International Valuation Application 2
Valuation for Lending Purposes

International Valuation Standards Committee

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1.0 Introduction

1.1 The objective of International Valuation Application 2 (IVA 2) is to offer guidance for Valuers preparing valuations for loan security, mortgages, and debentures. IVA 2 provides a framework within which Valuers can perform valuation engagements for lending institutions and others that provide financing to be secured by specific fixed assets rather than the general credit of an individual or enterprise/entity. Advice from Valuers may extend to other areas, but this Application deals only with property valuations for loan security, mortgages and debentures.

1.2 Many financing arrangements are secured by specific assets. The security taken for a loan, mortgage, or debenture in other financing arrangements may be more broadly defined. In some instances the net worth of an enterprise/entity is pledged as security without regard to specific assets. Valuers typically deal with *Market Value* when valuing specific assets to secure financing. They may on occasion deal with going concern value, liquidation value, or other types of value depending upon laws, circumstances, and the secured party's requirements, but those who supply financing are most commonly concerned with *Market Value*.

1.3 Although properties vary in location, utility, age, suitability, and other factors, valuation principles do not. It is important that Valuers consistently apply valuation principles within the scope of these Standards, performing objective evaluations that are relevant to the needs of and clearly understood by valuation users.

2.0 Scope

2.1 This Application applies to all circumstances in which Valuers are required to advise or report to lending institutions or other providers of debt capital when the objective of the valuation relates to loans, mortgages, or debentures. This Application should be viewed as an extension of IVS 1.

3.0 Definitions

3.1 *Market Value* as defined in IVS 1 remains the foundation for the Valuer's work. It is defined as:

> *Market Value is the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.*

3.2 The term *property* is used in paragraph 3.1 above because the focus of this document is the valuation of property. This use of the term *property* should aid in distinguishing valuations for lending and other types of valuation engagements from those for financial reporting, which deal with the *assets* reflected on the books of an enterprise/entity.

3.3 All *Market Value* measurement methods, techniques, and procedures will, if applicable and if appropriately and correctly applied, lead to a common expression of *Market Value* when based on market-derived criteria. *Sales comparison* or other methods of market comparison should evolve from market observations. Construction costs and depreciation should be determined by reference to an analysis of market-based estimates of costs and accumulated depreciation. The *income capitalisation approach* or *discounted cash flow analysis* (DCF) should be based on market-determined cash flows and market-derived rates of return. Although data availability and circumstances relating to the market or the property itself will determine which valuation methods are most relevant and appropriate, the outcome of using any of the foregoing procedures must be *Market Value* if each method is based on market-derived data.

3.4 The manner in which property would ordinarily trade in the (open) market distinguishes the applicability of the various approaches or procedures of estimating *Market Value*. When based upon market information, each approach is a comparative method. In each valuation situation one or more methods are generally most representative of (open) market activities. The Valuer will consider each method in every *Market Value* engagement and will determine which methods are most appropriate.

3.5 Those seeking security for financing or attempting to evaluate the status of that security will sometimes request valuations on a basis other than *Market Value*. In such circumstances the Valuer should obtain the regulatory definitions that may apply and proceed with any valuation on a basis other than *Market Value* only if that valuation is not in contradiction with applicable laws or regulations and will not otherwise be misleading. Under such circumstances, it is customary for Valuers to include a *Market Value* estimate or other appropriate information as to the extent to which a *Non-Market Value* estimate may differ from *Market Value*.

3.6 IVS 2 provides value definitions that differ from *Market Value*. Particular caution should be taken by the Valuer to avoid any situation where *Non-Market Value* estimates may be confused with *Market Value* estimates. Although there may be circumstances where *Non-Market Value* estimates are appropriate, those who use such valuations should be made aware that such values may not be, and generally are not, realisable in the market.

4.0 Relationship to Accounting Standards

4.1 Valuations performed for public financial disclosure purposes do not necessarily meet the same qualifications as those performed in connection with loan security, mortgages, or debentures. For example, the concept of *Depreciated Replacement Cost* (DRC), where used as a surrogate for a market-related value, is generally not appropriate for the valuation of property for security purposes. One of the underlining principles of valuation for financial reporting is the assumption of the continuation of the business. Accordingly, a Valuer may be required to assess the value of business assets such as property for which there is a limited market or no market. Such an assumption, however, does not attach to property upon which loans are to be secured.

5.0 Application

To perform valuations that comply with this Application and Generally Accepted Valuation Principles (GAVP), it is mandatory that Valuers adhere to all sections of the IVS Code of Conduct

pertaining to Ethics, Competence, Disclosure, and Reporting (sections 4, 5, 6, and 7).

