Social Housing Valuation Methodology

The affordable housing sector is unique in that it is the only type of property asset to have its own basis of valuation. It is also unusual in that the terminology used for referring to the other, more commonly recognised, basis of valuation, is different. In this brief commentary, we explain the two main bases used for assessing the value of tenanted social housing properties; explain how these are applied in practice; and comment briefly on how one of them might change in the near future.

The basis of valuation unique to affordable housing is Existing Use Value for Social Housing (EUV-SH). A "basis of valuation" means a definition, or a set of assumptions, laid down by RICS as the valuers' professional body and regulator which provides mandatory, best practice standards for the valuation profession. This means that valuers can only apply a basis which is defined by RICS and published in what is widely known as the Red Book.

Clearly, the assumptions a valuer is required to make will determine the nature of the opinion of value he or she forms and the figure reported. It is essential to bear in mind that all opinions of value are just that – opinions. Valuation is not a precise science.

EUV-SH has been in use for over 25 years, since local authorities began transferring their housing stock in privately-financed transfers. EUV-SH was devised specifically for this purpose. In essence, the definition is built upon the principles of Market Value (see below) and assumes a hypothetical sale, by either a mortgagee in possession or a Registered Provider (RP), to another RP, on the strict assumptions that: the stock will continue to be let at affordable rents in perpetuity; will be managed in accordance with the regulator's requirements; and that any void properties will be re-let and not sold with vacant possession.

It therefore reflects the constraints of a regulated sector, including the levels of rent at which properties may be let, which must remain affordable. It typically, therefore, produces opinions of value which are considerably lower than Market Value with vacant possession (MV-VP). The difference is greatest in areas of the country with high market values and market rents; and smaller in areas of the country with low market values and rents. Indeed, in extreme conditions, with failed property markets, there are areas of the country where there is little, if any, identifiable difference between EUV-SH and Market Value (as explained below). However, in high value areas, such as parts of London, EUV-SH might be as low as 20% of MV-VP.

The established methodology for arriving at an opinion of EUV-SH is a discounted cash flow, which allows the valuer to capture explicitly the many variables affecting the letting, management and operation of social housing; and to set these out transparently over the long term. However, this is not the only or prescribed method of arriving at such a valuation and valuers should also have regard to comparable transactions (where evidence is available); the relationship between EUV-SH and Market Value with vacant possession; and both gross and net yield.

The second basis of valuation is Market Value, albeit this is generally referred to in the sector, where used for loan security purposes and applied therefore to tenanted properties, as "Market Value, subject to tenancies" (MV-T, or sometimes MV-ST or MV-STT).

There is no published definition of MV-T in the RICS Red Book. This because one is unnecessary, as it is essentially Market Value. When a valuer provides an opinion of MV on any residential or commercial property asset, it is normally the case that he or she reflects the property as it is found, including any leases or tenancies in place. Thus, for example, a valuer looking at a retail property let to a tenant would not (unless specifically instructed to do so) ignore the lease, but would value subject to that tenancy. Social housing is no different in principle.

MV-T differs from EUV-SH in that the purchaser is assumed to be operating outside the regulated sector and is therefore free to approach the properties in a more commercial way.

The hypothetical sale is assumed to be by a mortgagee in possession (or acting upon an enforcement); and, since lenders are not regulated by HCA, they would not be bound by the same regulatory standards as bind RPs. Similarly, in the great majority of cases (unless there are binding restrictions on title) a purchaser from a mortgagee in possession would similarly not be so restricted and would be able, in principle, to operate the stock in a commercial manner.

This would mean raising rents to market levels; managing and repairing in line with necessary commercial standards (but not necessarily those expected of an RP by the regulator) and selling voids as they arose to the extent the local market would bear. A combination of raising rents to market levels – typically over a three to five year period, but sometimes more rapidly, where the difference between affordable and market rents is low - and sales with vacant possession, tend to drive out a significantly higher value. For example, this could be two or even three times EUV-SH, although there will be instances where, as noted above, the difference is much less.

Again, the established methodology is a discounted cash flow, which is generally recognised as being the only way in which a valuer can capture the necessary variables. However, this is not prescribed by RICS and is simply a matter of accepted best practice.

Moreover, a valuer should have regard also to transactional evidence where available of the sale of tenanted housing portfolios; the relationship between MV-T and MV-VP; and, again, the gross and net yield.

Lastly, we touched above on possible changes to EUV-SH. The government has recently paved the way for a partial deregulation of the sector through some of the measures in the Housing & Planning Act 2016. These are the government's response to a decision in the autumn of 2015 by the Office for National Statistics, which held that RPs should be treated as part of the public sector for the purposes of the government's accounts and therefore their private debt should sit on the government's balance sheet.

The ONS arrived at this decision because of the various ways in which government has influence over RPs through the regulation of the HCA. In order to get that decision reversed, some of those levers of control have to be released or removed. That is likely to take place through secondary legislation early in 2017, which will give force to the measures in the H&PA 2016.

These will include removing the need for Regulator's consent on asset disposals, allowing RPs greater freedom to manage their own assets as they see fit. It follows that a basis of valuation which expressly rules out disposals; permits only re-letting; and refers to the Regulator's consent being necessary, will be out of date and look increasingly artificial. It will also become out of step with available market evidence from stock rationalisation transactions between RPs. It may well therefore be appropriate for RICS to revise the definition, although no firm decisions have been taken on this as yet.

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