Fair Value for Real Estate

Measuring fair value of real estate investments in an inactive market.

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CURRENT MARKET conditions have paralyzed the capital markets upon which owners and investors of commercial real estate have long depended. This monumental impasse has created illiquidity and large price differentials between what a willing buyer and seller might normally accept for real estate investments. Since the second quarter of 2008, real estate values have been on a path of steady descent. Significantly reduced transaction volume and lack of relevant and reliable market information is creating challenges for companies, investors, appraisers, and others with respect to assessing or determining the fair value of real estate investments. The annual transaction volume decline for the primary property types ranges from approximately 60 percent for industrial properties to nearly 90 percent for hotel properties from the second quarter of 2008 to the second quarter of 2009 (Table I). These figures demonstrate the drastic reduction in activity within the market across all property types. Similarly, property returns have been severely affected. Annualized long-term historical returns (from 1978 through second quarter 2009) for commercial real estate are just above 9 percent, across all property types. The average national percentage return from the second quarter of 2008 to second quarter of 2009 is -19.56 percent. These decreases are largely attributable to negative returns posted during the fourth quarter of 2008 and the first two quarters of 2009 (Table II).

Table I: US transaction volume ($ millions)

Property Type	2Q 2008	2Q 2009	% Change
Office	16,759	2,348	-86.0%
Industrial	5,393	2,291	-57.5%
Retail	5,632	1,626	-71.1%
Hotel	3,533	473	-86.6%
Apartment	10,078	3,029	-69.9%

Source: Real Capital Analytics

One of the factors that has contributed to the decline in activity in the real estate market is the differing perspectives regarding transaction price between buyers and sellers (the bid-ask spread). Although the pool of potential buyers has become dramatically smaller due to tightened credit markets and the desire to preserve cash, there are some investors seeking bargains on real estate assets. However, due to uncertainty in the current market and the widening of the bid-ask spread, if a property owner has the financial ability to hold a property until the market recovers, the owner will not be willing to significantly discount the price. This has led to an increase in market exposure time for listed properties and has contributed to decreases in transaction volume.

Table III shows a comparison of the percentage of asking price achieved by sellers in the third quarter of 2007 in an active market versus the second quarter of 2009. It is important to note that the data in

Table II: Percent returns (including income and value changes)

Property Type	2Q 2008 to 2Q 2009	1Q 2009	2Q 2009	Annual Since Inception
Office	-22.19%	-7.97%	-6.52%	8.38%
Industrial	-19.20%	-7.50%	-5.09%	9.46%
Retail	-12.89%	-4.31%	-3.03%	9.54%
Hotel	-22.99%	-8.55%	-5.46%	8.94%
Apartment	-20.93%	-8.70%	-5.13%	8.48%
National	-19.56%	-7.33%	-5.20%	9.10%

Source: NCREIF

Table III: Percentage of ask price achieved by property type

Property Type	3Q 2007	2Q 2009
Office	94.00%	90.32%
Industrial	94.00%	87.08%
Retail	94.00%	89.70%
Hotel	95.00%	N/A
Apartment	95.00%	89.30%
National	95.00%	89.15%

Source: Real Capital Analytics

Table III is calculated off of the final asking price at the time of the accepted bid and does not incorporate reductions in the original asking price. Accordingly, the actual percentage of ask price achieved may be much lower than what is represented in these figures. Nonetheless, this data provides evidence of an increase in the bid-ask spread.

ADDITIONAL GUIDANCE

In an effort to provide additional clarity and guidance to preparers of financial statements when measuring fair value, in April 2009 the FASB (Financial Accounting Standards Board) issued a Staff Position entitled *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly.* This new guidance addresses estimating the fair value of an asset or liability (financial or nonfinancial) when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not "orderly." Even in circumstances where there has been a significant decrease in the volume and level of activity, and regardless of the valuation technique used, the objective of a fair value measurement remains the same. The FASB re-emphasizes that fair value is an exit price in an orderly transaction between market participants at the measurement date under current market conditions. This measurement is intended to be market-based and not an entity-specific or hypothetical future market-based measurement.

If an entity concludes there has been a significant decrease in the volume and level of activity in relation to normal market activity, transactions or quoted prices may not be determinative of fair value. An entity should also evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence. An entity cannot assume that the observable transaction price is not orderly simply because the volume and level of activity have significantly declined. Further analysis is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value.

