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The influence of valuers and valuations on the workings of the commercial property investment market

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Abstract

The major aim of the research is to examine the influence that valuers and valuations have on the workings of the commercial property investment market in the UK. The research involved interviews with 30 fund managers and owners and their property advisors and finds evidence that valuations do not stand above the market, but are an integral part of it. Opportunities for client influence exist and appear to be used. Valuations primarily affect which properties are sold rather than purchased and the research has important implications for research which assumes valuations and prices are independent of one another; for example, the valuation accuracy debate. The research also reveals differences in the way that valuers amend frequently reviewed periodic valuations and also an increasing concentration in the number of valuers providing valuations for monthly indices on account of price competition in the provision of valuation services.

1. Aims and objectives of the research

Property valuations perform an essential role in property markets. They provide advice on prospective purchase and sale and supply material information to underpin the property lending decision. Since the 1960s and 1970s, property valuations have also been used to proxy the exchange price of property investments for performance measurement purposes. This latter use of valuations exacerbates existing differences between the operation of property and other investment markets where performance measurement is undertaken by reference to transactions. This, in turn, has been used by some analysts to argue against property as a portfolio asset. The under-representation of property in many portfolios, as compared to that suggested by the use of valuation-based indices, might be evidence that the industry does not accept valuations as valid indicators of prices and hence returns.

Property valuations are subject to a rigorous code of practice set out in the RICS Appraisal and Valuation Manual commonly known as the Red Book (RICS, 1995). Bases of valuation are usually grounded upon the concept of an estimation of the exchange price in the market place, a theoretically objective concept whereby, in a perfect world, all valuations of the same property at the same time would be the same[1]. One facet of the concern that valuations may not be the perfect surrogate for prices - and the basic question underlying the research described here - is the degree of independence of valuations from the market. Do and should valuations have a neutral influence on the market as they are only necessary because of the relative infrequency of transactions? They are effectively a proxy for non-existent transactions and should be viewed as providing information only. Hence the feedback relationship is one way. Valuations rely on information from the market. The concern is that this type of model does not hold. Instead, they are an integral part of the workings of the market and influence prices, liquidity and the recorded performance of the property market. By influencing the behaviour of other players in the market, valuations influence the market itself, as markets are a product of those who operate within them. Consequently there is a more complex two way feedback relationship whereby valuations influence the price formation process which, in turn, influences subsequent valuations.

The major aim of the research was therefore to identify how valuations may influence the commercial investment market. The research was undertaken in two phases.

The major objective of Phase One was to explore the use made of valuers and valuations by investors and identify specific circumstances or examples where valuers are perceived to have influence over market operation.

The major objective of Phase Two was to examine the position of valuations and the use of them from the perspective of the valuers undertaking those valuations.

1 However, there are variations between definitions according to whether valuers are estimating best or most probable price.

The research was undertaken by a combination of a review of the literature on the valuation process and behaviour and a semi-structured interview survey of over 30 representatives from property owners and fund management organisations and the valuers who provide the valuation services to them. A detailed analysis of the organisations interviewed is set out in section 4 of this paper and the results of the review of the literature form the basis for the background section which follows.

2. Background to the Study

There has been a considerable amount of research into the operation of the valuation process in various parts of the world, especially the US and the UK. Early research tended to concentrate on the methods used by valuers and there were some findings that suggested that poor technique was responsible for inaccurate pricing and that this inaccurate pricing influenced the operation of a few sub-markets. Examples in the UK include the short leasehold market in the 1970s and 1980s where the use of dual rate conventional YP applications were exploited by a small group of pension funds (Baum and Crosby, 1995).

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More recent research has concentrated on procedural aspects (bases, instructions, reporting) and the way that information is processed. Research on valuation to date has therefore included:

- the bases of valuation for the various roles and uses of valuations
- the various elements of the valuation process from instruction through to reporting of the result
- the methods used to arrive at the valuation
- the external influences on the valuer undertaking the valuations
- the accuracy of the valuations and the probable margin of error
- the use of information within the valuation process

A number of these themes provide background to the study of the influence valuations may have on the workings of the property investment market.

2.1 Valuation accuracy and variation

Previous research into the valuation process increasingly leads to the conclusion that valuation is a very imprecise activity, much less precise than valuers would have the users of valuations believe[2]. The imprecise nature of property valuation is borne out in a number of studies into valuation accuracy and variation. Whilst acknowledging the methodological limitations and problems of this type of research, these studies have led to a number of conclusions concerning the probability of a valuation being within certain parameters of a sale price (valuation accuracy) and within another valuer's valuation (valuation variation). Crosby, Lavers and Murdoch (1998) estimate that valuation variation studies suggest only a 2 in 3 chance of valuers getting within 10% of each other. Brown, Matysiak and Shepherd (1998) suggest only a 1 in 5 chance of a valuer getting within 10% of a sale price. This has implications for investors who may change their valuers, and also for quarterly valuation based series, and calls into

[2] Interestingly, the RICS Information Paper (1997) states that ñ...the valuer and most informed users of the valuation recognise that there will be a degree of uncertainty attached to the figure providedò (RICS, 1997, p.26).

question the ability of valuers to routinely come within parameters that are set for them by the courts.

Within courts, valuers have sustained the view that an acceptable margin of error or bracket is around the +/- 10% to 15% and no expert valuation witness has ever argued for a bracket of more than +/- 20%. The valuation variation evidence would suggest that 1 in 10 valuations are outside this margin. However, the research into accuracy is predicated on the assumption that valuations and prices are independent of each other. This may not be the case.

2.2 Valuation smoothing and lagging

There is a considerable body of comment and investigation of the 'smoothing' effects of the use of valuations in the measurement of property investment performance. In order to explain the low level of volatility in property returns relative to other major investment classes, researchers have focussed on the nature of the valuation process. The common assumption is that appraisers do not record all the price movement suggested by market change due to a combination of anchoring on past appraisals and a lack of confidence in most recent transaction evidence due to the potentially misleading effects of transaction 'noise'. Quan and Quigley (1991) argue that it is a rational strategy for valuers to put less than full weight to more nebulous current market-state information given a market characterised by price dispersion.

In the past, this reduced volatility of returns has been used as an argument for the acceptance of lower returns from property and optimisation techniques for the allocation of funds using the unadjusted indices tend to suggest very high weightings for property within investment portfolios. However, there is an increasing body of literature on the unsmoothing of property indices, which results in indices being adjusted to show more volatility of returns from property (Geltner, 1993; Barkham and Geltner, 1994). But recently the conventional valuation smoothing arguments have been criticised. It has been argued that a moving average process fails to explain the extent and persistence of serial correlation in valuation-based property return series. Indeed Lai and Wang (1998) demonstrate that conventional understandings of valuation smoothing can result in an overestimation of volatility for individual property return series. Alternative explanations have focussed on the effects of *combining* individual return series into an index and the effects of cross serial correlation (Brown and Matysiak, 2000).

The second related question concerns whether valuations, in addition to smoothing the variation in returns, also lag prices in both rising and falling markets. Blundell and Ward (1999) suggest that (after adjusting for a time lag between valuations and subsequent sales) that there is a 3% difference between them, with valuations falling behind prices. However, this does not necessarily suggest that valuations are always less than the true price as it may be a product of data which predominantly came from rising markets. Matysiak and Wang (1995) look at the accuracy of valuations in different market states and suggest that valuations are higher (lower) than prices when markets are falling (rising). This is consistent with studies in both the US and Australia (Webb, 1994, Newell and Kishore, 1998).

This view that valuations lag the market underpinned discussions between representatives of the bankers and the valuers in the early 1990s which led to a new basis of valuation for lending purposes being introduced in 1992 (see 2.3 below). However, again these analyses are based on comparison of prices with valuations and that these data are independent of each other

2.3 Procedural influences

There are a number of other compelling reasons for expecting valuations to be smoothed and lag market prices. Legal precedents and procedural norms will have an impact. These include the effect of statutory intervention and third party rental determination; regulatory requirements within professional guidance; and the requirements of competent practitioner tests within negligence cases. A number of examples illustrate this kind of influence.

First, bases of valuation are defined in detail in professional practice notes (The Red Book in the UK). The basis of valuation adopted for the vast majority of valuations is ñopen market valueò (OMV). The virtually identical basis of ñmarket valueò is used the world over. As indicated previously, conceptually it represents an attempt to estimate what the exchange price would be if a transaction took place on the subject property. Unfortunately, the identification of a single snapshot-in-time exchange price valuation, in a market which takes time to transact, requires some detailed interpretation. Hence the RICS Red Book definitions which have evolved over time and continue to do so.

