PRACTICAL ISSUES IN REAL ESTATE VALUATION IN BELARUS

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1. Introduction

Valuation of real estate in Belarus is regulated by normative legislation. It was created taking into account the best practices of international valuation practice. However, Belarus real estate market is still in its development stage and valuer can experience difficulties while applying some of valuation methods in reality due to highly fluctuated indicators of property market and transitional nature of economy. The purpose of this paper is to discuss different practical issues in applying market value approach in real estate valuations in Belarus and give recommendations how to avoid possible inaccuracy of estimations.

2. Overview of real estate market in Belarus

There are no large property companies operating in the Real Estate market in Belarus as in many countries in Europe. Many people own their apartments and houses that they got through privatization processes. It is possible for physical persons to own the land for residential purposes, but it is not possible for the companies, that can only take a land for long-term lease.

Secondary housing market experienced a reduction in the level of activity during recent years. Prices have risen to a level that is perceived as un-sustainable. But it is obvious that the real estate market has grown in size and value. For example, during the 2006-2008 the number of mortgages in Belarus has doubled every year (although starting at a very low level). The total number now stands at 34 thousands as compared to roughly 450 thousands in Sweden.\footnote{Development of Real Property Market in the Republic of Belarus. Sida Evaluation 2008:19. p.16}

There are 28 different banks operating in the country that are offering mortgages to citizens. Interest rates for real estate loans are between 19% and 27% and majority of real estate loans are taken in Belarus rubles. Interest rate is quite high and it is quite risky to finance housing property with such loans. These interest rates can be attractive only to buyers who want to take a loan with low loan-to-market value. The
average loan period is between 15 and 20 years, that is in a high contrast to Europe, where loans are taken for 30-40 years.

The construction industry is operating at a high level of activity, particularly in Minsk. Partly, the sector is driven by the government programs to stimulate housing projects for poor families through subsidies.

Prices for new apartments for March 2010 are between $700 and $3000 per square meter. The price per square meter for secondary housing market is about $1453 on the beginning of March 2010. If we look a dynamics of housing prices (Figure 1) one can observe that during 2009 prices were highly fluctuating in the interval of -10%...+5%. Just in the first quarter of 2009 housing prices have fallen by about 20%.

According to Colliers International commercial real estate market for office premises in Minsk has grown by 90 thousands square meters in 2009. This is about 1/3 of the competitive supply for 2008 that is equal 325 thousands square meters. Class A is accounted to 10%, B is about 40% and C is the rest. All newly constructed real estate objects belong to class B. Rents for office premises fell down by 25-30% in 2009 (Rent dynamics for 2002-2007 is presented on Figure 2). Average vacancy rate is about 17%. Real Estate analytics predict that these tendencies can hold strong in 2010.

![Figure 1. Housing price dynamics](image)
3. Methods of Real estate valuation in Belarus

Valuation of real property could be done for different reasons including assessment of the value of a real property for the purpose of taxation, privatization, leasing as well as compensation in cases of expropriation of real property. Main real estate valuation methods are determined in the normative legislation by “Instruction on valuation of capital buildings and constructions as objects of real estate property (Decree #67 from 20th December, 2007)” (further “Instruction”). This instruction regulates the rules for applying different valuation methods adopted in World practice. However valuer can experience difficulties while applying some of these methods in reality. It is worth to discuss here different issues in applying market value approach regard to the current conditions in Real Estate market in Belarus.

Cash-flow prediction.
In paragraph 51.1. of the instruction it is stated that cash-flow prognosis should be based on cash-flow:

1. of the previous year;
2. average for the last three years;
3. current year;
4. current Market rents;
5. rent rates from comparables.

As it was seen from the overview of commercial real estate market in Belarus rents fluctuations can be about 25-30% per year (for 2009), that makes quite difficult to apply the first two types of cash-flows as a base. The same refers to the current year rate, since it can be a subject to change in the next years. It is not always possible for valuer to obtain information
about current rent rates from comparables. In such cases the only possible method is to apply current market rents as a base for predictions. But as market rent strongly affected by the competitive supply, rate of vacancies and other conditions in the market, this method also become quite doubtful.

**Vacancy rates application.**

According to paragraph 54 of Instruction Effective gross income should be calculated as:

$$\text{EGI} = \text{PGI} - \text{V&L},$$

where EGI – effective gross income;

PGI – potential gross income;

V&L – vacancy losses.

As it is seen from the data presented above current vacancy rate in Minsk for office premises is 17%, that can be considered as quite high vacancy rate for applying for 5-year predictions. Such a high vacancy rate can affect Net Operating Income value and in such a way press the present value of NOI significantly. That decreases accuracy in Real Estate valuations.

