**Introduction** Page 01

**Key challenges and uncertainties** Page 02 - 03

**What are the questions audit & risk committees should be asking?** Page 03

# Property valuations in a volatile economy

Property valuations have reliably trended upward in the low and/or decreasing interest rate environment we've enjoyed over recent years however interest rates are now rising swiftly. We're back in a time of uncertainty as supply chains are constrained, inflation is rising and central banks are responding by increasing interest rates.

Listed equity markets typically react first to a changing rate environment (as we've seen with local ASX and global stock market performance over the past few months), transactional pricing follows, and declines in property valuations often lag until there is objective evidence that emerges from that transactional data. The uncertainly is heightened as some observers believe that the rising interest rate environment could be short lived.

In this environment and until transactional experience paints a clearer picture of what properties are worth, the art of property valuation comes to the fore.

In times of uncertainty, it is even more important to make sure that the financial report provides clear disclosures relating to significant judgements and critical estimates made by the entity. Properly documenting these assumptions and positions taken can also assist in protecting both management and directors in times of volatility.

Directors have a crucial role to play in understanding and challenging valuation positions and these responsibilities are put under the microscope in a potentially turning market.

# Key challenges and uncertainties

## Background

An upward trend in interest rate environment typically has an inverse relationship to asset values. After the Australian cash rate remained at record lows for much of the COVID-19 pandemic, the Reserve Bank of Australia (RBA) increased this rate by 75 basis points during the first half of 2022, with another 50 basis point increase in both July and August with every indication that further rate increases will occur.

The valuation equation is not that simple however, as other systemic and property specific dynamics have major impacts. We are in a very different environment to similar turning points in the past as there is plenty of capital in the market and pressures to realise asset values, particularly for institutional asset owners, are not as strong. Accordingly, there has been a slowing of transactional activity in many parts of the market and this means the transactional evidence that generally drives valuation movements has been occurring in lower volumes.

However, to the extent that current conditions begin to manifest into longer term changes to the overall level of economic activity or even recessionary environments, these would begin to impact on property values over the medium to long term.

## Key asset classes

Different asset classes will be impacted in different ways. Those that benefit positively from changing societal and economic factors, such as logistics, are likely to remain in demand however these asset classes have been trading at historically low yields.

**The impact of these economic events on various property classes differs significantly:**

**Industrial** – there has been substantial cap rate compression in recent years and vacancy rates have allowed landlords to increase rents which may somewhat shield many industrial assets from inflation.

**Retail** – supply chain disruptions and labour shortages have significantly affected the operations of retail tenants and rising inflation will likely put pressure on household spending. The issues already facing the retail sector and the substitution of physical stores with online fulfilment are being compounded. That said, thinking about all retail as being the same is also inappropriate. Footfall at destination assets is improving and non-discretionary spend focused assets have proven to be resilient.

**Office** – hybrid working is leading tenants to re-evaluate their long-term office space needs (e.g., less individual workspaces replaced with more meeting rooms or collaborative layouts) and will require innovative strategies from landlords to generate new revenue streams in a sector that is in a state of flux. As tenants reconsider their space requirements, the climate impact of buildings is also a consideration as the drive towards carbon neutral and 'green' buildings gathers momentum.

**Hotel and leisure assets** – despite international travel beginning to recover after the pandemic, Australia is some way behind many other parts of the world in part due to its initial approach to combating the pandemic and geographic positioning. Occupancy levels are expected to take a significant time to fully recover as costs to travel remain high with high global oil prices and as the situation in Russia/Ukraine continues. Further, ongoing COVID restrictions and vaccination requirements in some countries continue to impact travel demand in certain jurisdictions.

**Construction and development assets** – these asset classes have experienced significant headwinds recently as they are exposed to the construction cost increases and labour shortages Australia is currently experiencing. As profitability on these contracts decrease, so do the values of these development sites, as valuations are flexed up and down depending on the projected profit. Furthermore, timing impacts resulting from construction delays have driven down values in situations where working capital gets locked up in a delayed project, risking sending the project into liquidation.

**Other property classes** – real estate investments in the hospitality, gaming, residential and transportation industries, such as casinos, parking garages, etc., are seeing a range of impacts based on how they are impacted by macroeconomics, changing consumer demand and asset specific factors on their underlying real estate forecasts and valuations.

Importantly, not all economic impacts necessarily involve evaluating downside risk. Sub-sectors including industrial assets such as warehouses and logistics may see increased medium and long-term demand, as businesses adjust their operations to a post COVID-19 world. However, consideration should also be given to the impact of supply chain disruptions, inflationary pressures and rising interest rates on this sub-sector, which could well counteract and depress any upside potential that may exist.

## Asset specific factors

Like the varying impacts on asset classes, individual assets within asset classes are impacted in very different ways. It's expected that quality, A grade assets that appeal to institutional investors will likely to continue to perform well however there may be downside risk for assets in secondary locations or that require significant capital spend. Location will also be a major factor and we are already seeing asset owners focus on how management teams and their service providers look to take advantage of the market dynamics. There are upside factors for some assets also as some leases include CPI linked clauses which will drive rent up for certain assets.

## Financial reporting considerations

Under Australian Accounting Standards, real estate entities may elect to hold investment properties at 'fair value' as defined by AASB 13: *Fair Value Measurement*. Fair value is based on the asset being used for its highest and best use to maximise its value. When applying AASB 13, three valuation techniques need to be considered:

- **The market approach** – based on direct comparison using prices generated by market transactions
- **The cost approach** –market approach for land plus current depreciated replacement cost for buildings and site improvements
- **The income approach** – capatilisation of maintainable income adjusted for capital items or Discounted Cash Flow based on the present value of future cashflows from the asset

In their focus areas media release for 30 June 2022 financial reports, ASIC specifically referred to several factors that may adversely impact property values, such as rising interest rates, expected changes in office space requirements of tenants with flexible working arrangements, shifts towards on-line shopping, future economic or industry impacts of tenants, financial condition of tenants and restructured lease agreements. ASIC also highlighted that commercial property would be an industry likely to be particularly impacted by current economic conditions.

