EUV-SH and MV-T Valuations – Impact of Covid-19 Crisis

This joint statement has been prepared by JLL and Savills to consider and explain the impact of the Covid-19 crisis on valuations of affordable housing stock. We address valuations on the bases of both Existing Use Value for Social Housing (EUV-SH) and Market Value subject to tenancies (MV-T), prepared for both loan security and balance sheet purposes.

Our statement is intended only to give guidance as to the principles on which our valuations are now being prepared, in the light of the economic and financial considerations influencing our valuation assumptions. It is not intended to give definitive advice in relation to any particular valuation, nor necessarily to apply universally to all valuations. Specific professional advice must be sought in each case and no formal responsibility can be accepted for any of the contents of this statement.

Our statement is divided into five sections, as follows:

1. Valuation practicalities.
2. The housing market.
3. EUV-SH valuations.
4. MV-T valuations.
5. Conclusions.

1. Valuation Practicalities

It is not possible under the current restrictions imposed by Government to carry out inspections of any properties or sites. Both firms ceased to conduct internal inspections on 16 March and, following the announcement of lockdown, stopped external inspections from close of business on 23 March. This is in line with both firms' internal policies and with RICS guidance and is therefore common across the profession.

We are therefore conducting all valuations on a desktop basis. Desktop revaluations of stock already charged and (in most cases) already familiar to the valuer are well understood in the social housing sector and widely accepted. However, the same approach may also be applied, and is currently being so, to valuations for new charging and re-valuations of existing charged properties where there is a change of valuer.

As valuers, we are governed by RICS, including the Registered Valuer scheme, and by the Red Book. The Red Book provides for valuations to be carried out and reported with "restricted information". This refers to information about the property or properties, as opposed to a lack of market activity (see below).

Under the current restrictions, it is not possible to conduct inspections and, where properties have not previously been seen by the valuer or have not been seen for a few years and would therefore normally be due reinspection, this would constitute restricted information. Some of a valuer's other, normal requirements may also not be available, such as environmental reports, reports on title or the results of local authority searches.

In such cases, the valuer's report must state clearly what information has been made available and what has not been provided. A report may also make clear where steps will be taken in the future to remedy those deficiencies – for example, through inspections, when restrictions are lifted. That is a matter for agreement in the valuer's instructions.

Please note that a valuation on the basis of restricted information should not be given for accounts purposes. Valuations which are to be used in Financial Statements will require additional information, otherwise there is a risk of an audit qualification if material to the Financial Statements as a whole.

In our joint experience, most lenders are understanding and accepting of the need to value in some instances with restricted information, provided that it is agreed as part of their instructions and stated transparently in the report.

Separately, all valuations are currently being reported subject to a material uncertainty clause (MUC). This is true across all asset classes in both commercial and residential property and is common across all major firms, on the basis of RICS guidance. It is important to emphasize that the use of an MUC remains a matter for the individual valuer to decide which, in practice, a policy decision taken by each firm. Regular discussions are taking place between the major firms and the RICS, and all firms are currently aligned that such clauses are necessary and should properly be applied to valuations. However, the position will be kept under regular review, especially in markets that continue to see some transactions.

The wording of the MUC has been published by RICS, as guidance, and should appear as follows:

> ***Material valuation uncertainty due to Novel Coronavirus (COVID-19)***
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> *The outbreak of the Novel Coronavirus (COVID-19), declared by the World Health Organisation as a "Global Pandemic" on the 11th March 2020, has impacted global financial markets. Travel restrictions have been implemented by many countries.*
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> *Market activity is being impacted in many sectors. As at the valuation date, we consider that we can attach less weight to previous market evidence for comparison purposes, to inform opinions of value. Indeed, the current response to COVID-19 means that we are faced with an unprecedented set of circumstances on which to base a judgement.*
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> *Our valuation(s) is / are therefore reported on the basis of "material valuation uncertainty"' as per VPS 3 and VPGA 10 of the RICS Red Book Global. Consequently, less certainty – and a higher degree of caution – should be attached to our valuation than would normally be the case. Given the unknown future impact that COVID-19 might have on the real estate market, we recommend that you keep the valuation of [this property] under frequent review.*

The MUC is currently a necessary part of responsible, professional reporting, to alert the reader of the report and any party relying upon it to the fact that the valuation is reported in unusual market conditions. In particular, since the onset of the crisis in the UK in early March we have experienced unprecedented volatility in stock markets and the financial sector, in Government policy and therefore in property market conditions. We are, genuinely, in uncharted territory, and all working under conditions in which the transaction of property, whilst not impossible, is certainly materially more difficult than it has ever been.

There must, therefore, be greater uncertainty as to the value which any property asset – including a portfolio of social housing – would change hands in the hypothetical sale envisaged by the valuation definition, at any current date of valuation. The MUC rightly alerts the user of the report to that fact, but is not intended in any way to suggest the valuation cannot be relied upon, nor that it is not as accurate as can be reasonably determined. There has been some misreporting of the implications of the MUC in the press, in relation to commercial valuations and this statement is therefore of pivotal importance.

The MUC should be accompanied by appropriate commentary, which explains the valuer's rationale for his or her approach and assumptions. These aspects are discussed in Sections 3 and 4 below.

2. The Housing Market

There are very few transactions taking place in the housing market, whether sales or lettings, under the current restrictions and whilst there is so much financial uncertainty affecting both banks and consumers. Our expectations are that transactions will be down over the course of 2020 by between 40% and 50% with particular impact in Q2, during lockdown. A normal year would see about 1.2m housing transactions so this could be down to around 600k.