The FASB does not prescribe a methodology for calculating the adjustment, and indicates that significant judgment is involved. However, the FASB clarifies that, as part of this judgment, an entity may deem it necessary to change its valuation techniques. When using multiple valuation techniques, an entity needs to consider the reasonableness of the range of results provided by the valuation techniques and use the point within that range that is "most representative" of fair value under current market conditions. Entities should place more weight on observable transactions determined to be orderly and less weight on those with insufficient information to determine whether the transaction is orderly.

Entities do not have to incur undue costs and effort in determining if a transaction is orderly. Entities need to include an appropriate risk adjustment in the fair value measurement, because a market participant would demand a higher return if there is significant uncertainty in the cash flows.

MEASURING FAIR VALUE

In determining fair value, real estate as an investment class is generally classified as level three under the fair value measurement framework established by GAAP (Generally Accepted Accounting Principles). In measuring fair value of real estate, companies' management and their internal and external valuation specialists typically already apply multiple valuation approaches—cost, income and market. These approaches are generally accepted practices promulgated by the Uniform Standards of Professional Appraisal Practice (USPAP). The application of multiple approaches in the determination of fair value for real estate investments existed long before the issuance of FASB's fair value guidance. Additionally, because observable market information, when it is available, is specific to a particular asset, management and valuation specialists have historically adjusted the observable data to the specific asset subject to valuation. Therefore, preparers of financial statements have normally been required to apply subjective adjustments to assumptions and other inputs in arriving at fair value. In each case, the starting point is based on observable data.

What happens when observable data become thin and, in many cases, stale due to lack of market comparables and other observable data? Often the immediate response is that companies and specialists seek more guidance and rules from regulatory and other professional standard-setting bodies in applying the precepts of valuation literature. However, in lieu of establishing methodologies for determining fair value adjustments to existing market information, regulators and standard setters continue to require the use of professional judgment and reconfirm the original objective in the fair value measurement framework issued by the FASB in September 2006.

While the United States is heading down the road towards International Financial Reporting Standards (IFRS), the fact of the matter is that recent accounting literature on fair value measurements had been developed, as part of a convergence project, with the International Accounting Standards Board (IASB) and already encompasses these principles-based concepts, which often require the application of a significant degree of professional judgment, in the absence of detailed rules of application.

Estimating fair value in times of market inactivity creates challenges for valuation specialists, who rely heavily on market data to support underlying assumptions. When there is lack of transaction data available to analyze, it is necessary for valuation specialists to perform additional procedures to estimate fair value. This may include: performing more detailed market rent and growth rates analyses; testing against value trends; carrying out comparable sales analysis, lease-up analysis, and highest and best use analysis; conducting surveys of market participants; and additional approaches to value.

In both active and inactive markets, there is a range of fair value for every property that can be supported with market evidence. However, in periods of inactivity when there is less market evidence, there is a greater level of subjectivity, which often translates into wider fair value ranges.

Because professional judgments can vary, it is important that companies exhibit an appropriate level of transparency and clarity in describing: their valuation processes and methodologies; selection of inputs and assumptions from available market information; and judgments made surrounding that information to tailor to a company's specific real estate investment or investment portfolio. In order to provide transparency to the users of the financial statements, robust financial reporting disclosures and other management discussion and analysis will be appropriate supplements to management's fair value estimates. Users of financial statements need to clearly understand the risks and uncertainties inherent in significant valuations that valuations are based on the information available at the date the valuation was prepared, and that changes in market conditions or assumptions could affect values in the future.

LOOKING FORWARD

The timeframe for recovery in the overall commercial real estate market will not be uniform across all markets. Location and asset class will be determinants affecting recovery time. In weaker market sectors, there is typically a "flight to quality." As such, an uptick in activity may occur first among newer properties with a strong credit tenant base and longer-term leases in place that are located in primary markets with relatively stable employment. Older properties in secondary and tertiary markets may experience the longest road to recovery. While it is impossible to predict the timing and strength of any recovery, some of the factors that would signal a turn in the commercial real estate market include: credit flowing more freely; tightening of the bid-ask spread; reduction in days on market for listed properties; positive absorption of space leading to decreases in vacancy rates; reduction or stabilization in unemployment rates; stabilization of value in residential housing markets; increase in permitting activity for new construction; and uptick in transaction volume.

While many investors will continue to sit on the sidelines until the economy demonstrates clear improvement, there may be a significant amount of opportunistic capital available for investment when market conditions improve. As such, the real estate market may experience an initial spike in activity once market fundamentals begin to turn more favorable. In the meantime, it is important to remain transparent with investors and employ robust valuation practices to support fair value measurements.