As was the case during the start of the pandemic in 2020, third party property valuations have once again increasingly included caveats to draw attention to the reduced reliability of observable market data in the current environment. These valuations typically draw upon historical pricing benchmarks and in the current environment consideration needs to be given to whether those pricing benchmarks are still relevant or require adjustment.

In summary, general economic and market sentiment is something that is difficult to quantify but is generally a lead indicator of changing market conditions and is often an early indicator of a market transitioning from a growth phase to a contractionary phase or vice versa. There  are some signs of a change in sentiment occurring at the moment as we enter a new phase with higher interest rates, concerns around inflation and overall supply challenges. There are a range of different factors playing out at the moment that mean many assets may prove to be resilient however. When the market enters a transitionary phase, there is typically a lag in transactional evidence and anecdotal evidence may be the only indicator of changing market conditions. The need for professional and well instructed independent valuations will become increasingly important during market periods where direct market evidence is less abundant and experience and judgement by the valuer will be increasingly important and governance from the board is equally important. In this paper, we highlight some of the governance questions directors and senior executives should consider when determining property values.

## Questions to consider

| | |
|---|---|
| **1** | Do valuations during this reporting cycle appropriately represent what management and the board believe is the fair value of the asset? How has the company considered the changing economic environment? |
| **2** | Do governance structures such as additional valuation focused audit committee meetings or board valuation sub committees need to be considered to facilitate sufficient and robust challenge of valuation methodologies and assumptions? |
| **3** | Where valuations are performed on a cyclical basis does this need to flex to ensure sufficient coverage of the portfolio? |
| **4** | Should the valuation methodologies be reconsidered given uncertainties? |
| **5** | Do any internal models used, reflect changes in assumptions being utilised by external valuers? |
| **6** | Is market transactional evidence emerging that suggests valuation assumptions should be revisited especially where valuations are done in advance of reporting dates? |
| **7** | Where third-party fund managers are used is management comfortable with their response to managing valuation uncertainty including disclosing sensitivities? |
| **8** | Do any valuation uncertainty disclosures or caveats mean it may not be possible to rely on valuations for either financial reporting or unit pricing purposes? |
| **9** | Do financial reporting disclosures need to be enhanced to provide users with enough information to understand the valuation uncertainty? |
| **10** | If market volatility observed through market transactions accelerates through to the point of signing the financial statements, should the company disclose the impacts of those changes? |

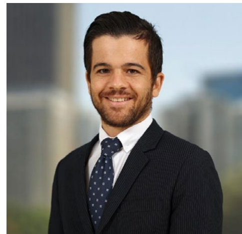
# Contacts

**David Rodgers**
**Partner**
Audit & Assurance
E: drodgers@deloitte.com.au

**Anna Crawford**
**Partner**
Audit & Assurance
E: acrawford@deloitte.com.au

**Andrew Coleman**
**Partner**
Audit & Assurance
E: acoleman@deloitte.com.au

**Cameron Chatwood**
**Partner**
Financial Advisory
E: cchatwood@deloitte.com.au



**Jonathan Streng**
**Director**
Audit & Assurance
E: jstreng@deloitte.com.au

**Alex Collinson**
**Partner**
Audit & Assurance
E: acollinson@deloitte.com.au

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited ("DTTL"), its global network of member firms or their related entities (collectively, the "Deloitte organisation") is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No representations, warranties or undertakings (express or implied) are given as to the accuracy or completeness of the information in this communication, and none of DTTL, its member firms, related entities, employees or agents shall be liable or responsible for any loss or damage whatsoever arising directly or indirectly in connection with any person relying on this communication. DTTL and each of its member firms, and their related entities, are legally separate and independent entities.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited ("DTTL"), its global network of member firms, and their related entities (collectively, the "Deloitte organisation"). DTTL (also referred to as "Deloitte Global") and each of its member firms and related entities are legally separate and independent entities, which cannot obligate or bind each other in respect of third parties. DTTL and each DTTL member firm and related entity is liable only for its own acts and omissions, and not those of each other. DTTL does not provide services to clients. Please see www.deloitte.com/about to learn more.

Deloitte is a leading global provider of audit and assurance, consulting, financial advisory, risk advisory, tax and related services. Our global network of member firms and related entities in more than 150 countries and territories (collectively, the "Deloitte organisation" serves four out of five Fortune Global 500® companies. Learn how Deloitte's approximately 312,000 people make an impact that matters at www.deloitte.com.

Deloitte Asia Pacific Limited is a company limited by guarantee and a member firm of DTTL. Members of Deloitte Asia Pacific Limited and their related entities, each of which are separate and independent legal entities, provide services from more than 100 cities across the region, including Auckland, Bangkok, Beijing, Hanoi, Hong Kong, Jakarta, Kuala Lumpur, Manila, Melbourne, Osaka, Seoul, Shanghai, Singapore, Sydney, Taipei and Tokyo.

The Australian partnership of Deloitte Touche Tohmatsu is a member of Deloitte Asia Pacific Limited and the Deloitte organisation. As one of Australia's leading professional services firms, Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, risk advisory, and financial advisory services through approximately 8000 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit our web site at https://www2.deloitte.com/au/en.html.

Liability limited by a scheme approved under Professional Standards Legislation.
Member of Deloitte Asia Pacific Limited and the Deloitte organisation.

©2022 Deloitte Touche Tohmatsu