

GOVERNMENT'S RESPONSE TO COVID-19: HAS THE BILL OF RIGHTS BEEN GIVEN EFFECT TO?

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The impact of COVID-19 on the property sector – how does it influence property values and possible litigation?



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By
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The COVID-19 pandemic has had a major impact on the international population and economic markets. South Africa (SA) has not yet been ruled out and it is expected that this pandemic will still have an impact on the country for quite some time. Apart from the obvious infections and deaths caused by

the virus, the implemented measures to contain the spread has had severe consequences. With businesses that are unable to operate, the income generation of society has been severely hampered. General business expenses are also negatively affected and the immediate consequence of this is that many people and businesses will most certainly fail on their contractual obligations. In the property sector, this impact is far wider than just rent foregone (direct impact), but includes the downstream influence of people that should have received that income and further spend in the economy (indirect impact) and the negative growth of new entrants to the sector (induced impact). The link between the construction sector and the property sector should also be taken into account in the assessment of the impact.

The role of property in the economy is due to property being a fixed asset, with the specific attribute of being a scarce resource and mostly indestructible, and as such very attractive as an investment and the consequent ability to act as security for debt. It is furthermore also

a good indication of wealth and hence very popular for purposes of wealth tax, such as property rates. In addition, all economic activity happens on property, developed or undeveloped, and all people occupy in some form or another the property of someone. It is, therefore, evident that property forms a very critical part of the economy as a whole.

However, how do we determine the impact on an individual property and what can be expected of property values in the short to medium term future?

Valuation methods

The courts throughout the world, including SA, prefer the comparable sales method of valuation (see *Minister of Water Affairs v Mostert and Others* 1966 (4) SA 690 (A) at 723F), but due to the expected reduction in disposable income of households due to the impact of COVID-19 on economic activity, it is expected that property values will reduce (DGB Boshoff 'The impact of affordability on house price dynamics in South Africa' (2010) 17(2) *Acta Structilia: Journal for the Physical and Development Sciences*



126). This might take some time to be evident in the market as it is expected that sales will slow down and will take time to be registered at the Deeds Office and be captured by secondary data providers. So on the one hand there is the reduction in value, but on the other hand is the lag of information behind the change in such values. Furthermore, this reduction in value may have a negative impact on the balance sheet of any property owner, as well as on the security that is placed on such property by financial institutions or any other party where property serves as security (eg, contractors' *liens*, tenant's rights in the event of landlord liquidation, or any other specific contractual arrangement). The lack of information could – if the valuer is not careful – mislead the person that is relying on such a valuation, especially for litigation purposes. Examples of these are when a property is to be foreclosed due to non-performance by the lender, a contractor wishes to exercise their *lien* due to non-performance in terms of a construction contract and has a specific idea of what can be recouped from the property, or a

concurrent debtor that bases their claim on the expected proceeds from the sale of a property.

The comparable sales method is mostly used in a market that is fairly homogeneous, such as residential property, but income producing property such as retail facilities, industrial and offices, are valued on the basis of the expected income that is capitalised at a rate determined by the income/sales price relationships of comparable transactions. Hence, the income capitalisation method is still a type of comparable sales method, albeit considered an indirect sales method. It, therefore, suffers from the same problem of lack of information that can create difficulties in valuing a property. In addition to this, income-producing property is widely reported to suffer severely from non-payment of rent due to the negative impact of COVID-19 on affordability. This means that the income is directly affected and the capitalisation rates that should determine the value of a building from this income, is affected by the lack in information on comparable sales. The commercial real estate market is, therefore, under a double impact of uncertainty in terms of value determination and the information needed for this.

A third method of valuation, and not often used, is the depreciated replacement cost method. Although some may think that this is only a method used to value churches, schools, monuments, etcetera, it is actually used more often than one would think. The reason for this is that it is based on the principle of comparable substitution, whereby a person would not pay more for a property, than another property, that satisfies their needs equally well. Therefore, a property with less depreciation, namely, newer and thus less physical obsolescence, or having a trendier style and layout and thus less functional obsolescence, would probably satisfy more of the needs of the purchaser and would attract a higher price. In addition to this, economic obsolescence can be seen in a market such as the current market where significant impact on value is evident due to external factors. This method, is probably used frequently to compare different options. Also, where there are specific cost related items, namely, properties under construction, it can be used to adjust the market value based on the impact of individual items, such as the cost to complete construction or the impact of an extra lift to an office block.

From the above, it is evident that the different valuation methods are not necessarily loose standing, but interrelated and all feature the use of the basic requirements in South African courts, namely the use of comparable transactions in order to validate the accuracy of

market activities. It is, however, essential that the date of valuation is critical. With a turbulent market as caused by COVID-19, the factors need to be put into perspective. Distinction should be made between temporary, short-term and long-term effects. An example would be the vacancy rate of an income producing property, where it is expected that vacancies would drastically increase due to the impact of COVID-19. Let us assume a rate increases from 5% to 20%. If the income of a property is simply reduced by a 20% vacancy due to the current situation, the capitalised value will be 15% lower than what it would be with the long-term 5% vacancy. This assumes the 20% vacancy would exist into perpetuity, which would undervalue the property in question. Instead, a long-term view with market supply and demand factors should be considered in order to determine the most likely vacancy rate to which the market will return, but also estimating the short-term higher vacancy and deducting the present value of such lost income from the value determined with the long-term equilibrium vacancy. It is, therefore, imperative that in markets such as the one that we find ourselves in currently, valuers make use of a properly researched discounted cash-flow analysis in order to determine the longer term effects on the value of property, rather than a simple income capitalisation.

