is worth, who should have what input on the valuations process, as well as what factors should inform an asset's value.

With the aim of sharing best practice regarding valuations, our group of Global CFOs and COOs from prominent real estate investment managers met to discuss this topic. We discussed who should be responsible for carrying out the valuations process, the skillset and location of personnel involved.

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To kick off our session, we discussed the approaches of different funds to making valuations. Although the GIPS Valuations Principles often serve as a basis for achieving comparability across investment management firms, their approaches differ in terms of how frequently valuations are carried out and who presents to valuations committees.

Most of our panel conduct their valuations quarterly, with one CFO explaining that their model is decentralised in a way that they leverage the expertise of the various asset platforms such as commercial real estate, residential credit and operating companies. There were some variations, with one of the US private equity funds doing valuations for certain products on a monthly basis.

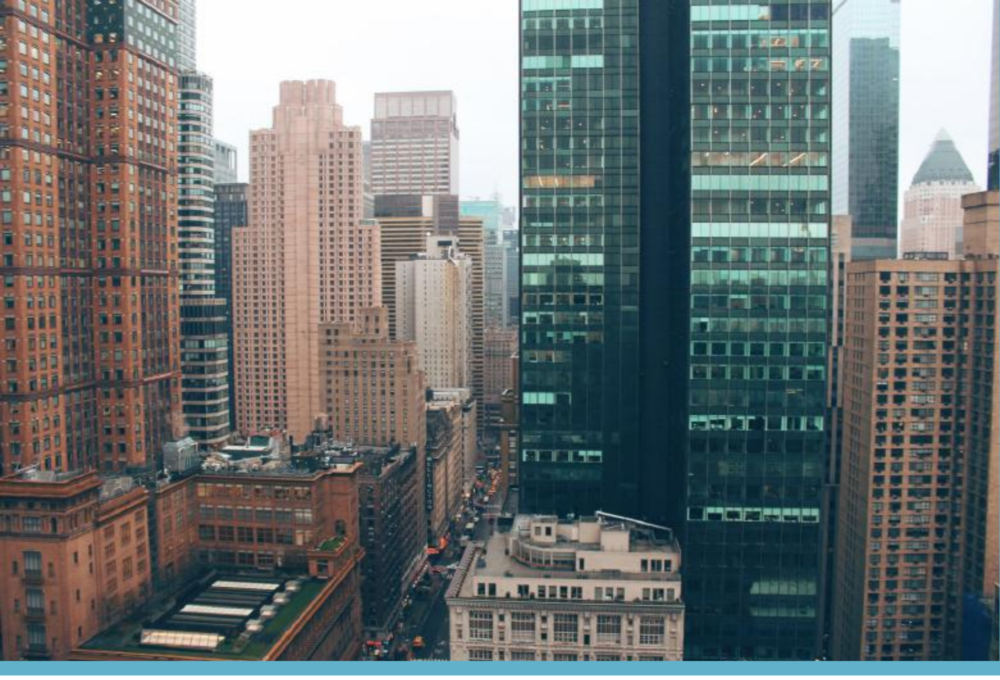
We also discussed daily valuations. Of course, it’s not necessary to run a DCF every day but one fund is currently tackling this topic, considering whether to divide the difference in valuation by 90 to calculate a daily valuation from a quarterly figure.

Once the models have been run and a valuation achieved, the task of presenting these to a valuations committee arises. The make-up and process of these committees varies from fund to fund. At one investment manager, the finance team completes an overview of the macrotrends with the portfolio managers then presents the valuations to the committee – this part was relatively standardised across the funds. However, one participant explained that valuations are an embedded function within each of the regions and platforms, with specialists running scenarios and asset managers sitting next to these people, giving updates on assumptions. The make-up of the committee is largely dependent on structure, though the CFO/COO, platform head, and Head of Portfolio Management are typically the main people featured on these committees.

BUILDING THE VALUATIONS PROCESS OF THE FUTURE

Valuations are an essential part of an asset manager's job description. However, one participant commented that 'the creation and submission of models is still part of their responsibilities and it's weighing heavily on their job satisfaction', a sentiment echoed by the rest of our group. Often, asset managers spend too long on model creation and manipulating figures. It is a time intensive process and not naturally a strength, which diverts them from being out in the market, talking to advisors, buyers and sellers to inform assumptions.