OMV is defined as:

an opinion of the best price at which a sale of an interest in property would have been completed unconditionally for cash consideration on the date of valuation (in previous definitions the words óreasonably expectedô appeared after óbest priceô), *assuming:*

- *(a)* *a willing seller* (a hypothetical owner who is neither eager nor reluctant i.e. not forced but not at a price which suits only him/her);
- *(b)* *that prior to the date of valuation, there had been a reasonable period (having regard to the nature of the property and the state of the market) for the proper marketing of the interest, for the agreement of the price and terms and for the completion of the sale prior to the valuation;*
- *(c)* *that the state of the market, level of values and other circumstances were, on any earlier assumed date of exchange of contracts, the same as on the date of valuation;*
- *(d)* *that no account is taken of any additional bid by a prospective purchaser with a special interest; and*
- *(e)* *that both parties to the transaction had acted knowledgeably, prudently and without compulsion.* (This last assumption has been added by the latest Red Book).

The perception in some parts of the market (Mallinson, 1994) is that the basis is backward looking because of the timing of the marketing period and, by definition, produces historic valuations. It was this perception that produced the alternative basis for loan valuations of ERP, where the assumption was that the marketing period followed the date of valuation.

The question is whether any lag in valuations was a product of the definition itself or other procedural effects. The reality may be that valuers will adopt evidence of present and past market activity, as well as recently agreed but not yet completed sales, to form their opinion of value at the valuation date, paying little attention to the precise content of the definition. If that was so, any lag would be the inability to process (or obtain) information correctly, not a forced backward look because of the nature of the definition.

A second example is the effect of precedent on the behaviour of professionals and the way in which they may be judged in the event of a challenge to the competency of the task undertaken. There has been a significant increase in the 1990s in the incidence of valuers being sued for negligence (Crosby, Lavers and Murdoch, 1998). ñCorrectò procedures and hierarchies of evidence relating to the use of comparables are reinforced by tribunals and courts (advised by leading proponents of these valuation ñrules of the gameò acting as expert witnesses). A valuer strays from these norms at his or her peril and will be found negligent if either the approach or the result is too far away from the approach or the result obtained using all of these rules. These influences may all lead a valuer to place reliance on hard transaction information (or a previous valuation or agreement that appeared to be hard information) and less weight on softer market sentiment feelings which cannot be proved.

Anecdotal and valuation evidence exists that such effects manifest themselves in the commercial lettings market where new lettings tend to lead rent agreements and determinations at review by significant amounts. Valuation evidence suggests it is by an average of around 10% in rapidly changing markets in the UK and that, in falling markets, the rent determinations are higher than the level of new lettings, a strong lagging effect (Crosby and Murdoch, 1997).

2.4 Anchoring

Research into how valuers undertake their task has revealed that they do not necessarily follow expected procedures nor use information in the ways generally assumed. As indicated above, valuers are prone to display "biases" in arriving at their judgements. Most typical of these biases is "anchoring". Anchoring is a form of behaviour in which people, when required to arrive at an estimate, do so by adjusting from an initial starting figure. This figure is typically an *underestimate*, anchored by and biased towards the initial starting figure.

In a series of studies in which appraisers were required to simulate their everyday behaviour, Diaz (1990a; 1990b; 1997; Diaz and Hansz, 1997; Diaz and Wolverton, 1998) has shown that they:

- fail to follow the procedures in which they have been trained[3];
- do not always examine all available information[4];
- are influenced by knowledge of another person's valuation, but only when valuing in an unfamiliar area[5]; and

3 Based on a residential appraisal.
4 Based on a residential appraisal.
5 Based on an industrial appraisal.

- inadequately adjust from their previous appraisals in performing current valuations[6].

Using a similar approach, Gallimore and Wolverton (1997) studied how knowledge of a pending sale price affected the choice of comparable sales to support a valuation. Their study, which concerned a residential appraisal/valuation, involved US appraisers and UK valuers. They found that in both countries pending sale price knowledge had an anchoring effect, although the nature of this differed between the countries. They suggest that this difference is attributable to differences in data availability and reporting requirements. Gallimore (1994) surveyed valuers and in a series of questions and simulated tasks found evidence of anchoring behaviour and also of a tendency to give greater weight to more recent items of evidence[7]. In a later survey, Gallimore (1996) investigated whether valuers were prone to confirmation bias (a tendency to act so as to confirm existing views or judgements). He did not find confirmation bias to be a significant facet of valuer behaviour, although almost half of the valuers in the survey exhibited ñprecipitanceò (a tendency to form judgements very early in the valuation process). This behaviour appeared to be present equally in both residential and commercial valuers.

2.5 Summary

The outcome of all this research tends to suggest, *inter alia*, that valuations are prone to uncertainty, are slow to react to market movements and therefore tend to lag prices, may be systematically biased and work to smooth peaks and troughs in actual prices. As a result they are likely, at the individual property level, to diverge from the actual prices by significant amounts and from each other by a lesser but still significant amount.

To summarise, the expectation might be that:

- Valuations would be based upon the previous valuation plus or minus a *perception* of change
- The perceived changes, unless the subject of very hard transaction evidence, would be conservative.
- Valuations would be affected by procedures and precedents of a statutory and regulatory nature.
- The results of legal judgements would be a powerful influence on valuations.

This research also tends to suggest that these conclusions are not to be taken as criticisms of valuers, rather a natural product of what the courts have accepted is an imprecise activity leading naturally to individual valuers reaching varying conclusions to each other and to any transaction price. They are the product of seemingly rational behaviour by valuers in attempting to identify the market value from the available information.

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6 Based on the appraisal of residential apartments.

7 Based on a commercial property, though not differentiating responses by type of valuer (i.e. residential or commercial).

However, as previously suggested, all this research is predicated on the basis that valuations stand above the market, acting purely as attempts to commentate on its operation. The research described in this paper seeks to identify whether this is a correct interpretation. For example, evaluations of valuation accuracy involve valuations being tested on their similarity to prices: but it is possible that valuations themselves influence the level of prices due to the part they play in the advice to vendors and purchasers. If so, a close relationship between valuations and prices may actually originate in the influence of the valuation on price (Crosby, French and Ward, 1993).

Questions are therefore raised concerning the effect valuations have on the workings of the market and the effect on valuations of procedural and behavioural influences. However, other issues are based upon whether the valuations are also influenced by participants in the market, such as clients who may influence the actual valuation received.

3. Client and valuer relationships

Section 2 sets out the evidence, backed by a strong theoretical basis, that an individual valuerôs periodic valuations of a property may be smoothed and lag prices. This will lead to under-valuations in rising markets and over-valuations in falling markets. This should also exaggerate market turnover in a rising market and reduce turnover in a falling market as vendors are more likely to sell at prices above than below valuation. But reduced valuations in rising markets may stifle purchasers as they could lead to reduced finance offers or the spectre of an end of year valuation at below initial cost. This, in turn, biases the data by which these questions are tested.

What are the influences that flow? There are anecdotal comments from market participants of deals not taking place because the offer does not match the last valuation seen by the vendor, or the valuer refuses to endorse the figure that the transaction has been agreed at - with implications for short term performance measurement. The shorter the time frame between valuations, the more likely they are to become expressions of intuition of market strength anchored upon the last periodôs valuation. The shorter the performance time the more likely that a refusal to endorse a sale price would kill the deal.

The foregoing sets out the issues that surround the reliability and validity of valuations. Gauging the impact that valuations have on clients' decision-making, however, requires looking beyond valuation issues *per se*. Having considered how valuers may actually behave in producing these valuations, it is also necessary to investigate how valuers interact in this process with clients and how clients utilise valuers' advice in making investment decisions. These are complex situations that are unlikely to be fully captured by economic models that assume purely rational utility maximising behaviour. Clark (1998a), for instance, describes how decision-making by pension fund trustees is not simply an exercise in risk-return calculations but can only be understood if habits of behaviour, rules of proprietary conduct and norms governing relationships are taken into consideration.

In fact, a wide body of research into decision making has revealed that people often behave in ways that are at odds with accepted economic or financial models. In the past decade this work has extended to how some of these tendencies impact on the work of valuers and appraisers; and, more recently, how this behaviour affects the interactions between valuers and their clients. Though much of this work has used residential property as the subject matter, the results where commercial property has been used suggest that the patterns of behaviour transcend both the type of property and type of valuer. The majority of these studies have been conducted in the US. Nonetheless, work in the UK, including UK-US cross-cultural studies, suggests that most of the findings hold here, too.

3.1 Client influence

There are a number of studies which have investigated the behaviour between valuers and their clients. Working with US commercial appraisers, Kinnard, Lenk and Worzala (1997) found that two out of five appraisers were willing to revise upwards their valuation estimate at the request of their client, despite having no documentary evidence to support their clientôs argument for a higher valuation. Client size was found to directly affect the behaviour of the appraisers (the bigger the client, the more likely the appraisers were to revise their estimate). Gallimore and Wolverton (2000), in a survey of mortgage valuers, found that almost a third had reformulated the mortgage valuation goal, believing that this was to validate pending sale price rather than produce an objective opinion of value. Residential valuers, especially those who performed little or no other professional tasks, were particularly prone to this. This tendency, however, appeared not to be linked to experience of feedback from clients following an unsupportive valuation report. In a similar study in the US, Wolverton and Gallimore (1999) also found that residential appraisers were more likely than were commercial appraisers to have reformulated the appraisal goal to validate sale price. However, feedback from clients following an unsupportive report had a bigger impact in this respect on commercial appraisers than on residential appraisers.