5.1 **In performing valuations of property where the results will be used to obtain loans, mortgages, and debentures, Valuers shall normally estimate the *Market Value* of such assets in accordance with these International Valuation Standards.**

5.2 **When circumstances, regulations, and laws provide for or require departures from *Market Value,* and only in such circumstances, Valuers shall apply such other value definitions and procedures as are appropriate. This departure shall be clearly set forth and explained in the Valuation Report or Certificate, along with an identification and definition of the value type estimated and an explanation of reasons for the departure. If there is a substantial difference between the *Market Value* of the property and an alternative value-type reported, this fact should be set forth in the report or certificate and discussed with the client.**

5.3 **The basis for the Valuer's engagement shall be clearly set forth in any reports or certificates to be used by third parties, and all reporting shall be accomplished in a manner that will not be considered by reasonable people to be misleading. The valuation conclusion shall be reported in accordance with IVS 3, Valuation Reporting.**

5.4 **In certain States, standards of professional appraisal practice set forth specific requirements for property valuations associated with loans, mortgages, and debentures. Generally, compliance with their requirements produces results that are compatible with this International Valuation Application, although compliance therewith is a separate issue. Any departures should be clearly explained.**

5.5 **A large percentage of corporate and private loans from banks and other financial institutions are secured by an interest in specific property assets. To undertake valuations in such circumstances Valuers need to have a comprehensive understanding of the requirements of such institutions, and the structure of loan agreement terms and arrangements. Sometimes lenders require**

that specific terms pertaining to the particular loan be kept confidential, but this does not relieve the Valuer of the obligation to have a general understanding of the lending process.

5.6 **The Valuer should set the valuation in the context of the market and provide an assessment of risks attaching to the subject property, both for the present and in the future. Any unusual volatility in the value of the specific property or the market of comparable properties should be mentioned in the Valuation Report or Certificate.**

5.7 **Clear, objective, pertinent, and understandable reports and valuation estimates are important to all valuations for loans to be secured by property assets. Valuations for debenture purposes, where these have a public quotation, may fall within special rules. Valuers shall ascertain, understand, and comply with all special requirements pertaining to such valuations.**

5.8 **The Valuer shall make such disclosures as are appropriate to a given engagement and shall meet the Standards for reporting discussed in IVS 3, Valuation Reporting, and in section 7 below.**

6.0 Discussion

6.1 In general the requirements of valuations for loans to be secured by property assets are similar to those for other *Market Value* engagements. In particular, it is necessary to establish and report a basis for any departure from standards. As discussed below, various property types require special considerations.

6.2 *Investment Properties*

6.2.1 Revenue-producing properties are usually valued individually, but lending institutions may wish to know the value of a property as part of a portfolio of properties. In such instances, the distinction between such potentially different views should be clearly expressed.

6.2.2 Lenders are particularly interested in a Valuer's opinion as to the security of the debt service on a loan, or the ability of the property to meet interest payments and repayment of principal (where appropriate) over the term of the loan.

6.2.3 For investment properties, it is recommended that Valuers distinguish between leveraged and unleveraged overall property yields. Similarly, references to internal rates of return (IRRs) should set forth whether they are debt-leveraged or not. Any special treatment of taxes should also be explained.

6.3 *Owner-Occupied Properties*

6.3.1 Owner-occupied properties should be valued on the basis of vacant possession, i.e., land or built-up property to which rights to ownership are held but which has no current occupant, and in consideration of the property's *highest and best use*. This does not preclude consideration of the owner as part of the market, but it does require that any special advantage of the owner's occupancy, which may be reflected in a valuation of the business, be separated from the value of the property. In the event of default on the financial arrangements, security for the financing can be realised only by a change in occupancy. If the Valuer is required to produce a different basis of valuation, the valuation report or certificate should also refer to the value derived from market evidence of vacant possession sales of similar properties.

6.4 *Specialised Properties*

6.4.1 Specialised properties, which by definition have limited marketability and derive value from being part of a business (see General Valuation Concepts and Principles, para. 8.2 and IVA 1, para. 6.2 et seq.), may not be suitable as separate security for loans. If they are to be pledged for loan security individually or collectively, they should be valued on the basis of *highest and best use* assuming vacant possession, and all assumptions fully explained. The *depreciated replacement cost* (DRC) method of valuation is usually applied to specialised properties in financial reporting under IVA 1 in the absence of market data. DRC should not be confused with market methods relying solely on market data (including a market-based *cost approach*) in valuations for loan security.

6.5 *Properties Normally Valued as Trading Entities*

6.5.1 Certain classes of property, including but not limited to hotels and other leisure related businesses, are usually valued in accordance with a careful assessment of the sustainable level of income derived from accounting data or projections, excluding any special goodwill derived from an operator with above average management skills. In such cases the lender should be made aware of the significant difference in value that may exist between an operating concern and one where either

6.5.1.1 the business is closed;

6.5.1.2 the inventory is removed;

6.5.1.3 licences/certificates, franchise agreements, or permits are removed or are in jeopardy;

6.5.1.4 the property is vandalized; or there are

6.5.1.5 other circumstances that may impair future operating performance.

6.5.2 The Valuer may also extend advice to cover potential future fluctuations in the status of the property as security. For example, if the free cash flows of a property are heavily dependent upon a given tenant, tenants from a single industry, or other condition that could cause future instability, the Valuer should note these facts in the Valuation Report or Certificate. In certain cases, an assessment of the value of the property for alternative use with vacant possession may be appropriate.

