

# Social Housing Valuation Methodology

## Introduction

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;
- how these are applied in practice; and
- how a third basis of valuation is now available to lenders, reflecting the current legislative and regulatory framework within which RPs operate.

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.

## Existing Use Value for Social Housing (EUV-SH)

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.

The definition was recently updated in the latest edition of the Red Book, which came into effect in January 2019, to reflect regulatory changes arising from the Housing & Planning Act 2016 (discussed in more detail below).

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 cashflow, 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.

### **Market Value Subject to Tenancies (MV-T)**

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). The assumed approach behind this basis of valuation would only be available to a lender acting upon an enforcement of its security and is therefore only applicable to loan security valuations.

There is no published definition of MV-T in the RICS Red Book. This is 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 Regulator of Social Housing (RSH), 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 cashflow, 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.

### **Market Value, Subject to Special Assumptions**

Thirdly, funders now have the option of instructing valuers to value on the basis of Market Value, but subject to Special Assumptions, which are explained below. As readers will be aware, the Housing & Planning Act 2016 introduced a partial deregulation of the sector as a means of Government reversing the decision taken in the autumn of 2015 by the Office of National Statistics, which held that RPs should be treated as part of the public sector for the purposes of accounting for Government debt. This decision was reversed by a legislative release of various levers of control previously held by Government over RPs. These included the ability of the Regulator to withhold consent for disposals including the charging of assets for loan security purposes.

RPs now have the power, in law at least, to manage their assets in the way they see fit, including disposal of either tenanted or vacant, either within or outside of the sector. Whilst there may well be regulatory consequences from such behaviour, the Regulator has now power to prevent it.

Accordingly, experience in the market since the introduction of these measures on 6 April 2017 shows that more active asset management is taking place and, critically, that transactions in the stock rationalisation market of tenanted assets bought and sold between RPs include some assumptions of future sales with vacant possession.

This market evidence is a powerful driver for a different approach to loan security valuations and indeed for valuations undertaken for stock rationalisation purposes. Leading valuers have recently confirmed with RICS that funders may instruct a valuation on the basis of Market Value subject to Special Assumptions agreed between the lender and the valuer; but which would, in essence, restrict the market for the hypothetical transaction to that amongst RPs and similarly bind any future sale.

This would reflect the operational and trading freedoms that RPs now enjoy but exclude the wider, commercial market. At the time of writing, it remains to be seen whether lenders adopt this new approach although it is already gaining traction in the stock rationalisation market.

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