3.2 Principal-Agent Issues

A complementary perspective from which to view the valuer/client relationship is that of the economics of information. In this, the relationship can be analysed in terms of a principal-agent problem. Such problems are found where one individual acts on behalf of another in undertaking some activity where there is moral hazard. Essentially it is based on the premise that rational persons always prefer the alternative that makes them better off. Hence

> ñAgency theory postulates that because people are, in the end, self interested, they will have conflicts of interest over at least some issues any time they attempt to engage in co-operative endeavoursò (Jensen, 1994, p.6)

Ideally the principal is seeking the perfect agent who will always make decisions without regard to their own interests or preferences. A key problem is that the principal is unable to observe fully the actions of the agent. Hence there is information asymmetry. Consequently, ñif the agentôs objectives differ from those of the principal, then the former may take advantage of the unobservability of actions to pursue his/her own endsò (Molho, 1997, p.191).

In mainstream micro-economics, much of the analysis has focused on potential conflicts between shareholders/managers and employers/employees. The applied research has tended to be concerned with developing incentive structures which optimise the actions of the agent from the principalõs perspective. In the property literature, the majority of research on principal/agent problems is found in the US journals. Topics relate to managerial incentives in the REIT sector (Solt and Miller, 1985; Hamill, 1993), the role of principal-agent conflict in the S&L crisis (Eisenbeis *et al*, 1996) and brokerage incentives (Zorn and Larsen, 1986;Yavas and Colwell, 1999). From the perspective of the research described here, the most relevant recent paper is by Graff and Webb (1997). Contrary to the expectations of the efficient market hypothesis, they identify significant serial persistence in the returns of individual properties. In basic terms, they find that some properties consistently remain in the best performing quartile whilst others remain in the worst. They explain this persistence in terms of agency costs. They argue that this persistence reflects mispricing and misvaluation, arising from incentives (bonuses, fee structures) for managers to acquire assets and to overbid for rarely available assets. However, since the transaction price provides an ñanchorò for subsequent valuation, ñthe appraiser will need overwhelming and incontrovertible evidence that temporary/abnormal economic factors were involved in determining the sale price in order to produce an appraisal valuation that differs in a major way from that priceò (Graff and Webb, 1997, p. 21). Subsequent performance reflects the filtering through of the prior over/underpricing into the appraisal process.

From the point of view of this research, there are a number of areas where it is possible to identify classic principal-agent or moral hazard problems

- Portfolio valuers have an incentive to ôconfirmô a valuation since acquisition may produce an increase in the fee income.
- Investment agents have an incentive to provide a confirmatory valuation since their agency fee income depends upon a completed transaction. Moreover, since fees may be linked directly to price, there is an incentive (rational from the vendorõs perspective) to maximise price and subsequent valuation.
- In periodic performance valuations, the fund manager is unable to observe the effort that goes into the valuation service. The lack of movement in valuations may reflect partially agency costs rather than poor information arrival, thin market effects etc.
- Where the valuer is external rather than independent, good client/valuer relationship may lead to other instructions.

Indeed, given the acknowledged uncertainty surrounding valuations, there is considerable scope within which the agent (valuer) has discretion.

There are notable analogies between the roles of valuers in portfolio valuations and auditors in approving corporate accounts. An archetypal representation of both professions is of neutral and independent providers and analysts of financial performance information. However, in the accountancy literature, given the enormous weight given to accounting information in capital market decisions, the independence and impartiality of the auditing process has generated a longstanding body of commentary and empirical research

A persistent theme in auditing research is the presence and potential of incentives in the auditor-client relationship to bias reporting. A common concern is auditor independence. This is defined as the absence of collusion between the auditor and the manager of the client firm[8] (Lee and Zhaoyang, 1998). The central concern has been that there has emerged a ñmutuality of interestsò between auditor and client due mainly to auditor economic dependence and/or the provision of non-auditing services by the auditing firm (see Zhang, 1999; Windsor and Ashkansay, 1995; Zimbelman and Waller, 1999). Hence questions have emerged among regulators, policymakers and practitioners as to whether

> ñauditors may have become so economically interested in the success of a client that they actually become advocates for the client as opposed to independent attestors of client prepared informationò (Jenkins and Lowe, 1999, p.74)

A common strand in this research is the influence of engagement risk vis-à-vis incentives on reporting strategies. Engagement risk refers to the level of potential risk associated with an instruction due to the nature of the client, the potential for error and potential repercussions for auditor (see Colbert and Luehlfing, 1996). A significant proportion of empirical research has been on identifying how the conflicting influences of economic interests and engagement risk can shape financial reports. For instance, Hackenbrack and Nelson (1996) found that auditors tended to be more aggressive in their reporting when engagement risk was judged to be moderate and to be more conservative when the converse situation held. They also discuss the significance of the scope for subjectivity in accounting regulations which permit differences in what can be ñreasonably estimatedò. Beattie *et al* (1999) stress the importance of scale of analysis in researching potential bias due to, *inter alia*, engagement risk, the provision of non-auditing services and economic dependence. For instance, the effects of economic dependence can be measured at the level of individual, section, office or whole company.

In summary, there is a body of theory and empirical evidence from both micro-economics and behavioural studies which suggests that the nature of the social and economic relationships between clients and valuers will influence the valuation formation process. In addition to issues related to market structures such as thin trading, confidentiality, legal and institutional guidelines and methodology, questions can be raised about the incentives valuers have to adopt strategies which involve, among other things, the endorsement of transaction prices and a response to client pressure. Given the structure of the economic relationship, it is can be reasonably argued that it is rational for valuers to adopt such strategies. However, given asymmetric information, the strategy of the valuer may not be one of simple compliance in the medium to long term. Whatever the precise nature of the client/valuer interrelationships it is clear that there is potential for valuations to be biased.

[8] Beattie *et al* (1999) distinguish between independence in *fact* and independence in *appearance*. The former is characterised by an unbiased mental attitude. The latter is defined as the perception by a reasonable observer that the auditor has no relationship with the client that would suggest a conflict of interest.

4. The Interview Survey and Results

4.1 Aims and objectives

The aim of the interview survey is to explore whether issues of process and client influence impact on valuations and whether valuations impact on acquisitions and sales of commercial property investments. The focus of the research is on periodic valuations for performance measurement although some of the issues raised are equally important for one-off valuations such as for loan security. The loan valuation area is worthy of significantly more detailed investigation than possible within the confines of this project.

The objectives of the study are to investigate:

- The methods of appraisal used by owners/managers to inform the acquisition and sale process for investment property and whether valuations mimic those methods.

- Whether valuations influence which properties enter the market and the price at which they are sold. Do they in many cases kill the deal or at very least lead to re-negotiation of price?

- Whether there is undue client influence on periodic valuations. Previous research suggests that clients can influence valuations and the research needs to identify whether the valuation process allows this situation to occur, is it happening and, if so, in what circumstances.

- Whether the process by which periodic valuations are produced, especially for frequently reviewed valuations, raises any questions of bias, influence of inaccuracy.

4.2 Methodology

As indicated at the beginning of the paper, the main research approach was a semi-structured set of interview surveys. Although a discussion of the epistemological and ontological debate relating to the merits of qualitative research as opposed to quantitative, positivist methodologies is outside the scope of this study. a detailed account of, and rationale for, the research methodology is required. Although sparse in the property research literature, there has been considerable discussion of the validity, limitations and potential methodological flaws of qualitative research methodologies in the sociology and geography literature (see Clark, 1998b, Denzin and Lincoln, 1997, Neumann, 1997, Miller and Dingwall, 1997, Bailey *et al*, 1999, Baxter and Eyles, 1997). In this study the main motivation for a qualitative research approach is that such an approach permits a more creative, exploratory and flexible style of research since the research area was relatively broad based. This is a common rationale for a qualitative methodology. Moreover, the approach is also based on a preconception that knowledge of the research questions was *situated* with professionals and could be best accessed by personal interview or ‘close dialogue’ (Clark, 1998b). However, it seems apposite to acknowledge the common criticisms of qualitative methodologies so that the key issue of validity is continually considered.

Although qualitative research is often portrayed as being essentially inductive, it is sometimes difficult to distinguish between induction and deduction in qualitative research. Inevitably, research agendas are influenced by researchersô preconceptions and models of social reality. Furthermore, in qualitative research the questions and even the method may mutate as findings in one part of the research programme generate further research questions and hypotheses. This was the case in this study and is to be expected. As a result the data generated should be recognised as being (unavoidably) partially researcher led and value and theory laden. Pre-existing values and theories will affect also data interpretation and analysis. In addition, the focus on individuals as the unit of analysis implies an acceptance that explanation lies in their views, experiences and attitudes. However, a full explanation would need to explore the institutional, social and economic structures which have constrained their decisions, choices and actions. Given the above, researchers need to be wary of simply observing what they want to observe and hearing what they want to hear during the interviews.

