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B2B: Property Valuations in an Uncertain World

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I have been asked by a number of people to contribute a more technical article on valuations, specifically how you approach them when there are wide fluctuations in the local currency and traditionally valuations have been expressed in hard currency.

We are potentially on the cusp of a significant change in the market with the very real possibility of commercial property rents switching to predominantly being denominated in rubles, whereas traditionally they have been denominated in hard currency and valuations of quality commercial property assets have likewise been expressed mostly in U.S. dollars and sometimes in euros.

This throws up a number of issues and questions just a few of which I lay out below:

How do you value property when short -term discounts are being offered and what period of discount is it reasonable to expect? How do you treat currency corridors for hard currency leases?

When do you treat these discounts as becoming permanent?

Is a ruble corridor on a hard currency rental rate the same as a ruble lease?

What discount rate should you use on a ruble income when the CBR policy rate is 15%, government 5-year ruble bonds are trading at 14.3% (the risk-free rate?) and the cost of ruble debt is typically 20% or higher? 20%? 25%? More!?

Are higher policy rates short term or can they become entrenched?

If the market switches to ruble rents under current conditions it is almost impossible to argue for property valuations that are at rates of return below the risk-free rate. Why would a rational investor choose a property asset over a government bond if there is a greater return on the bond? Logically, this would lead to a massive destruction of value across the board. Exit values would evaporate, investment activity and development would stop and basically all debt, whether in rubles or hard currency, would become both unaffordable and technically delinquent. The market as we know it would become unworkable.

How would the banks react to this new reality?

This is all very well in theory ... but what happens in practice you may ask ...

In the longer term the market would correct and the lack of development activity that will result from the current conditions will restrict supply in all sectors and the market will return to balance when the economy starts to recover. However — how long is the long term and what happens in the short term?

Today the market is dislocated, or more accurately non-functional, but in any market there is a level at which a willing buyer and a willing seller would transact. However, willing sellers are absent from our market today and buyers become opportunistic. Rational price setting is not occurring and therefore valuation becomes a theoretical process. We must have regard for what is happening in the broader market but we must always remember that property is a long-term investment asset and a store of value.

What should be abundantly clear is that ruble denominated incomes will require significantly higher discount rates as you cannot get around the fact that the cost of rubles are higher. So are the opportunity costs and so are the risks.

Plainly, it is somewhat counter-intuitive there should be serious consideration of moving to a ruble-denominated market when, ordinarily, times of stress would result in a flight to safe havens and stable currencies!

I have, of course, not answered the original question: How do you value property in the current market? That is on purpose. We know how to do it and how to produce robust valuations in which all parties have faith — but it is no longer magic when everyone knows how to do it!

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