Valuation and financial reporting for properties under development

Real Estate, Hospitality and Construction Development Roundtable
2017
Dear real estate professional

With the significant growth of development activity across the Greater Toronto Area and, to some extent, other markets across Canada, real estate developers, owners, their boards and their investors are increasingly focused on the way they approach the valuation of their development property portfolios.

In September 2017, EY facilitated a roundtable discussion hosting a group of approximately 50 senior finance and development executives from a broad range of real estate-focused entities. The session gave attendees the opportunity to share and gather insight on the various valuation methods and polices adopted in the development sector.

All participants’ names have been kept confidential, and their responses were only used in combination with others to protect anonymity.

EY would like to thank those who attended the Development Forum Roundtable.

If you have questions about the Development Forum Roundtable, please reach out to your EY representative or any of the contacts listed at the end of this report.

Zach Pendley
Partner,
Transaction Advisory Services
Real Estate, Hospitality
and Construction
Toronto, ON

Stephanie Lamont
Partner,
Assurance Services
Real Estate, Hospitality
and Construction
Toronto, ON
With rapid changes in the market, it is increasingly challenging to use cost as a proxy for fair value.
Fair value adoption framework
Properties under development

The Greater Toronto Area is no stranger to the development market. The City of Toronto reported 27 residential land transactions in Q2 2017 and Urban Toronto issued a report in spring 2017 identifying approximately 840 development projects in the GTA. With historically low vacancy rates in both the commercial and residential real estate spaces, land values continue to appreciate.

With growing demand and supply constraints on both development land and institutional or investment grade assets, real estate owners and developers are now re-evaluating the highest and best use to extract value. This potentially leads to the redevelopment of various assets.

The approach to valuation is typically unanimous across the sector during the property (land) held for development (PHFD) and income-producing property (IPP) stages. However, the fair value of properties under development (PUD) can be more difficult to value. As such, fair value measurement of PUD is an area receiving particular focus from issuers and auditors.

Sources: Altus InSite Investment Trends Survey, Realnet, MCAP, UrbanToronto, CBRE.

More than half of the attendees acknowledged having a formal guideline (varying degrees of flexibility) when determining when to transition from cost approximating fair value to a cash flow or yield method of determining fair value.
At what stage do you move away from cost approximating fair value?

<table>
<thead>
<tr>
<th>Pre-leasing status</th>
<th>50%</th>
<th>75%</th>
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<tr>
<td>Construction status</td>
<td>50%</td>
<td>90%</td>
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Early adoption may occur if the developer is under a fixed cost contract with the contractor and if the asset is substantially pre-leased.

Some groups have guidelines in place that assess either percent of gross or net leased area or percent of revenue to measure pre-leasing status, especially on retail properties.

Generally, rather than following strict policies, attendees suggested more flexible guidelines are common in practice, and the time of transfer varied based on the type of asset and the market. For example, in a single-tenant building with leasing in place before construction commenced, some would likely not wait until 50% construction is completed to switch to a yield approach as a market participant would attribute value to the tenant.

Disclosures surrounding asset type, development status, various phases and staging are considered important and helpful for users. For example, office towers with longer-term pre-signed leases would have more certainty than multi-family assets, thus earlier adoption may be warranted. Predictable future revenue in the form of pre-leasing activities is a key indicator for commercial properties. Another consideration is the unit of measure for multi-phase, multi-type large-scale developments. It may be difficult to bifurcate the value of a project by building, phase or asset type. Although challenging, leading practice would suggest to value these multi-phase projects at a bifurcated level, with a value assigned to each phase. The types of projects are common in pension funds, and generally the in-progress phase is valued using the income approach, with upcoming phases valued using cost approximating fair value.

A majority of respondents indicated that they would typically move from cost to a yield or cash flow method of valuation upon pre-leasing and construction completion over 50%.

Late adopters. Some attendees expressed the view that the switch to a yield/cash flow method should be closer to when the property is fully operational. As a result, these sometimes resulted in significantly large fair value bumps upon transfer.
Challenges in the measurement of the fair value of properties under development means this is an area on which issuers are particularly focused.

Combatting challenges

When repurposing an asset, what are some of the challenges faced in valuation and how are they addressed?

- One of the biggest challenges is finding the neutral or gradual fair value increase through development – avoiding the “hockey stick” effect on completion that may not accurately reflect value for investors and stakeholders.
- Some attendees considered this to be an expected pattern in development, as the risk often dissipates fastest towards completion of the development.
- Some attendees said the accurate assessment of fair value on the date of transfer is challenging. The decision to repurpose the asset indicates a potentially conflicting view of the highest and best use – its existing use is presumably viewed as containing a flaw (hence the decision to repurpose). There is presumably an assumption the current value would be expected to erode over time, whether through lower occupancy or capital requirements.
- Some attendees acknowledged incorporating development yields/risk into a fair value assessment would be an area of specific judgment and subjectivity.
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While timing of the adoption of a yield method may differ for each asset type and market, industry participants will generally refer to leasing (intent vs. executed leases), passage of time, and construction progress and completion to guide decision-making.

A small group of participants would seek third party/external valuations. The majority indicated growing interest in having a dedicated internal development valuation expert.

The degree of collaboration and the knowledge sharing process between development/investment teams and the finance teams is an important consideration in determining a reliable fair value estimate (whether using cost as a proxy or a yield method).

The uniqueness of each development project adds challenges to finding comparable indicators of value and risk assessment.
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Contacts

Zach Pendley
Partner, Transaction Advisory Services
Real Estate, Hospitality and Construction
Toronto
+1 416 943 5465
zach.pendley@ca.ey.com

Stephanie Lamont
Partner, Assurance Services
Real Estate, Hospitality and Construction
Toronto
+1 416 943 5321
stephanie.lamont@ca.ey.com

Tim Buss
Senior Manager, Assurance Services
Real Estate, Hospitality and Construction
Toronto
+1 416 932 5936
tim.buss@ca.ey.com