In terms of interview surveys specifically, there are numerous well-documented hazards. The most fundamental is the problem of self report, i.e. respondents providing interviewers with an inaccurate reflection of reality. Respondents may subconsciously and possibly deliberately mislead interviewers producing potential for systematic and/or random error in the data. For instance, in interviews with professional experts involving commercially and professionally sensitive topics, it is reasonable to assume that respondents will generally wish to appear honest and competent to researchers. In addition, other factors such as interviewer status and characteristics, audience influence and subjective and/or mistaken interpretations can bias data and analysis. Interviewee selection is also an issue that needs to be addressed.

It is apparent from the discussion above that there are risks inherent to a qualitative, interview-based, research methodologies which will lead to doubts about the rigour of the process and the validity of the results and conclusions. There has been considerable debate in the geography literature about approaches to qualitative research practices. Manifestly the key goal is to produce results and conclusions that are valid. However, in qualitative research validity is perceived in a more relaxed manner in the sense that inferences are probable, reasonable and plausible (Huberman and Miles, 1997). Baxter and Eyles (1997) have criticised the lack of methodological rigour and transparency of qualitative research in social geography in terms of the lack of explicit consideration of methodological issues in conducting the research and analysing the data. The range of remedies for such limitations has been summarised as ógrounded theoryö. In practical terms, the application of such theory focuses on increasing transparency about the research process, researcher reflexivity and data scepticism whilst applying more rigorous methods to the evaluation of data eg. triangulation. Such methods have been applied in this study mainly by using multiple interviewers and by examining the research questions from the perspective of both óconsumersô and óproducersö.

The initial research agenda emerged in the context of the academic debate highlighted in the previous literature review on issues related to client influence on valuations, valuation uncertainty and the effect of valuations on the operation of the commercial property market. In addition, this research project was driven by a perception among several of the researchers that valuations and valuers have significant impacts on liquidity, price setting and trading in the commercial property market. This essentially set the research questions. The first set of interviews were with leading property owning and fund management organisations in order to investigate their use of valuations in property investment decisions. The first stage of the research therefore focused on ‘consumers’ of the valuation service rather than valuers themselves[9]. The interview approach was considered most relevant since it was judged that the inherently restricted nature of a questionnaire survey would limit the scope for in-depth discussion of opinions, experiences and attitudes. In addition the use of questionnaire implicitly suggests that the researcher has a relatively full understanding of the subject area and is able to set the parameters for the research. However, in this case, it was hoped that the use of interviews would reveal new issues which were not uncovered in the literature review.

Generally the approach adopted was that the discussion was led by one or two researchers with another researcher taking near verbatim notes of the dialogue (but not participating in the dialogue). Given that there were a number of researchers, for the purposes of consistency an interview schedule was developed which would provide a relatively uniform structure to the interviews. In order to reduce potential interviewer bias further, one of the research team was present at all the interviews to ensure that a generally consistent line of investigation was followed. However interviews did not necessarily follow the interview schedule structure, as respondents would often anticipate future issues or questions. Moreover, where earlier interviews had raised interesting issues not previously considered by the research team, later interviews tended to be adapted to include a discussion of these matters.

The interview schedule used for the fund manager and valuers were different but both consisted of a number of factual, closed-end and attitudinal open-ended questions. The first part of the fund manager interview generally consisted of some factual questions concerning the nature of the interviewee and their organisation, their property portfolio and their use of valuations. The second part consisted of a discussion of their experience of the use of valuations in the acquisition and disposal processes and portfolio valuations. All interviewees were assured that no individual respondent would be identified in the report and that confidentiality would be respected.

In total, 20 interviews of fund managers and were carried out during May and June, 1999. The size of sample reflected relatively consolidated nature of the institutional property investment market and an intuitive guess at a figure that would be *adequate*. Indeed, this was probably an overestimation as saturation was probably achieved after approximately 10 interviews. No formal methodology was developed to identify potential interviewees. The person typically targeted was the senior fund manager or equivalent. The sample can be characterised as self-selecting and ‘convenient’ in that interviewees were identified from the researchers’ knowledge and experience (often personal) of important market participants in terms of organisation and their key personnel. As a result interviews were sometimes between researchers and interviewees who had a pre-existing professional and friendly relationship[10]. An

[9] One interviewee’s main responsibility related to valuation services for a firm that provided fund management services.

[10] We have no reason to believe that this biased the data. We have observed no significant differences despite the presence or absence of a pre-existing relationship.

introductory letter was sent to the potential interviewees outlining the background to the research and the broad scope of the interview. Interviews typically lasted from 45-90 minutes.

The second set of interviews was carried out with representatives of the leading valuation firms who were óproducersô of the valuation services for fund management organisations. It was envisaged that interviewing the óproducersô would provide a fuller picture of the issues addressed as well as providing a check on the reliability and integrity of the data obtained from the fund managers. However, the interview schedule had been refined in light of the findings of the previous set of interviews. In total 11 interviews of heads of valuation departments were carried out during June and July, 2000. The sample was smaller reflecting new perceptions of adequacy and the dominance of the sector by a small number of major providers. Many of the same points apply as above in terms of interview structure and issues addressed. The sample was again both convenient and self-selecting and there were often pre-existing relationships between researchers and respondents. The interview schedule included some factual questions on the organisation and the nature of valuation work and open-ended questions on the process of valuation for various purposes focusing on performance measurement and acquisition and sale.

The interviews were shared between five researchers. This was usually, although not always, with a single respondent. The main motive of sharing the interviews was to spread the workload but has the benefit of reducing the potential for interviewer bias. In most cases, each a number of records of the interviews were retained in order to reduce the scope for bias and/or misinterpretation. The qualitative, non-factual data was analysed by a sequential process of open, axial and selective coding. The data are reported and interpreted below.

4.3 The interviewees and their organisations

The list of organisations that agreed to participate in the interviews is presented in Appendix 2. Of the owner/fund management interviewees, it is apparent that half the respondents categorise themselves as fund managers. As stated above, the majority of the respondents held senior positions in their funds generally responsible for strategic, tactical and buy/sell decisions concerning the property portfolio. A number of the interviewees were responsible for managing a variety of funds including unit trusts and life funds. All of the interviewees were constrained to some extent by a requirement to seek authorisation for property transactions from some form of executive body.

The 19 owner/manager organisations interviewed who answered the question on value and number of properties, held over 10,000 properties in their portfolios with a value of over £40 billion. The split by property type was nearly 50% retail, 30% offices and 20% industrial. It is apparent from the research that there is diversity between the interviewees in terms of fund size and value, allocation to property and type of organisation. Whilst the average size of property funds managed by organisations was £2.12 billion, this conceals considerable variety in the size of fund managed. This is also the case with allocation to property where an average figure carries little meaning. Typically the property companies and unit trusts allocated 100% of their assets to property, whilst the multi-asset funds allocated more typical weightings in the range of 2% to 8%. Some respondents found the question too general since they were involved in managing a number of funds; each with different weightings. Although the results are not reported here, there was less diversity in terms of sector weightings, for most funds the typical order was retail, offices and industrial ï only very small proportions were held outside these sectors.

Reported below are the results of the research in terms of the main issues that emerged from the interviews. In some cases proportions of responses are discussed. Firstly the use of valuations made by intervieweesô organisations is outlined in conjunction with a discussion of the timing of their portfolio valuations. This is followed by a discussion of the main findings of the research categorised according to:

- Market structure of valuation providers;
- the role of valuations in the acquisition and disposal process;
- the effect of valuations on trading;
- The valuation process
- client influence on valuations;
- The impact of new fund managers/valuers
- the issue of the status of different valuations and
- the accuracy of and lag in valuations.

In discussing these issues, quotations from interviewees have been used. However, the research interviews were not taped, but transcribed from notes taken by one member of the team, who did not take an active part in the questioning. The quotations are of the main thrust of the point rather than the precise words in some cases.

The 11 valuation firms are harder to categorise as the number or value of valuations undertaken are distorted by whether the valuations are monthly or some longer period. However, it became clear that the vast majority of short term periodic valuations, the main focus of the study, are in the hands of no more than five major firms. In addition to the issues outlined above, the valuers were questioned on the process by which periodic valuations were produced and the use of information in that process.

4.4 The role and timing of valuations

The reasons why external valuations are commissioned by clients is set out in Table 1.

Table 1 : The reasons for external valuations

Use	No.
Financial statement	18
Performance measurement	17
Advice ï sale	5
Advice- acquisition	9
Loan	6
Portfolio restructuring	5
Other	1

Not unexpectedly, nearly all respondents commissioned external valuations for performance measurement and financial statements. A significant minority also indicated that they were commissioned during the acquisition and disposal process.