There is a close correlation over the last 30 years between the level of housing transactions and house prices across the market as a whole. When the number of transactions falls significantly, so house prices fall; similarly, when something triggers a fall in house prices, transactions turn down rapidly thereafter. At the date of writing, there is no empirical evidence that house prices are already falling, but it seems likely that house prices will fall during the remainder of this year and that should be reflected in any short-term assumptions around house price inflation.

Whilst there are very few sales, there are also very few new lettings. The overwhelming majority of tenants whose tenancies expire are choosing to renew because it is virtually impossible to move at present. Renewals are generally at the same rent and potential evidence of increases is therefore being lost.

Moreover, many people across the economy are suffering reductions in income as a result of lockdown or of worsening trading conditions for their businesses, and consumer confidence is at a low ebb. Government has given residential tenants some latitude in pausing rent payments and other are agreeing reductions with landlords. We consider that there are greater risks around rent collection and rental growth at the present time and these should be reflected in valuation assumptions in the short term.

However, both firms take the view that we expect no net loss in either forecast GDP growth or HPI over a five-year period from 2020-2024 – we expect to end up in the same place, but via a different path in the short term. The housing market and the economy are closely linked. In the early stages of the pandemic, a V-shape was anticipated, lasting around three months and resulting in house price falls of around 5%. However, as the crisis has unfolded the prospect of a more gradual economic recovery over 6–9 months looks increasingly probable and house prices could therefore fall further, by up to 10% in total. Clearly, Government decisions on easing the lockdown will have a material influence on this course of events. We expect the housing market to recover quite strongly driven by pent up demand and quite probably by Government policies to incentivise both demand and supply, in Q3 – Q4 onwards.

3. EUV-SH Valuations

We expect EUV-SH values of social housing to hold up well. The following paragraphs explain why we take this view, which we appreciate is particularly important around financial year ends at 31 March 2020.

In terms of adverse impacts on social housing, we have identified the following:

- rent arrears are generally increasing as a result of tenants experiencing financial hardship;
- voids are increasing, albeit marginally, particularly (sadly) in the care and sheltered housing sectors. RPs are unable readily to re-let properties, but equally tenants will find it very difficult to move out; and
- despite recent LHA reforms (see below), there is a heightened risk to the proportion of rent not supported by housing benefit.

On the positive side, however, RPs are implementing a number of measures which mitigate and offset the above factors. These include:

- management costs are being pared back as a result of activities being restricted;
- major or planned repairs and component replacements are being delayed to 2021 or beyond, with a consequent marked reduction in capital expenditure which in some organisations will be at least 50% this year and, in some cases, more;
- non-urgent, non-health and safety related works are also being delayed including some cyclical maintenance and external decorations; and
- Government support for incomes through its furlough scheme is also a positive underpinning of earnings and therefore rental income.

On balance, we consider that the mitigation measures evident in the sector are sufficient to address any loss of income and increase in risk, such that EUV-SH values for the vast majority of stock are unaffected. Values as at 31 March generally also benefit from rent increases which, in our experience, all RPs are applying and therefore gross rental income is higher than at the same time last year.

4. MV-T Valuations

MV-T valuations may show modest falls of up to 10%, depending on local circumstances, during the crisis period and effectively for the remainder of the year. In essence, in areas of low house prices, the impact will be less; conversely, in areas where high house prices make the valuation more sensitive, the impact will be greater.

We take this view for the following reasons:

- as set out above, we expect house price growth this year will be negative, driven by sharply reduced transactions, before recovering strongly in late 2020/early 2021;
- in a stagnant market operating under severe restrictions, we would not expect investors to be relying on sales income until late 2020/early 2021;
- there will be no growth in market rents this year and growth next year will also be suppressed as the economy and labour market recover;
- we consider that there will be higher risk on rents and rent collection, for the reasons given above;

- however, on the upside, investors would have to defer some capital expenditure from year 1 to later years, for the reasons given above;
- the increase in the housing benefit element of universal credit to cover at least the lowest 30% of market rents in local areas will be helpful to underpinning income; and
- investors' motivations are likely to swing back more to yield in the current market (rather than buying portfolios for house price growth) and this may have a bearing on achievable values.

5. Conclusions

From a valuation perspective, the social housing sector remains generally in good financial health. Compared with the commercial property market, with widespread tenant problems, rental income is remarkably robust and any increases in arrears or voids are marginal. Banks are, in our wide experience, being understanding and supportive both of their borrowers and of the constraints imposed upon valuation processes at present.

Moreover, as has been demonstrated by three recent bond issues which have been heavily over-subscribed and keenly priced, and by transactions which have completed in the stock rationalisation market during the crisis period, there has been no reduction in investor demand and a willingness on the part of other RPs to transact and to do so at prices agreed pre-crisis without reductions.

We can therefore take a great comfort, as valuers from this transactional activity in reaching the conclusions set out above and in continuing to report values for both loan security and balance sheet purposes, with reliance, in the confidence that they are robust.

To reiterate, we are not seeing any significant reductions in EUV-SH valuations, whether at 31 March or subsequently, and we expect this to continue. MV-T valuations may show modest falls of up to 10%, depending on local circumstances, during the crisis period and effectively for the remainder of the year. This represents our views at the time of writing, but we are in a rapidly changing situation where unanticipated swings in circumstances and sentiment can occur.

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29 April 2020