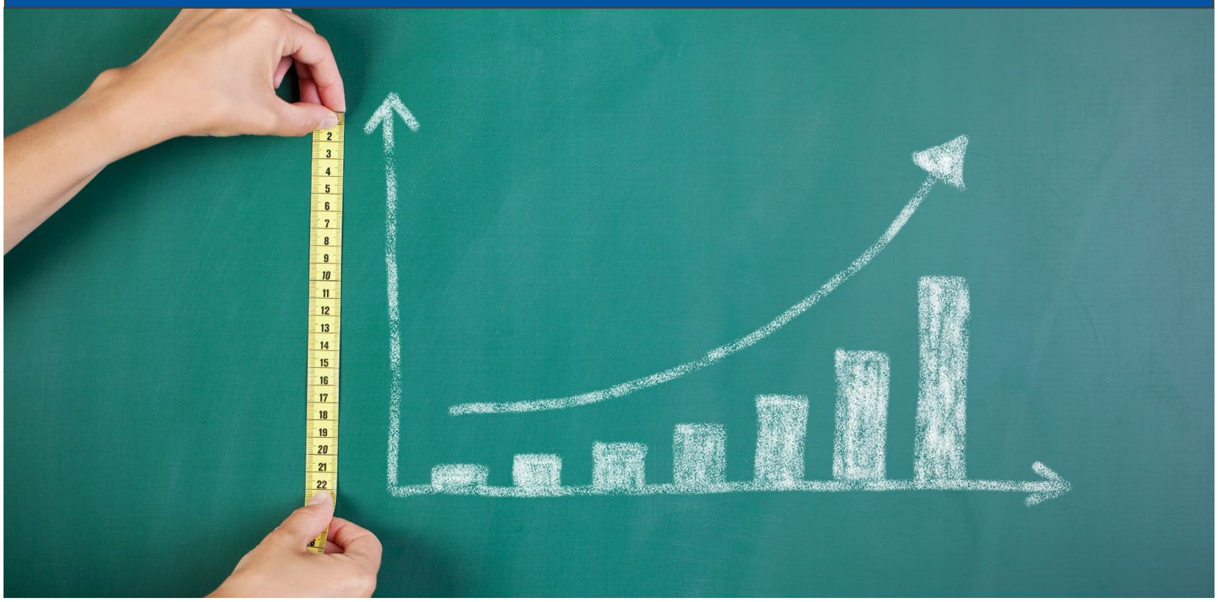
Dennis Webb's
Multidisciplinary Guidance & Insights Newsletter #6

Subscribe

In Defense of the Income Approach



The income approach is ubiquitous in both business valuation and real estate appraisal. Its assumptions are transparent, its methodologies well-established, and its results can be readily evaluated by the client. Still, in spite of its usefulness the approach has, from time to time, generated intense criticism from the bench and elsewhere. Some detractors have even gone so far as to suggest that forward-looking models should not be the province of appraisers, as their use of such models is more like "speculating" than valuing. I disagree. Strongly. Thus, this short article.

What is the valuer's job, anyway?

The valuer is an observer and interpreter of markets. This is true regardless of whether a market is active or almost nonexistent.

Active markets generate transactions. As those transactions are observed, the buyer/seller pricing process is analyzed and value indications are obtained. Transactions may be for specific assets, for groups of assets (databases of transactions), or based on capitalization and yield rates observed in transactions and market participant surveys (RP) or built up from broad market analysis (BV). Proxy market data are needed in some cases because of a lack of market activity for the specific property or business type (mostly BV).

All market observation is intended to assist the valuer or appraiser in interpreting the decision-making process of buyers and sellers of the asset being valued. The three traditional valuation approaches are simply different methods for extracting the same information. The valuer's job is to select those methods that best reveal how buyer and seller (actual or hypothetical) would price the subject interest.

Comparable sales are always best, right?

There is an intuitive attraction to the notion that actual sales of similar properties or interests are always the best indications of the subject's value. I believe this comes from the fact of widespread home ownership and the broadly accepted idea that analyzing the prices on sales of similar homes is the best way to determine what my house should sell for. So far so good. But projecting this concept broadly doesn't work very well. It is especially unhelpful in rapidly changing markets, where the (always lagging) sale indications are difficult to project to a current date of value.

Besides the fact that they occurred in the past, the principal limitation of sale transactions is that they are largely opaque. The real property appraiser is busy contacting the buyer, seller and/or broker to both confirm price and to determine whether there were any conditions of sale that might have influenced the purchase or sale decision.

Business valuers, on the other hand, are rarely able to make such direct confirmations. Instead, they rely on data from samples of supposedly similar transactions. The size of the datasets are intended to offset any variations from 'conditions of sale' and the like. In addition, they embed hidden but important variables, making results unreliable in mostly undetectable ways.

Regardless of the process used, however, transactions often embed crucial elements of buyer/seller decision-making that are difficult to uncover.

What does the future have to do with it?

Everything. Every transaction embeds buyer/seller expectations for the future: The buyer will be holding the property into the future and would logically value that future (use or return) in making the decision to buy. The seller is giving up his or her expectation of the future of that particular asset. The transactions we can observe have already occurred, but the principal motivations were never about the past. *They are always about the future.*

Sales comparison methods (or for BV, the market approach/direct market data methods) are generally considered backward-looking, since most (if not all) of the information available concerns past performance. There may be some information about future expectations, though, for example: leave as-is, remodel or redevelop (RP), or integrate the target company into a larger operation (BV). Even cap rate observations can be backward-looking if they are based on actual net operating income (RP) or historic cash flows (BV).

The critical question is whether the intentions of the buyer/seller in any one transaction match the circumstances of the subject property or company *with respect to future expectations*. The data available to us does not usually offer such insights.

Why not the income approach?