In terms of portfolio valuations, there was considerable variation in terms of the period of valuation and the size of sample valued. The majority of organisations used external valuers sometimes supplemented by internal valuations. Table 2 displays the range found in terms of coverage and timing.

Table 2 The Timing and Coverage of Portfolio Valuations (by number of respondents)

	Monthly		Quarterly		Bi-annually		Annually	
%	Internal	External	Internal	External	Internal	External	Internal	External
100%	2	4	0	3	2	1	2	3
75-99%	0	2	0	1	0	0	0	0
50-74%	0	0	0	0	0	0	0	2
25-49%	0	0	0	2	0	0	1	3
<25%	0	2	0	0	0	1	0	3

Having established the nature of the organisation, the reasons for commissioning valuations, the coverage and timing of portfolio valuations and in the case of the valuers, the valuation process, the rest of the interviews explored a number of questions raised in the literature review. The results of the process are set out below by reference to the issues identified within the interviews. It is reiterated that the interviewers with the valuers were informed by the findings of the interviews with fund managers. Given the exploratory nature of the research, it was found that where certain issues emerged in early interviews, later interviews were adapted to pursue them.

4.5 Valuation Providers – Market Structure

In discussions with the valuers, a number of issues emerged relating to the structure and economics of the valuation sector. Interviewees indicated that the delivery of periodic portfolio valuation services has been characterised by economies of scale leading to the dominance of the sector by four or five providers. A commonly cited development reinforcing this concentration was consolidation trends amongst both clients and providers. Medium-sized practices typically felt that they were being ópriced outô of the market since their costs usually exceeded market fee levels in a high volume, low margin business. One respondent stated that this concentration was generating concern within the industry at the influence of a single firm in the provision of valuation data for the IPD Monthly Index. In terms of profitability, although it was felt by a number of respondents that the large practices offered periodic portfolio valuation services as a loss-leader, the large firms interviewed were definite in stating that it was profitable in its own right. However, while it was apparent that the boundaries between the two were becoming blurred, firms normally preferred to act as external rather than independent[11] valuers in order to take advantage of possible óspin-offsô from valuation work.

4.6 The Acquisition and Disposal Processes

Part of the discussion focussed on the process of identifying and pricing potential properties for disposal or acquisition. In terms of acquisitions, the most clear cut feature of the research was that all fund managers were using the explicit calculation of worth as the basis for pricing assets. Prospective returns were typically estimated over a one and/or three and/or five year holding period. It would appear that explicit worth calculations now dominate the price formation process for institutional investors. Some respondents pointed out that this would often be in conjunction with gut feeling and valuations. Consequently there appears to be a dichotomy between the essentially comparative methodologies that valuers are using to estimate price and the forward looking, often research and forecast driven methodologies used by market participants to form prices. One interviewee commented on this pointed explicitly stating that ñValuers use a different means of ascertaining price than fund managersò[12].

In assessing potential disposals a similar process in reverse tended to dominate. Typically at performance review each property is assessed in terms of its future returns and hold/trade decisions made. However, the most recent portfolio valuation is a key element of the calculations leading to such judgements. One interviewee commented that ñValuations are starting points for assessing the property. They are treated as knownò. However, some interviewees pointed out that they had experience of situations where a óhighô valuation had resulted in forecasted poor performance. However, after exposure to the market the valuation was proved to be incorrect and was amended with consequent improvements in forecast performance and changes to hold/trade recommendations.

4.7 The Effect on Trading

A key question at the outset of the investigation was that valuations might cause transactions to be aborted when the reported figure failed to support the agreed price. In this way valuations could partially influence both market prices and levels of activity. It became clear during the interviews that there were basically two types of investor attitude towards a valuation/price mismatch ï óvaluation constrainedô investors and óvaluation independentô investors. For over 50% of fund managers, a market price below valuation indicated a ólowô price at which they could not trade. Often a threshold was present at which non-trading would occur, typically if the price diverged from the valuation by more that 5%. The main reasons that selling at a price below latest valuation was problematic related to obtaining necessary authorisation from trustees and other executive bodies. It was also stated that such a situation could potentially undermine confidence in other asset valuations of the remainder of the portfolio.

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[11] As monthly valuations are normally for Property Unit Trusts who require independent valuations, questions are raised as to whether monthly valuations can only economically be carried by a few major firms.

[12] Quotations from the interviews have been used to illustrate the points raised. Where a list of quotations is presented, each quotation is taken from a separate interview. The number of quotations on a given issue also provides a broad indication of how often the issue was brought up during the interviews.

"To sell 3-5% below the valuation is ok. It is rare to sell any more below" ***"Worth is the true indicator of whether a sale should go ahead, not valuation. However, it is uncomfortable to go below valuation"*** ***"If the portfolio valuer really does not like the deal the company will withdraw or readjust the deal"*** ***"Acquisition only occurs if backed by a supportive valuation report from the agent or another valuer"*** ***"An informal valuation is usually acquired for advice purposes prior to negotiation. This is particularly important for funds who don't want the property to be written down so they take a performance hit"*** ***"As this fund is successful it doesn't matter if it takes a hit on acquisition or sale. However, it is difficult to sell below 5-10% of the valuation."*** ***"The trustees like the price to be underwritten and presentation would not be given to the board without this"*** ***"If valuation is not a reflection of current price then it can be difficult to sell"***
"If the sale price is lower than 10% below valuation it throws into question the valuation of all other assets. It is a psychological barrier" ***"If the worth and valuation calculations don't agree then this might cause problems"***

A range of valuations were cited as the benchmark for comparison ï independently commissioned valuation, most recent portfolio valuation or, when acquiring, informal valuation by portfolio valuer.

However, for others investors, essentially the problem was perceived as a óhighô valuation. As a result a mismatch between the price and valuation would not result in an aborted transaction. The same type of óconfidentô market participants felt that a ólowô valuation when buying would not deter them from acquisition.

"There is no problem selling below book value"

"The company will buy property at a price above independent valuation even for unit linked funds"

"There is no difficulty in selling below valuation"

"There has never been any problem taking a performance hit as deals are made with an horizon of 3-5 years."

"The valuer may influence but would not stop the deal. Renegotiations of the deal and with the valuer may occur"

"The company will sell below valuation with no problem"

"If the sale is going to be below valuation it will be examined closely as it will mean a performance hit but if that property is going to drag your performance down anyway then it is worth selling"

However, it is important not to overstate the importance of this issue. The problem of valuations inhibiting liquidity or impairing transactions appears to be one of potential rather than practice. A number of interviewees stated that occasionally transactions were ósabotagedô by valuers. However, often this was qualified as very occasionally. This difference to the anticipated situation is almost certainly because these organisations had direct control over investment funds, rather than relying on funds borrowed for the purpose of a particular transaction. In these circumstances, the treatment of valuations in general, and "adverse" valuations in particular, appeared to be different from the classic borrower/lender scenario. First, as described below, the valuation itself may not be entirely uncontaminated from the transaction. Second, there is rather more evidence that valuations are used to re-negotiate price, as distinct from causing a collapse of the transaction. Depending on the circumstances, valuation constrained or valuation independent investors would be prepared to use an óunfavourableô valuation to renegotiate.

This analysis is generally supported in the interviews with the valuers. Valuers were commonly consulted to provide ócomfortô when acquiring. However, the level and extent of consultation could vary considerably among different clients. Despite the high level of consultation, it was apparent that valuers had minor effects on transactions completed. Essentially, it was generally felt that valuers rarely caused transactions to be aborted.

“I cannot recall a situation in which a deal or transaction was aborted through the advice of a valuer”

“It is unusual to abort a transaction on the basis of a valuation”

“Rarely have we given advice that has killed a deal.”

However, it was stated on a number of occasions that sales were more likely to be affected by failure to match a previous performance valuation. Confirming the findings with the fund managers, a significant proportion of vendors feel unable to sell below óbook valueô[13]. This finding has important implications for the validity of valuation accuracy studies since it strongly implies that the samples used are biased towards transactions where the prices achieved exceeded previous valuation and that the independence of price and valuation is compromised.

One issue which emerged at the interviews that appeared common practice was the use of the introducing agent as the provider of the formal purchase valuation report, in addition to any informal discussions with the funds external or independent valuer. The fact that the introducing agentôs fee is dependent upon the success of the deal does raise questions of moral hazard, even though a number of interviewees were of the opinion that valuers who did not act objectively would be exposed and not used again.

4.8 The valuation process

When focusing on valuers, these findings prompted detailed research on the valuation formation process for periodic performance valuations. Two main issues were addressed. Firstly, the process in terms of research, timing and consultation through which valuations were produced was investigated. Secondly, the nature and extent of client influence on the valuations produced was explored. In terms of levels of effort and research it was clear that levels of research varied with time period. In essence annual valuations received most attention from both clients and valuers ï with annual valuations being given the ófull Red Book treatmentô. However, in monthly valuations, it was clear that this was not the case. Many respondents[14] expressed scepticism of the utility of monthly valuations given limited information flows in the property market. It was commonly held that the market was subject to lengthy óflatô periods for instance post Christmas and summer holiday seasons.