In order to ensure that the lag of information is captured adequately, valuers should also familiarise themselves with time-series relationships, such as capitalisation of disposable income to determine long-term affordability and subsequent property value indices. The relationship between the marketed price and eventual sales price over time can also give an indication of movement in the market, taking into consideration that in a downturn, a higher percentage of sales take place under duress or are 'forced' sales. It is important to note that valuers cannot simply use dated sales as if they are the current value, but should evaluate sales and adjust them based on properly researched economic factors.

With the above taken into consideration, when one considers the value of a share on the stock exchange, the value is the last sales price of that share, so the comparable sales principle comes into play again. Similarly, one tends to think that a property is different, because it is bricks and mortar, and if the desired sales price cannot be achieved, the seller simply hangs onto it until the desired price is achieved. If the seller cannot hold onto it long enough, it means in essence that the seller is compelled to sell, indicating that the sale would be a sale under duress and, therefore, not qualified as a comparable sale in terms of the definition of open market value. Only

those sales that are achieved, where the seller is not under duress, can be taken as comparable for valuation purposes. But, with a downturn in the market, even if property can be held onto for a better price later, the seller competes with those that need to sell urgently, as well as the increased number of forced sales. In such a market, there are typically fewer buyers, and more 'bargain hunters', the buyers would not pay more for a property than another property that satisfies their needs equally well. Therefore, they would not pay more for an ordinary sale property than for a property that is available as a forced sale. The essence is that a higher number of forced sales are indeed driving the market down, although it might be seen that it does not meet the definition of open market value. More importantly, is that the date of valuation becomes critical.

With the date of valuation the temporary effects of a downturn market would, similar to shares on the stock exchange albeit not as volatile or liquid, cause the property market to see measurable differences in value. In terms of litigation, either where the property itself is cause of litigation or where it serves as security in another form of litigation, the effect of value change over different times should be carefully considered. The question that should be raised is: When did the loss cause litigation to rise? This will determine the date on which the valuer would want to determine the value; or when the anticipated date for realising the value from a property due to sale is in execution or otherwise? These different dates might cause the requirement for more than one valuation on a property at different dates in order to obtain the full picture.

The impact of the date on the actual value of property, or the temporary effect of the out of the ordinary COVID-19 situation, also raises a further aspect, namely, how should a decision on litigation be taken? For example, a financial institution that holds a bond

over a property as security, in the current circumstances if the owner fails to meet payments, the financial institution might consider selling the property in execution in order to recoup losses. But in an already distressed market, and as indicated earlier in the article, a higher number of forced sales can put further downward pressure on the market. The financial institution might not realise the proceeds that it hoped for, given the original decision to finance and the associated security value at the time. The financial institution might consider rather delaying the execution, in order for the market to recover so that a higher sales price may be obtained. In the meanwhile, the interest rollover might be covered by the future market recovery and might even create a situation where the owner's situation also recovers, which will resolve the issue. It is obvious that where a default started prior to the COVID-19 situation, the decision would be different from a situation directly caused by COVID-19.

These effects are then also amplified if indirect real estate is involved, such as Real Estate Investment Trusts (REITs) where the shares in the property fund already take into consideration that the fund is highly geared. The price of such shares are found to be related to the value of underlying property assets (DGB Boshoff and C Cloete 'Can listed property shares be a surrogate for direct property investment behaviour?' (2012) 15(1) *South African Journal of Economic and Management Sciences* 72), but due to the financing and other operating expenses of the company involved, the share price would be much more volatile than underlying property assets at a rate that is directly linked to the structure of the company and its financial performance ratios, such as debt coverage ratio or operating profit (DGB Boshoff 'Towards a listed real estate investment valuation model' (2013) 16(3) *South African Journal of Economic and Management Sciences* 329). Care should, therefore, be

taken when property is valued for indirect purposes and the resultant effect is influenced by non-property aspects, or where property rights are divided, such as with land-leases and associated top-structure development by the land-tenant (DGB Boshoff 'Valuing Real Estate as Contractual Cash-Flow with a Put-Option' (2012) 1 *Proceedings in ARSA-Advanced Research in Scientific Areas* and DGB Boshoff 'The Use of Options Pricing to Value the Bare Dominium of Property with Long Leases' (2016) 24(2) *Journal of Real Estate Literature* 251).

Conclusion

To summarise, the COVID-19 pandemic is to surely result in increased litigation due to contractual agreements that cannot be met, or even be exploited. The reliance on property valuation as a source of information on balance sheets or causes of loss of parties involved can also prove to be more difficult due to changes in the market activities. To address this, valuation methods should be based on comparable transactions as per the requirements by courts, which should carefully take into account the adjustment between different properties, or dates of valuations by using different valuation techniques, wider economic data and statistical significant relationships, in order to get a more accurate determination of value as at the specific date of valuation. A vast amount of knowledge can be gained by comparing the results of different techniques to each other and performing wider statistical and economic analysis.

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