All income methods value future expectations, either explicitly (*discounted future returns methods*) or implicitly (*direct capitalization*), with the future risk and growth embedded in single-period capitalization, or "cap," rates. This is the basis for the various objections raised by critics of income methods: "How can the valuer know the future?" "Projection of future results is just speculation," and my personal favorite, "The conclusions are too sensitive to the inputs."

My rejoinder is that the valuer/appraiser *must* do his or her best to discover and interpret the market's view of the future, not the past. This is not optional.

Market value is about the market's decision-making process, which is about the future. Of course it is speculative, because the future hasn't happened yet. Any observed sensitivity simply is what it is. But looking forward is the only way that buyer/seller expectations can be reasonably understood.

Analyzing and demonstrating such expectations is the province of the income approach. Sales comparison just obscures such expectations and sensitivities; it doesn't make them go away. Believing the conclusion is reliable because sensitive variables aren't revealed doesn't make it so. On the contrary, closing one's eyes to the potential for hidden facts can be downright misleading.

The "sensitive variables" of income methods include dividend/distribution rates, dividend and value growth rates, and risk-adjusted return rates. Such metrics of expected future results drive the entire market—a condition which is independent of valuation method. In this way, income methods give the user of the report something to look at, and users can choose to agree or disagree from there. The valuer puts his or her cards on the table, so to speak, and all of the variables can be tested for reasonableness and their sensitivities measured. Yields can be compared with other types of investments. Growth can be compared with inflation expectations, for example, and even with past patterns (such as supporting a forward 10-year forecast with 10 years of historic observations, or with a similar business cycle). Income modeling is *useful*.

By contrast, value concluded by sales comparison is relatively opaque. The reader might disagree with the weighting given to specific transactions, but that's largely it. They can either accept the valuer's conclusion, or not. The conclusion could be nonsensical and no one would ever know.

A prediction or a valuation?

A revealing paper* was recently published by the RICS, in which the author makes a series of recommendations to the RICS Standards and Regulation Board based on extensive discussions with a handpicked advisory panel of global experts. The author observes that

> [C]lients are becoming increasingly discerning about how valuation outcomes are arrived at, and they are becoming increasingly critical of the methodology used. This is particularly the case as the property market is now more analytical than it was in the past, and clients expect that there should be more transparency in the data points used…

> What is apparent is that clients are becoming less accepting of 'implicit' valuation inputs, assumptions, and outcomes within the method and models used; instead, the models should be 'explicit' to achieve the required levels of transparency, understanding, and education.

Concern with forward-looking analysis is expressed in terms of valuer liability risk:

> Valuers can be reluctant to engage in discussions around a property risk analysis and the forward look because it can be seen as more of a prediction than a valuation. It is therefore naturally riskier for the valuer than assessing current market value and raises liability concerns.

But what if "looking forward" is what the market does? Can the valuer ignore the market's principal valuation method because making a prediction is not the valuer's role?

I suggest that the valuer's forward-looking, multiperiod analysis is an *interpretation* of market data, rather than a *prediction*. It is a projection or forecast based on current and past observations, and (more frequently in BV) management's forecast. There is quite a bit of discussion in business valuation about the appropriateness of uncritically accepting management's forecasts, but that such forecasting is within the valuer's domain is broadly agreed upon.

* Peter J. Pereira Gray, *Independent Review of Real Estate Investment Valuations*, Commissioned by RICS Standards and Regulation Board, December 2021

Enabling cross-discipline interaction

The business valuation version of the sales comparison approach (which includes various market methods) is completely different from the real property version. Collaboration between the two disciplines around these methods is essentially impossible because of the extensive and very different approaches and training required by each profession.

Income methods, by contrast, are universal. Finding the present value of future returns involves the same process regardless of how those returns are generated. Yes, the *methods* of analyzing return rate data are specialized—with the real property appraiser getting rates from investor surveys and individual or aggregate transactions, and the business valuer building up rates from capital market observations—but the process is so similar that it provides an excellent and accessible basis for collaboration.

The ability to collaborate is a virtue, and the income approach is a universal "language" that can help the development of that virtue.

Conclusion

The income approach has a very long history in the bodies of knowledge of both the real property and business valuation disciplines, and is widely applied in the market. It has great advantages in terms of transparency—making market assumptions explicit—and it is the only method that facilitates collaboration between the disciplines. So, I am quite disturbed by the suggestions that it is "too sensitive to the inputs" and that the sales comparison/market methods should be preferred. Non-valuers elevating the idea that comparable transactions amount to the "Holy Grail" of valuation is understandable—but wrong.

Unpacking the moving parts of a sale transaction is an arduous task, which very often leaves out material information about buyer/seller expectations and makes that sale's value indication specious. "Out of sight out of mind" is unhelpful.

I don't see how anyone can suggest that market participants care about the past more than the future. The entire purpose of acquiring a business or property is to receive future benefits, so their explicit analysis should be part of any market valuation. Discovering what those benefits are likely to be and the level of risk that the market assigns is the task of the appraiser, one way or the other. They are either left hidden or made explicit. While the underlying assumptions might be arguable to some degree, the discounted future returns method in particular at least puts them on the table, allowing the user of the valuation to better understand and evaluate the concluded value.

Every possible approach to value must be considered, of course. The more the merrier. I hope I have made the case that the income approach should be strongly considered, at least as test of reasonableness, but more often as a primary valuation method. It is hard to find a meaningful downside, and the benefits in transparency and better understanding make it worth the effort.

Dennis Webb

The income approach is the foundation of the transformative *Valuing Fractional Interests in Real Estate 2.0* (© 2021), the definitive and only truly interdisciplinary text on this subject. You can find it at primusivs.com.

PRIMUS
INSTITUTE FOR VALUATION STUDIES™