[13] In this context, book value refers to the most recent performance valuation.

[14] A contrary view that the monthly valuation was just as accurate as the annual was expressed.

"The six monthly valuation is a review"

For monthly valuations "..every quarter the properties are marked to market yield with the advice of an investment colleague…A full ring round for comparables is done every quarter"

"Monthly meetings are held with the investment team to discuss, sentiment, yields and rentals"

For monthly valuations "they will not run the numbers on every property…For quarterly valuations the valuer will do more"

"Each property is thought about…Monthlys are incredibly difficult to do"

"When producing monthly valuations, it is generally a waste of time to look at rental values. This is done every three months…the investment market is considered in detail every three months"

The timing of the production of the annual valuation was interesting. Typically, most draft valuation meetings took place in early December with some clients requesting figures as early as October. Given that the necessary research would be done earlier, and that figures would rarely be changed, this raises questions about the timeliness of December valuations.

The lack of ôhardô information in the property market generated an interesting and clear difference of opinion among valuers regarding the incorporation of changes in market sentiment into valuations. In effect, some respondents felt that they could not move their valuations without transaction evidence, whilst others felt that changes in market sentiment should be reflected. However, the latter also pointed out the difficulties of estimating the timing and level of basically subjective adjustments.

"Transactions that fall through are not market movement. If there is no evidence of a falling market you cannot mark down values. You cannot reflect other markets movement"

"Monthly valuations ultimately have to move but generally stay stable through lack of volume of evidence"

"Monthly valuations involve picking up the local market information and then tweaking the valuations"

"Often values do not drop in the month that reflects the drop. The change crystallises in the month that it was not necessarily initiated in"

Valuations will move to wider market movement, not necessarily only provable movement. The valuers listen to their investment colleagues"

"Monthly valuations often miss sentiment cues"

For monthly valuations, sentiment builds up over two to three months and then is crystallised in the market. The question rests on where you start reflecting sentiment rather than reality?"

"I am known as a volatile valuer…I do not wait for cast iron evidence"

A scenario raised by both interviewees and interviewers was the dilemma faced by property valuers in ‘stalled’ markets. This was illustrated starkly in the aftermath of the Russian debt crisis of 1998. During October-December of that year, uncertainty about the prospects for the economy and the property market led to changes in investor attitudes towards commercial property. This was manifested in a decline in transactions due to a lack of buyers and aborted transactions. Many respondents believed that there had been a definite fall in values. However, valuers’ reactions were mixed, some reacted after a brief delay, whilst others tended to ‘sit it out’ and wait until evidence appeared.

In terms of the reliability of property indices, the points raised about are not trivial. How are valuers to measure changes in market prices in the absence of transactions data? The evidence from discussions with valuers suggests that they follow a number of strategies when faced with a lack of data supporting market change.

- No adjustment.
- Delayed adjustment.
- Conservative adjustment.

Moreover, a number of valuers felt that their clients preferred a slow adjustment in valuations and were wary of volatility. This body of evidence provides support for the smoothing hypothesis. This was further supported since it was confirmed that the same valuer normally valued the portfolio and was (obviously) aware of previous valuations.

4.9 Client influence on valuations

Clients appeared able to influence valuers during the formulation of valuation opinions. The majority of those interviewed described a procedure in which valuations were submitted to a process of discussion and possible moderation before being formally submitted. This might extend to the production of a draft valuation[15], seen by and subject to influence by the client. Although there was limited indication of coercion from the fund managers, investors could avail themselves of the opportunity to provide information on a selective basis. This information could be both factual and/or interpretative. Since portfolio managers are sometimes likely to have more up to date data factors affecting the portfolio’s value eg. rent reviews settled, leases renewed/terminated, they could ‘correct’ draft valuations. However, it appears that

[15] The practice of submitting draft valuations has been observed elsewhere. Schuck and Levy (1999), for example, describe this as "common practice" in New Zealand.

fund managers also attempt to influence valuations by stressing changes in ósoftô data such as market sentiment and manipulating the potential uncertainty in valuations that exists due to relatively thin trading.

"The draft valuation is open to negotiation, as the company will make available market information and additional valuation information to the valuers"

"There will be some negotiation with valuers over the draft valuation. They will be given both factual evidence and opinion on market sentiment. The valuation will be argued both up and down.

"Discussions with valuers over draft valuations is usually frank and constructive. Evidence to move the valuation both up and down will be shared"

"The company takes an active interest in valuation drafts and will negotiate over the values, providing information that might move the valuation both up and down."

"The valuers will be given information to move the valuation both up and down"

"The draft valuation is subject to negotiation"

"The company will give factual information and market sentiment information to their valuers"

"Valuers are provided with information to help them reach a fully informed valuation figure. However, this does not include information that would devalue the property though it is expected that the fund valuers will find out sooner or later"

"Information would be passed onto valuers to help with the discussion of ERVs etc until a mutually agreed figure is reached. Information that would result in a lower value is not passed on to the valuers unless it is during a purchase."

An extension of this is the practice, referred to by a two of the fund managers interviewed, of putting property on the market, getting bids, then using these bids as evidence that the valuer could factor into the valuation.

The practice of "negotiating" valuations has two main effects. It undoubtedly enhances the quality of the valuation by ensuring that the information upon which it is based is enriched. However, the practice is open to abuse with resulting valuations being biased and less reliable. There was a feeling from fund managers, however, that valuers could only be influenced in these ways over the short term, with re-adjustments being made at a subsequent valuation or valuations (a finding analogous to that uncovered by Graff and Webb (1997)). A number of participants did indeed suggest that this type of process could be observed. Moreover, there was also limited recognition that potential conflicts existed between the interests of the valuers and their clients.

"It is unsurprising that valuers confirm prices for the following reason. The valuer will want to increase the portfolio size so that they are valuing more property and thus increasing their fees"

"If a property is bought over the valuation, it is often valued at price of purchase but then marked down in following months. Therefore it is not worth pushing up valuations for short term performance"

"The valuers may even value the purchase initially at the purchase price. However, they mark it down over a number of months"

"Sales and purchases have to be within 5% of the external valuation figure. However, this has never been a problem. If a purchase is made that is over the valuation it may go on the books at purchase price and then the valuers will wind down the figures until the valuation reaches what they initially valued at"

"There may be a post-acquisition performance hit. This is due to valuers writing it on the books as price paid and then slowly reverting back to their original opinions"

The effect of such agency costs is that portfolio performance will tend to be over or underestimated at specific points in time.

Given the indication that meetings generally took place with fund managers to discuss draft valuations, it seemed appropriate to investigate the nature and outcome of these meetings. Generally (and not unexpectedly), the valuers put much more stress on coercion and manipulation by the fund managers. However, there was an interesting distinction between small and large firms. The latter suggested that coercion and manipulation were exceptional rather than normal characterising the meetings as ópooling of informationô which improved the quality of the valuations. Although able to point to individual incidences of extreme client pressure, they felt that they had developed strategies and personal relationships which enabled them to deflect pressure when applied. On the other hand the medium-sized practices seemed to experience client pressure as normal. One possible explanation for this difference is that larger firms have less economic dependence on single clients and thus feel able to risk losing their business.

"Valuers are mindful of information manipulation however, it comes down to the individual concerned…If a working relationship is maintained valuers will catch this type of deception."

"Draft valuation meetings can be quite unpleasant"

"Draft figures are prepared which will most probably differ from the views of clients who eat and breathe the portfolio"

"The tone of the meeting is not too aggressive"

"It is not a negotiation of value but an addition of facts. Arms are not twisted"

"You don't always know the whole truth regarding the property until the draft valuation meeting….The meetings are generally convivial"

"The clients are generally tough but fair"

"We have them* (fund managers) *well trained"

"Property companies put valuers under intense pressure"

"The fund managers who have monthly valued funds are paranoid"

This discussion was followed by questions about the proportion of valuations that would be challenged at the draft valuation meeting and subsequently changed. The responses suggested that as a generalisation 20%-50% of appraisals would be questioned with about 50% of those valuations challenged being changed. Typically the direction of the change was upwards. The main exception to this pattern was when properties were being considered for disposal. Again the implications of these points are not trivial, they suggest that valuations may be systematically biased in a positive direction and again provide additional confirmation of the lack of independence of prices and valuations.

In the first two interviews with valuers, both respondents indicated that they found that December valuation meetings could be difficult. They attributed this change in tone to the fact that fund managersô bonuses were influenced by this valuation. As a result, subsequent valuer interviewees were asked whether any particular meeting was problematic. The issues of bonuses and the use of December valuations by IPD were commonly cited as a motivating factor in client pressure. However, again this perception was not universal. Larger firms did not feel that fund managers were generally motivated in this way. This finding is consistent with the result that client pressure was less significant with the larger practices.