It seems to be reasonable that the most appropriate method to be applied in such situation is comparable sales analysis. But the problem is that sometimes it is not possible to find enough number of comparable sales and it is quite difficult to form an opinion about current market value. Moreover it becomes impossible to estimate many indicators used in this method. For example, in paragraph 60.1 of the Instruction the capitalization rate should be calculated as:

$$R_0 = \sum_{i=1}^{n} \left( \frac{\text{NOI}_i^a}{\text{V}_i^a} \right) / n,$$

where $R_0$ - is an overall capitalization rate of the valuation object;

$\text{NOI}_i^a$ - net operation income of the $i$-comparable sales object;

$\text{V}_i^a$ - price of $i$-comparable sales;

$n$ – number of comparables.

To apply this method valuer should have data about the NOI of comparables and the price of transaction. But the number of transactions on commercial Real Estate market in Belarus is quite low, if not equal to zero, and it is not possible to obtain such a data. In such a way this method meets a lot of difficulties in application.

**Discount rate.**

Paragraph 61.1. of the Instruction describes cumulative method of calculation discounting rate as a sum of risk-free rate and different risks premiums:

$$r = r_f + r_1 + r_2 + r_3 + \ldots + r_n,$$
where \( r \) – discount rate;
\[ r_f \] - risk-free rate;
\( r_1, r_2, r_3, r_n \) - risks premiums for different kinds of risks, for example, risk of real estate market, risk of low liquidity, risk of real estate object management, financial risk. How to find out the appropriate rate of specific risk is not clear.

Validity and stability of market value estimations.

The positive moment of this Instruction is that Standard Valuation report should include Sensitivity analysis (paragraph 16.1 of the Instruction), where valuer can describe most likely, positive and negative scenarios using different assumption data. This implies that valuer should come up with some uncertainty interval for the final market value opinion. Unfortunately uncertainty interval in final market value opinion is not a guarantee that the market value is valid for a long-term. Fluctuations in real estate market can lead to a high range of uncertainty intervals in the predicted scenarios and this cancel the whole meaning of the valuation process. Some valuers indicate the validity interval for the final market value opinion in their valuation reports. But it is obvious that in the market with high rate of price change the validity interval can not be very long (maximum 3 month). This creates another problem when valuation is done for mortgage purposes. Impreciseness in market value calculations can creates problems for valuers, their clients and the banks. If market value is highly fluctuated, than the need in additional collateral emerges.

One can find a good example of solution for such problem from Germany. Germany has a very strong national valuation tradition. Traditional basis of valuation in Germany is based on a conservative approach and this is embodied in legislation. It is worth to mention that the majority of valuations were, and still are, carried out by the German valuation method (‘Wertverordnung’), which combines aspects of land and building value, focusing on sustainable market rents, neglecting, in part, future developments (market, vacancy, obsolescence, etc, as well as the current lease situation).²

The concept of market value is given less weight compared to international valuation standards. Germans use so called “the mortgage lending value” that should disregard short-term market fluctuations. In other words it attempts to measure the “sustainable value” of the property that is free from effects of peaks and troughs in the market. These approaches to value plays important role in developing lending policies in

² Briefings in Real Estate Finance Vol 4 No.1 PP 37 –49, p.46
German banks. Banks lending policies in their turn seems to support the more stable functioning of German property market.

*Property price adjustments for comparable sales.*

It is not also clear how property adjustments should be done if the comparable sales happened for 2-3 years ago. It is not appropriate to use consumer price index in such case, but applying the “Coefficients for the increase in the value for tangible assets” (Index method), that are used for accounting purposes seems to be not a perfect solution also. These coefficients take into account price change for different tangible assets including real estate, but they do not take into account business cycles on real estate market and the competitive supply coming from new production. For example the class B office premises stock in Minsk has increased by 1/3 in 2009 and this of course had a significant effect on price per square meter. That is not reflected in the coefficients of value change, mentioned above, since these coefficients are calculated as aggregated indexes. In such situation it can be appropriate to create a national real estate price index, like IPD in Europe.

*Valuation currency unit*

One more issue that it is important to mention is the currency unit that is used for valuation. Some valuers believe that using stable currency unit (like for example US dollar or Euro) in valuations can increase their reliability. That is not always true, since even if these currencies are more stable in comparison to Belarus ruble, they are also subject to fluctuations. That is why using stable currencies as a unit of valuation can decrease trustworthy of the market value estimation.

4. Conclusions

Estimating of real estate market value can meet serious difficulties when property market is still in development stage. It makes hard to make predictions due to high rate of changes in assumptions data for cash-flow proforma, it is not always possible to use data from comparable sales, it is hard to rely on current market indicators. This makes judgment about final market value extremely difficult and validity period of such estimations quite short.

In order to improve the quality of cash-flow predictions in highly fluctuating real estate market it seems to be reasonable to use long-term values for rents and vacancy rates growth in cash-flow predictions for estimating market values of real estate properties. The same is valid for
inflation and discount rate adjustments. One should also take into account
the current stage of the real estate business cycle and development of
competitive supply. The uncertainty interval in final market value
estimations should not be more that +10% and validity period of such
estimation should be quite reasonable.

Creating of a National real estate index can not only help valuers to
make their estimations more accurate, but it can make the real estate
valuations more transparent, understandable and trustworthy for foreign
investors. This can attract more actors to Belarus real estate market and can
speed up its development.

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