Asset managers therefore tend to have to wear two hats: being commercially savvy and engaging with market contacts, whilst simultaneously being able to translate this into financial and technical tasks, in which most haven't been deeply trained nor do they generally have the interest or aptitude. Recruiting, motivating, and retaining asset managers who are best suited to these roles has proven tricky. It appears that separation of duties can be a solution once serious scale has been achieved. One of the panel explained that they have moved the ownership of their valuations function to the Indian subcontinent; the individuals here are by no means real estate experts but have heavy duty Argus skills and are able to run models and analyse trends. This saves asset managers from wallowing in Excel spreadsheets by allocating tasks to data specialists whose primary task is keep models up to date with any new assumptions. Another investment manager is replicating this in a similar way, albeit keeping the modellers closer to their North American headquarters.



REGIONALISED VERUS CENTRALISED MODEL

For larger, global asset managers, another point of contention is whether to concentrate valuations in a centralised location such as New York, London or wherever else the business might be headquartered, or whether to split these up by region.

Our panel generally felt that there were merits to both and that a combination was usually required. Often, the balance of a regionalised versus centralised model is linked to the size and structure of the company. For one real estate specific manager with portfolios and offices across the globe, there are certainly benefits to splitting into regions due to differing time zones. For another, having a centralised hub that the regions feed into is a better set-up.

Another CFO outlined how their process is an eclectic mix of regionalised and centralised as well as automated and manual. Here, a standard template is used in which everyone provides their valuations, which are then fed through automated checks prior to final review. This keeps valuations streamlined and has been working well since automated checks were implemented around two years ago. However, to prevent it from becoming too centralised, where a region (such as Europe), becomes of a certain size, the structure is replicated at a regional level to allow scalability of this model.

The group also agreed that new technology, such as artificial intelligence and predictive analytics, should be leveraged when it comes to standardising valuations across regions or allowing for differences as the case may be. Nevertheless, whilst this may work well for core assets where there is a higher level of predictability about the return an asset will generate, this automation might not work as well with value add and opportunistic assets where it is more challenging to rely on general assumptions in the valuations model.

TO INSOURCE OR OUTSOURCE?

Another common question for CFOs and COOs is when and whether to leverage third party providers. The consensus among our panel was that third party appraisers need only be involved when it comes to open end funds given that investors are coming in and getting out at net asset value. For closed-end funds, the market standard still appears to be to keep valuations in-house.

One of our panellists described how third-party appraisers can be somewhat prescriptive and not consider exceptional circumstances when making valuations, such as the COVID-19 pandemic. As a result of this rigidity there have been bizarre situations, whereby investment managers have asked third party advisors to decrease values and they have been unwilling to do so. Another described their experience of working with third parties as more collaborative, with the third party completing quarterly appraisals, sending draft valuations for the sign off and then reaching an agreement with the investment manager regarding what the valuations should be.

When working with third party appraisers, it is important to have an established process in place so that the manager knows when to expect valuations. For example, for Q4, data must be sent to the appraisers on 1st October, draft valuations must be received by the end of October, and final valuations two weeks before the end of the quarter. This keeps things standardised and allows for a collaborative relationship with the provider.

ESG: FACTORING CARBON EMISSIONS INTO THE VALUATIONS PROCESS

Along with the rest of the real estate industry, ESG topics are also weighing heavily on the minds of our CFOs and COOs, in particular how to capture the impact of carbon emissions in the valuations model. One participant described it as 'a whole new iceberg we need to start thinking about'.

Some businesses have reacted to this by launching company-wide projects to capture the impact of achieving net zero into the valuations model. Naturally, this has a cost given the need to measure carbon emissions across each of the company's assets. It is a time intensive process that often requires the assistance of third-party advisors. However, our panel agreed that factoring ESG into the valuations model will inevitably become essential as socially conscious investors shy away from high carbon buildings or those with a negative social impact. This impacts the liquidity of the product and therefore also the building's valuation. Europe is ahead of the curve compared to the US in this regard.

Concluding our discussion, one participant explained how the impact of ESG on valuations does not just apply to carbon, but also other forms of energy, as well as the social impact, many of which have associated costs that affect the capitalisation rate. As a result, 'all of us are going to have get really smart on it, really quickly.'

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The topic of valuations weighs heavily on the mind of senior figures within the industry. Evolving considerations such as ESG and new technology challenges the status quo of how these are carried out. It was clear from our discussions that the valuations process varies from business to business. However, there are some general trends when it comes to frequency, what to outsource to third parties, and the need for data literate asset managers, or at least data specialists sat alongside asset managers.

This was the second in a series of Bohill Partners CFO/COO roundtables, where we gather a small group of leaders from the global real estate investment management industry to identify common issues and discuss opportunities to benefit the sector.

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