"The thirty first December valuation is considered a big valuation as it goes into IPD"

"There was definite arm twisting exercise by the fund to rack up the figures"

"The fund manager's bonus depends on valuation so they are unwilling to sell below valuation"

"Though the funds are keen on the December valuation they are no better researched"

"Because of IPD December valuations are more important and also investor accounts and bonuses"

"End of year valuations are more important. Total returns are related to personal bonuses."

"The December figures are more important because this figure determines the bonus of fund managers and it is inputted into the IPD"

"Outrageous behaviour among fund managers has become a joke in the market"

"The fund managers are driven by bonuses and IPD measures"

"Fund manager bonuses do not really figure in the meetings"

Such findings imply that December returns should be higher than other months. Moreover, they highlight the issue of self report in interview-based research. No fund manager mentioned the issue of bonuses.

4.10 The impact of new fund managers and valuers

Given that this research suggests that clients can bias valuations, it would also seem reasonable to expect significant changes in valuation when new valuers and/or fund managers are appointed. This question also reflected anecdotal evidence known to members of the research team of changes in fund manager leading to significant changes in valuation. Hence a point addressed in some of the interviews (the question was not put in all the interviews with fund managers) was whether changes in valuers and/or fund managers had any impact on fund performance. Four fund managers stated that they had experience or know of cases where a change in valuer or portfolio manager seemed to influence the valuation ï with a number of respondents suggesting that they knew of rather than had experience of such practices.

"When changing valuation companies, a +/- 1-2% difference in portfolio valuation is expected. However, a change of fund manager produced a 7% change over one month. The market aggravated this."

"The company know of a 7.5% drop in portfolio value when the portfolio manager changed during a medium moving market"

"A new valuer marked a portfolio 20% down. The assets had to be downvalued because there had been ramping of the valuations."

Following a change in valuers ***"there was significant change in valuation. The new valuers took a fresh approach and with a lack of continuous data took a more cautious view using a lower base. They raised the valuations to previous levels over successive years"***

It was not clear whether this arose because the new valuer had different or less information; or because the client was able to exert a different set of influences over the valuer. Very few interviewees used more than one valuer and most of the few that did so had not conducted any kind of controlled comparison of their valuers.

Although a number of the respondents had no experience of taking on new instructions and/or fund managers, the discussions with the valuers suggest that the appointment of new valuers and fund managers does have effects on valuations. Where new instructions were taken on, the new valuers generally could not match existing valuations. One valuer (who felt that client pressure was the exception) gave an example of a new instruction which he had valued at 25% below the previous valuation. Subsequently, at the clientõs request he was removed from the instruction and went through a very difficult period at work. In contrast, the pressure from new fund managers tended to be for lower valuations ï ñNew fund managers will always cause disagreement. They have properties they like and ones they donõt like. They always like to downvalue when they joinò. The incentive in this case is for improved performance from an artificially low base.

4.11 Status of the valuation

It is clear from the above that questions arise about the impartiality of valuation advice. However, there are also significant problems concerning the legal status of a large proportion of the valuation advice. Much of the valuation advice described by the fund managers interviewed appeared to be something less than a formal Red Book valuation. Most notably with portfolio valuers, phrases such as ôconsultedô, ôinformalô and ôdraftô are found throughout the interview notes. Such valuations might emerge from a number of sources not all of which can be regarded as unbiased. For example, reliance appeared not infrequently to be placed upon a "valuation" supplied by an agent introducing the property for sale (who in some cases might also be the portfolio valuer). Conflicts of interest may arise here, although if these informal valuations are used to aid the purchasing process, the valuers could still perhaps be sued for damage if the figure subsequently proves to be an overestimate. It was also apparent that there were different levels of informality ranging from a telephone conversation, a meeting or some input into a report for the authorising body. It is unclear whether such discussions were recorded or minuted in any way.

This issue was also addressed in the discussions with valuers. They expressed concern at the status of informal valuations becoming particularly ónervousô when asked to provide such advice in writing. As a result, the vast majority of such advice was provided verbally. Typically the fund manager would send over a tenancy schedule and basic information about the property, sometimes with the price agreed and seek ócomfortô that the valuer was at ease with the price paid. Generally valuers found it difficult to argue with prices which were óon marketô and where there were a number of underbidders. Problems were more likely where prices seemed high for a property acquired óoff marketô. Although one respondentôs firm had taken legal advice on the issue whilst another opined that ñthere is no such thing as an informal valuationò, the context for the provision of such advice was based on trust, personal relationships and shared perceptions of its limitations. Consequently, most valuers interviewed felt comfortable that issues such as liability and negligence claims would not be a problem.

4.12 Valuation lagging and accuracy

Generally, the fund managers interviewed confirmed that their view was that valuers lag the market and tend to be conservative. This was not seen, however, as a major impediment to investment operations, due perhaps to other ways in which the resulting figure might be influenced.

"Valuations lag the market, thus it is possible to sell and buy above or below valuation and still get good market value"

"Valuations lag the market by about one month"

"Given that there is a valuation lag, it is possible to second guess valuers to make a sale"

"Valuers lag the market or not depending on how you feel about them"

"Valuers lag the market"

"When transactions are slow, valuers fail to capture the top and bottom end of the market"

"The valuers have a tendency to lag but the company is accepting of this retrospection"

5. Implications and Conclusions

The major aim of this research was to identify how valuations influenced the operation of the commercial investment market. This, in turn, raised a number of further questions concerning the use and impacts of valuations and the process by which prices were formed in the investment markets. The research was in two stages and was intended to evolve. The initial research highlighted periodic valuations as a key area in terms of influencing pricing outcomes and that they were, in turn, capable of being influenced by clients. As a result detailed research was carried out into the process by which periodic valuations were produced and for this purpose how they reached performance measurement organisations in their final form.

In particular, the following questions were addressed:

- The methods of appraisal used by owners/managers to inform the acquisition and sale process for investment property and whether valuations mimic those methods?

- Whether valuations influence which properties enter the market and the price at which they are sold? Do they in many cases ‘kill the deal’ or at very least lead to re-negotiation of price?

- Whether there is undue client influence on periodic valuations?

- Whether the process by which periodic valuations are produced raises questions of bias and accuracy in appraisal-based data?

The research included interviews of representatives of 30 organisations, reflecting the institutional ownership and management of the institutional grade property stock and the valuation providers who service them. The owner/managers owned or managed £40 billion worth of property assets.

The examination of the evidence revealed a number of strands to the research.

- market structure of valuation providers;
- the role of valuations in the acquisition and disposal process;
- the effect of valuations on trading;
- the valuation ‘production process’;
- client influence on valuations;
- the impact of new fund managers/valuers ;
- the issue of the status of different valuations; and
- the accuracy of and lag in valuations.

The research suggested that valuers and market participants were using different methodologies to estimate price. The fund manager/owners were carrying out explicit cash flows to determine bids whilst the conventional comparison based approaches are still being used by valuers to determine market value.

The research reveals significant differences in the ability of all but the largest firms to compete to provide periodic valuation services at market fee levels. There are economies of scale in the collection and analysis of market information. The majority of this work is now in the hands of relatively few firms and this raises questions concerning their influence on performance measures such as the IPD Monthly Index and unit pricing.

One of the initial drivers for this research was the anecdotal comments that market lagging valuations were preventing some acquisitions due to prospective performance ñhitsò. Although it appears routine for the portfolio valuer to be consulted informally during the acquisition process, there is little evidence of this advice causing the deal to collapse. Interviewees found it difficult to recall more than a handful of occasions when this had occurred. A more frequent scenario was the use of an óinformalô opinion of value from the portfolio valuer in an attempt to re-negotiate price. The status of this informal consultation is a little unclear and one avenue of future research should be the professional negligence implications of various types of valuation. There was some element of trust that fund managers would never sue which may or may not be misplaced in an increasingly litigious environment.

It became apparent that a more important issue was valuation influence on sales. It was suggested that, for a significant number of managers, offers at less than the previous portfolio valuation were difficult to justify to owners/trustees and conversely, a high offer compared to valuation was information used to support the sale.

This has significant implications for the long running academic and practice debate about valuation accuracy and bias. Studies which have found bias ï interpreted as either conservatism or lagging ï are based on an implied assumption that the sample of valuations and prices is itself unbiased. However, the evidence suggests that these studies are flawed as they are based upon the notion that properties which are sold are a true sample of the prices at which the whole stock would sell. Owners have a choice over which properties they do sell and this choice is influenced by the relationship between price and valuation. The fact that properties sold have a systematic tendency to be at more than valuation is an important conclusion from this behavioural study. As suggested in Crosby, French and Ward (1993), there are óself fulfilling prophecyô effects. Nevertheless, it is important to note that there was still a view amongst fund managers and some valuers that valuations did tend to lag the market.