6.6 *Development Properties*

6.6.1 Non-revenue producing properties held for redevelopment or as sites for development with non-specialised buildings should be valued with consideration given to existing and potential development entitlements and controls. Any assumption as to planning and other material factors must be reasonable and must be explicitly stated in the Valuation Report or Certificate.

6.6.2 The phasing and timing for funding in the lending agreement should be discussed with the lender, and periodic market valuations should be provided over the development cycle.

6.6.3 The appropriate method for valuation of development properties will depend on the state of development of the property at the effective date of valuation and the degree to which the property may be pre-sold or pre-leased. The method must be discussed and agreed upon with the lender prior to undertaking the valuation. Care should be taken by the Valuer to

6.6.3.1 take into account the time differences between the date of development completion and the effective date of valuation. The effect of additional development requirements on costs and revenues, using present value discounting where appropriate, will be reflected in this analysis;

6.6.3.2 adequately indicate anticipated market changes during the remaining period of development;

6.6.3.3 properly consider and indicate the ranges of risks associated with the development; and

6.6.3.4 consider and disclose any known special relationships between parties involved in the development.

6.7 *Wasting Assets*

6.7.1 Special problems are associated with wasting asset valuations. Particular attention needs to be drawn to the duration and profile of the loan including interest and capital repayment dates as they relate to the extent of the wasting asset and the planned program for its extraction or use.

6.7.2 A lease that exceeds market, or economic, rent and thus creates a special advantage to the lessor, may constitute a property asset associated with the real estate to which it applies. In such cases, the lease may constitute a wasting asset as any attributable value diminishes as the rents are paid and the term of the lease decreases.

6.8 *The Valuer*

6.8.1 The nature and scope of the engagement are particularly important to the Valuer and to the user of the Valuer's services. Valuers should be aware that an element of risk is associated with valuations for lending purposes where misunderstanding and/or error may lead to litigation between the lender and Valuer. For example, in the event of default by a borrower, the lender sells upon foreclosure and realises only a fraction of the estimated value.

6.8.2 In some jurisdictions legislation of financial services requires special licensing or registration when advice is related not only to the value of property, but also to securities issues such as equity, participatory interests, collective investment schemes, or syndicated loans.

6.8.3 Because of the special fiduciary circumstances involved with most loan security, mortgage, and debenture arrangements, it is particularly important that the Valuer be independent rather than related to one of the parties involved in the actual or proposed financial relationship. It is also important that the Valuer possess or be able to procure appropriate experience with the particular property type and locale for the property involved.

6.9 *Forced Sale or Limited Marketing Disposal Periods*

6.9.1 Lending institutions will sometimes ask for valuations on a forced, or liquidation, sale basis or impose their own limitations as to the time frame over which a disposal of the security is assumed to take place. It should be noted that such valuations do not meet the definition of Market Value and Valuers should comply with paragraph 3.5 of this Application.

7.0 Disclosure Requirements

7.1 Valuation reports must not be misleading. In general such reports prepared for valuations performed in accordance with IVA 2 will meet reporting requirements discussed in section 5, IVS 1, Market Value Basis of Valuation, and IVS 3, Valuation Reporting. In particular they shall contain a specific reference to the definition of *Market Value* as set forth in this IVA, together with specific reference to how the property has been viewed in terms of its utility or *highest and best use*.

7.2 Such valuations should also refer to the specific date of valuation (the date at which such estimate of value applies), the purpose and function of the valuation and such other criteria that are relevant and appropriate to ensure adequate and reasonable interpretation of the Valuer's findings, opinions, and conclusions.

7.3 Although the concept, use, and application of alternative expressions of value may be appropriate under certain circumstances, the Valuer should ensure that if such alternative values are found and reported, they are legal and appropriate, and cannot be construed as a representation of *Market Value*.

7.4 In reporting a *Market Value* estimate for loan security, mortgages, and debentures, the Valuer shall

7.4.1 completely and understandably set forth the valuation and the appraisal report in a manner that will not be misleading;

7.4.2 provide sufficient information to permit those who read and rely on the report to fully understand the data, reasoning, analyses, and conclusions underlying the Valuer's findings, opinions, and conclusions;

7.4.3 state any assumptions or limiting conditions upon which the valuation is based;

7.4.4 clearly identify and describe the property being valued;

7.4.5 identify the interest or interests being valued;

7.4.6 define the value being estimated and state the purpose of the valuation, the effective appraisal date, and the date of the report;

7.4.7 fully and completely explain the valuation bases applied and the reasons for their applications and conclusions;

7.4.8 disclose any prior or present, direct or indirect, personal or corporate relationship to the property or to the borrower that might lead to a potential conflict of interest; and

7.4.9 include a signed professional certificate of objectivity, non-bias, professional contributions, Standards' applicability, and other relevant disclosures.

8.0 Departure Provisions

8.1 **In following this Application any departures must be in accordance with directions made in IVS 3, Valuation Reporting.**

9.0 Effective Date

9.1 This International Valuation Application became effective 1 July 2000.