Session 4

Basics of Valuation

Definition of Valuation

- Valuation is the act or process of developing an opinion of value.

  As per The American Society of Appraisers (ASA) definition of valuation may include any of the four following operations, independently or in combination:

1. Determination of the value of property.

2. Estimation of the cost of (a) production of a new property, (b) replacement of an existing property by purchase or production of an equivalent property, or (c) reproduction of an existing property by purchase or production of an identical property.

3. Determination of the nonmonetary benefits or characteristics that contribute to value; the rendering of judgments as to age, remaining life, condition, quality, or authenticity of physical property.

4. Forecast of the earning power of property.

Cost, Price and Value

- Cost = It is *used in relation to production, not exchange.*
- It is the price actually paid, or amount required to produce.
- Price = the amount a particular purchaser agrees to pay and a particular seller agrees to accept <u>under the circumstances surrounding their transaction</u> (the amount asked, offered, or paid).
- A price, once finalized, refers to a sale or transaction price and implies an exchange. In other words, price is a fact.
- Value = an estimate of price, an economic concept,
  <u>not a fact.</u>

Definition of Values

of Market Value, (IVS definition):

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

conceptual framework behind the definitions

- "estimated amount" = an estimate and opinion, not an actual price.

- "property should exchange" = the assumption of a likely market transaction.

- "on the date of valuation" = the valuation is time-specific, as of a given date, and assumes simultaneous exchange and completion of the contract of sale.

- “willing buyer” = the buyer is motivated but not compelled to buy.

- “willing seller” = the seller is neither over-eager nor compelled or forced, but is motivated to sell at whatever price is available in current market.

- “an arm’s-length transaction” = there is no relationship between buyer and seller that would affect the sale price.

- “proper marketing” = the property has been exposed to the market in the most appropriate manner, and for an appropriate period.

- “knowledgeably” = reasonably informed about the property and the market.

Fair Value (IFRS definition)

- This IFRS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price).
- Conceptual framework behind the definitions
  - “orderly transaction”:
    - A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities;
    - it is not a forced transaction (eg a forced liquidation or distress sale). Similar with “proper marketing’’ of IVS definition.

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- Exit Price:
  - Under the fair value standards, fair value is based on the exit price (the price that would be received to sell an asset or paid to transfer a liability),
  - not the transaction price or entry price (the price that was paid for the asset or that was received to assume the liability).
  - Conceptually, entry and exit prices are different. The exit price concept is based on current expectations about the sale or transfer price from the perspective of market participants.

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- "*Market Participant*": Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:
  - They are independent of each other, ie they are not related parties
  - They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction
  - They are able to enter into a transaction for the asset or liability
  - They are willing to enter into a transaction for the asset or liability
  - Measurement date: the valuation is time-specific, as of a given date

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- Fair Value (IVS definition)
  - The amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties, in an arm's length transaction.
    - Fair value represents the price that would be reasonably agreed between two specific parties for the exchange of an asset.
    - the asset is not necessarily exposed in the wider market and the price agreed may be one that reflects the specific advantages (or disadvantages) of ownership to the parties involved rather than the market at large.

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- Equitable Value/Worth (IVS definition)
- Investment Value/Worth (IVS definition)
- Synergistic Value (IVS definition)

Purpose of Valuation

- The purpose of valuation can be:
  - Sale purpose
  - Purchase purpose
  - Loan purpose
  - Insurance purpose
  - Financial statement purpose
  - Merger & acquisition purpose
  - Compensation purpose
  - Tax purpose
  - Litigation purpose
  - Etc.

Valuation Approaches

- Cost Approach (Depreciated Replacement Cost)
- Sale Comparison Approach
- Income Approach
- Profit Method
- Residual Valuation Approach

The Concept of Value

A discussion of the different concepts of 'Value':