The final issue raised by the examination of the influence of valuations on trading is the use of the introductory agent to provide the purchase report. Interviewees seemed relatively unconcerned that the purchaser was being influenced by a report prepared by a party whose fee was dependent upon the sale proceeding. The moral hazard issues were countered by the thought that any bias/omission in the report would become obvious during subsequent ownership and the introductory agent would not be trusted again by the purchasing fund, and this information would circulate amongst other funds. It still appears to be dubious practice.

The process by which periodic valuations are produced varied between different valuation providers interviewed. There is no doubt that the end of year December valuation is normally a more comprehensive review of the individual properties than monthly, quarterly and even six monthly valuations. Although some firms claimed a full update of location specific rental and yield information each month, others suggested that monthly adjustments were a general market sentiment change exercise. This would suggest that some óvaluer effortô effects persists i.e. some valuations at certain time periods have less research than, say, end of year valuations. The issue of change to monthly valuations is important. It is very difficult to objectively observe change in any property market on a month to month basis. Valuers exhibited different attitudes to changing valuations varying from the need to have changes proved by transactions to intuitive changes to valuations in response to sentiment in the market place. There is therefore evidence from the interviews that this change is inconsistently approached by valuers. Given the dominance of a few firms doing monthly valuations, the movement of monthly indices is influenced by these inconsistencies.

The final issue raised by this research is client influence. There is no doubt that this does occur and valuations can be influenced by clients. The draft valuation meeting is the most obvious event that enables this to happen. Although it is undoubtedly the case that the exchange of opinions and additional information at these meetings enhances the quality of valuations, there is also evidence that the valuations produced are biased. For instance, the study suggests that the majority of changes made were upwards. Some valuers suggested that end of year bonuses and awards influence pressure to increase valuations. The fact that a number of situations have been identified where valuations were significantly reduced upon a change of valuers or the appointment of new fund managers provides further support. Certainly the current process gives incentives and opportunities for this to happen and the whole area of draft valuations is open to debate.

This research makes clear that periodic performance valuations are partly the product of social processes as well as technical calculations. It would be incorrect to view the process by which valuations are arrived at as a clinical, methodical exercise, conducted in sterile isolation. It takes place in the real world. This is a world full of distracting influences, beset by problems of information quality, quantity and asymmetry. Indeed, an overarching factor is that incentive structures in the production of periodic valuations produce a range of moral hazard problems. This research indicates that these influences and problems distort the valuation process, creating something less than an independently pursued, unbiased opinion.

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Appendix One
Semi-Structured Interview schedule Pro-forma - Investors

Section A : Respondent, Organisation and Incidence of Valuations

A1 What category best describes your organisation?

Insurance Co	[ ]	Pension Fund	[ ]	Property Co	[ ]
Bank	[ ]	Short term/Unit Trust	[ ]	Fund Management	[ ]
Other	[ ]	Please Specify	....		

A2 What is your position in the organisation? ....

A3 Approximately, what is the total value of the property investment or property loan portfolio? Value .... Date ....

A4 Where property is only a part of the total assets in an investment portfolio, approximately what is the percentage of assets in property?
é é é é é é é é é .%

A5 Approximately, how many properties are in the portfolio? ....

A6 What is the approximate breakdown by property type (by capital value)?

Offices é é .% Retail é é .% Industrial é é .% Other é é é .%

A7 For what purposes do you commission external valuations?

Financial Statements : Yes [ ] No [ ]
Performance Measurement : Yes [ ] No [ ]
Advice on Sale : Yes [ ] No [ ]
Advice on Acquisition : Yes [ ] No [ ]
Loan : Yes [ ] No [ ]
Portfolio Restructuring : Yes [ ] No [ ]
Other : Yes [ ] No [ ].
(please specify the ótherô role/s) ....

A8 Approximately, what proportion of the total portfolio is valued in each time period specified below, by capital value:

	Internally	Externally
Every month?	...........%	...........%
Every 3 months?	...........%	...........%
Every 6 months?	...........%	...........%
Every year?	...........%	...........%
Every 2 years?	...........%	...........%
Every 3 years?	...........%	...........%
Every 5 years?	...........%	...........%
Other time period		
(Please specify)	...........%	...........%

A9 Approximately what proportion by capital value of the property portfolio is subject to a transaction each year é é é .%

Section B : The Acquisition and Sale Process

B1 What is the organisationôs overall strategy in relation to identifying property acquisition and sale opportunities?	
B2 More specifically, what part do previous valuations for other purposes play if any in identifying sale opportunities?	
B3 At what point in the transaction is a view formed on the purchase price/sale price that would be acceptable?	
B4 Is an internal or external valuer consulted at any point in the transaction?	
B5 If a valuer is consulted, what are the reasons? For example, (a) to advise on price before verbal agreement (b) to advise on validity of price after verbal agreement of price (c) to advise on the loan (d) to advise on the likely year end performance measurement valuation	
B6 Are there any implications of a valuer not confirming a purchase or sale price.	

Section C - Case Studies of Valuation Influence

C1 Does your organisation abort sale or purchase agreements/negotiations because of the external valuation of the property?

Always [ ] Usually [ ] Occasionally [ ] Never [ ]

C2 Does your organisation amend sale or purchase agreements on account of the external valuation of the property?

Always [ ] Usually [ ] Occasionally [ ] Never [ ]

C3 If the answers to either of the above are <u>not</u> never, please can you describe the various circumstances encountered.	

Semi-Structured Interview schedule Pro-forma - Valuers

Interview Number

Interviewers

Section A: Respondent Details and Valuation workload.

How many valuers do you employ?

What is the approx. total value of property appraised in a typical year?

How much of your valuation work related to PPV?

Do you consider this to be a profitable area?

Do you generally act as external or independent valuers?

Typically are you instructed and remunerated by the fund manager or representative of trustees?

For what purposes are valuations commissioned?

	Regular clients	one-off clients
Financial statements	[ ]	[ ]
Performance Measurement	[ ]	[ ]
Advice on Sale	[ ]	[ ]
Advice on Acquisition	[ ]	[ ]
Loan	[ ]	[ ]
Portfolio Restructuring	[ ]	[ ]
Unit Pricing	[ ]	[ ]

For periodic portfolio valuations

What proportion are monthly/quarterly/biannual/annual/other?

With current instructions is the valuer always aware of the previous valuation?

Does the same valuer generally carry out the valuation period-by-period?

Describe the process of the periodic valuation in your organisation in terms of

Level of research (variation according to valuation)

Consultation with óin-houseô staff

Number of site visits

Timing

Describe the process by which you present your valuations to clients in terms of

Timing

Presentation of draft

Number of meetings

Tone of meetings

Typical level of disagreement

Nature of disagreement
Outcome of disagreement

How are differences in interpretation resolved?

What proportion of draft figures would be <u>challenged</u> typically?

To what extent does this vary between clients?

What proportion of draft figures would be <u>changed</u> (in response to ‘challenge’) typically?

Do you consider that valuations lag the market? If so, why?

Do you consider that valuations fully capture market movement?

In sub-annual valuations, do certain periodic valuations stand out as more important than others?

Have you noticed significant changes in value when you have taken on a new instruction?

In what direction has this been?

Have you noticed significant changes in value when a new fund manager has been appointed?

In what direction has this been?

Are you always aware of the previous valuation on taking on a new instruction?

When valuing an individual property for purchase:

In your capacity as independent portfolio valuer, how and when are you consulted in the acquisition process

Are you consulted for all acquisitions?

What does your input consist of?

Verbal discussion.
Approval to trustees.

Do you provide informal valuation advice?

How is this recorded?

Is it verbal or in writing?

What do you consider to be the legal status of such advice? Have you any concerns about the legal status of such advice?

What weight do you place on the asking price and/or the price being offered by your client?

Are you generally informed of the agreed transaction price?

What weight do you place on the agreed transaction price?

How often do you disagree?

Have you ever forced transactions to be aborted?

To what extent is there scope for compromise?

How often does this happen?

Loan Valuations.

Client influence.
Source of instructions/information.
Incentives offered by borrowers/brokers.
Discussion of valuations before final report.

Appendix Two

List of organisations who took part in the research

Allsops
Boots Properties Plc.
CB Hillier Parker
CCLA Investment Management
Drivers Jonas
DTZ Debenham Tie Leung
FPD Savills
Guardian Properties
GVA Grimley
Healey and Baker
Henderson Investors
Insignia Richard Ellis
Jones Lang Lasalle
Mercury Asset Management
Morgan Grenfell Property Asset Management
Nelson Bakewell
NIA GoochWebster
Norwich Union
PDFM Ltd.
Royal Sun Alliance
Schroder Properties Ltd.
Shell
Slough Estates Plc
Standard Life
Strutt and Parker
Threadneedle Property Fund Management Ltd
Unilever Superannuation Scheme
University Superannuation Scheme