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FAIR VALUE REVISITED BASED ON MARKET FUNDAMENTALS & THE REAL ESTATE INVESTMENT PYRAMID

International Financial Reporting Standards (IFRS) for Fair Value require market-based criteria for real estate; global challenges in the real estate market require a reconsideration of the real estate investment fundamentals.

The global recession has caused a re-examination of the financial services industry, specifically of the fundamentals of real estate transactions and reporting requirements based on IFRS and the use of Fair Value. The ensuing credit crisis has highlighted the need to appropriately reflect credit risk in the measurement of Fair Value of financial instruments. The paradigm presented in this brief provides practical criteria that a valuer or user of valuation services should consider in any real estate transaction or report.

IFRS defines Fair Value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly market between market participants at the measurement date.” This is based on the assumption that there is an orderly transaction for said asset or liability in either the principal market or, if there is none, the most advantageous market. The measurement of Fair Value takes into account the characteristics of the asset or liability that would be considered by market participants in setting a price in that market. Additional considerations of concern to banks and regulators resulting from Fair Value estimation are disclosures of credit risk as defined in IFRS 7, non-performance risk as defined in SFAS 157, and wrong way risk, as an additional source of risk.

The need for accurate estimation of Fair Value was amplified with the global recession. In the beginning, significant blame was assigned to the downfall of the U.S. housing sector, the associated de-regulation of the financial industry, and the lack of oversight of financial instruments and loans. Specific blame was also directed at the Community Reinvestment Act, Fannie Mae and Freddie Mac. However, the worldwide impact of the financial contagion and resulting global recession strongly suggests that the essential causes were, in fact, global.

Theories abound regarding the actual cause of the global recession, but fundamentally it can be attributed to the lack of proper assessment of risk of the various real estate instruments, specifically improperly quantifying the ability of borrowers to make payments on loans, improperly quantifying the Fair Value of the asset, and improperly quantifying the reserves required to maintain the assets in case of distress and failure. Overall, it was the lack of transparency and a lack of understanding of each of the real estate participants, such as buyers, sellers, lenders, and consultants. Unveiling the mystery of the real estate investment process, as well as the many parties involved, is necessary to avoid common real estate investment mistakes. This is the basis for the Real Estate Investment Pyramid as presented in "*The Secret of Real Estate Revealed*".

There has been a fundamental misconception that you can have just a single or few key building blocks to achieve maximum results with any real estate investment. In fact, all necessary building blocks must be present; trying to shortcut the process usually leads to fewer profits or, in worst-case scenarios, a failed investment. The Real Estate Investment Pyramid presents each necessary building block, or pillar, that must be present in order to achieve maximum results in any given real estate investment.

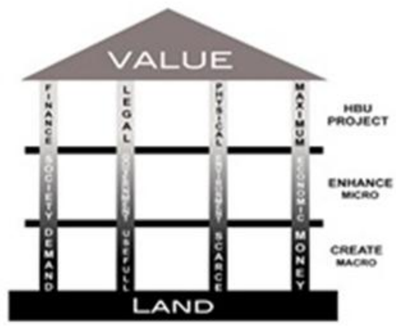
The foundation of all real estate investments begins with the land. Building on the value of the land are the following four critical macro elements that form the pillars of the next level of the Real Estate Investment Pyramid:

• **Demand** - This criterion represents the volume of desire and volume of participants who want any given commodity. Note that it only takes one person — such as a collector of art — to create demand. The highest level of demand is achieved when there is both volume of desire and volume of participants.

• **Usefulness** - This criterion represents the volume of adaptability and options in which the object can be used. For real estate, the volume of adaptability represents the many ways in which an existing property can be used. The volume of options pertains to vacant land and the variety of property options that can be developed on the land. The greatest utility is achieved when the highest number of alternatives is available for any existing or proposed project.

• **Scarcity** - This criterion represents the perceived uniqueness of the property and the limited number of said properties. The market, which is made up of participants, dictates what is important. The perception of the entirety of the market is what creates uniqueness. Once the market denotes uniqueness, the number of properties will denote the level of scarcity.

• **Money** - This criterion represents the ability of market participants to actually purchase the property using their personal resources — i.e., cash in the bank or financing. This can be the most critical cornerstone in creating value. Even if demand, usefulness, and scarcity are present, if the asset cannot be purchased (and retained), value is not created. The larger the pool of available funds, the higher the value created; the smaller the pool, the lower the value.



Enhancement of investment value comprises the next level of the Real Estate Investment Pyramid. This level brings life to the investment and provides detail, composition, and substance. The key pillars of this level are societal, governmental, environmental, and economic.

• **Societal influences** - including, but not limited to, population trends (including age, family size, and gender distribution) and crime rates;

• **Economic influences** - including, but not limited to, income levels, interest rates, and employment rates;

• **Governmental influences** - including, but not limited to, zoning, entitlements, development approvals, taxes and public support;

• **Environmental influences** - including, but not limited to, specific location, environmental permitting, flood zones, archeological and historical significance.

Many real estate investments achieve moderate or limited success at this micro level, however most go no further.

Maximization of the investment value is the final level in the Real Estate Investment Pyramid, bringing the highest achievable value to the investment by providing sustainability and securing market position. Legal uses, physical attributes, financial feasibility, and maximum profit are the pillars of the development of any successful real estate project.

The Real Estate Investment Pyramid exhibits the connectivity of all the pillars and how each are required to achieve the maximum return on any real estate investment. The result is transparency of information and market data that can be used to meet IFRS and establish the fundamentals that create sound investments.

If the principles of the pyramid are adhered to, the likelihood of another global recession based on financial contagion, lack of market fundamentals, and lack of transparency in the transaction significantly lessens, creating the required confidence in the markets to sustain an investment.

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President of The Doré Group – *an international real estate consultation and forensic valuation firm – has 27 years of experience in the real estate litigation, appraisal, counseling, publication, and educational fields. Mr. Doré is uniquely qualified in international valuation (USPAP, RICS, TEGOVA, and IVSC) with direct valuation and advisory experience in the United States, Russia, Japan, Cyprus, Mexico and South America. He is the first adjunct professor for the Ministry of Foreign Affairs and Finance Academy of the Russian Federation, advisor to the Duma and Central Bank of Russia,*

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