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Concerns of Difference in Value, Overvaluation and Undervaluation

Difference in Value concerns to the large variation in value of property estimated by two or more Valuers. Overvaluation implies assigning an excessive or too high a value on something and the Undervaluation refers to the act of deciding that something is less valuable than it really is.

Sometimes, the lenders – public sector banks mostly – often complain at various forums that due to overvaluation done by the Valuer at the stage of financing, they incurred losses on account of low recovery against outstanding loans. However, concerns are raised after liquidation of NPA. Such questions are not raised at the stage of funding, i.e., sanction and disbursement of loans.

Though, no valuer can be perfect, they are highly trained professionals with several years of experience and have the required understanding for assigning fair value to any property. Most often than not, the valuers work diligently to make reasonably fair valuation because of the potentially severe consequences of doing their job poorly or by issuing a biased or misleading report. Still, some biased, misleading valuation reports cannot be ruled out for which likely reasons could be one or more of the following?

The lender was impressed with borrower and ignored to conduct due diligence of latter's documents, background and credentials, or

The lender ignored the overvaluation knowingly, with a view to meet the loan disbursal targets set by the management, or

- The Valuer was keen to oblige the borrower with overvaluation, due to palm greasing by the latter to seek illicit advantage from lender, or

- There was collusion of the lender's officials with borrower, and the both misled the Valuer to provide report with higher value to facilitate the borrower with higher than eligible funds, or

- Lender's official did not perform the personal visit to verify the property's characteristics and its value before release of funds to the borrower

Answer to the above questions would be required to find out whether the lenders' claim to blame the overvaluation of properties by Valuers is the sole reason for accounts turning non-performing or former's losses during liquidation. Money advanced by Banks is public money and the bank officials are its custodians. Banks seek services of Valuers for fair valuation of borrower's properties before advancing loans. If the Valuer is negligent in conduct of the Valuation, the Banks - after following due process - have the option to blacklist the Valuers for negligence in conduct of valuation besides the option to file criminal cases for fraud or cheating.

However, blacklisting of Valuers by banks, in the past, has been rare, which is enough evidence that blaming Valuers for NPAs is more of a tendency amongst the bankers than the truth. The bank managements are cannot ignore that more bank officials have faced criminal charges for graft or fraud or negligence than an insignificantly small number of the Valuers in the Courts of Law.

Despite blaming and countering it, Differences in Valuation amongst Valuers, Overvaluation and Undervaluation are not uncommon and discussed hereunder:

Difference in Valuation amongst Valuers:

It is not uncommon to find large differences in Value between the reports of different valuers. Recently, a Regulator, during a video conference with some Valuers, was also curious to find out reasons thereof.

The difference or variation in fair value assets can be of two types. One can be difference in fair value between the stage of funding and liquidation. The other could be the variation in fair value done at the same time by different valuers

The former, in most of the times, could be due to genuine reasons, like wear and tear, theft or removal or destruction in natural disaster, of assets financed.

The other, i.e., variation in valuation by different valuers for valuation of assets done at the same time is of vital importance and needs to studied deeper. These could emerge mostly in case of large land parcels or industrial projects, where share of cost of land and buildings is much lower than the machinery.

Usual mode of Valuation of Land is through comparison with recent sale instances, local enquiries or listings, so large differences in value assessment by different valuers for small plots of land would be rare. However, in case of large parcels judgment of different valuers on land value may vary, particularly in cases where land use has been changed from agricultural to non-agricultural. The differences could however be in small range, if all valuers adopt the unit measure of land – acre/bigha/sq mt etc. - in accordance with the measure which is prevailing in local deals for similar sized land parcels.

However, the field of Plant and machinery is vast with various types of machinery, different specifications, different metallurgy, automation in controls, different quality and quantity of output, technological variations etc., so every machine or plant has to be considered on its merits and shortcomings besides potential profitability from its use, which makes the Valuation of Plant and machinery a very complex and difficult task.

Three approaches of Valuation, i.e., Income, market and Cost approach can be used for machinery valuation but due to limited or no availability of usable data, often, Valuation of machinery is done by Cost approach, wherein Depreciated replacement cost, subject to potential profitability, is considered as Fair Value.

Main factors in cost approach are Replacement Cost of new equipment, Depreciation including obsolescence, and the aspect of potential profitability. Each of the aforesaid factors of Valuation is subjective, as described hereunder:

Replacement cost should ideally be considered on the basis of fresh quotations of same machine or by some adjustment (again subjective) in cost of similar new machine with same utility. But in actual practice, getting fresh quotation is not easy as suppliers usually do not respond to queries from persons other than the potential users. So, Valuer has to estimate Replacement cost by applying Cost index for the cost inflation over its age. For domestic equipment, data of whole sale price index is published by the Office of Economic Advisor. Industrial units have mix of various machinery and equipment, therefore cost index is also applied subjectively. Precise data of import of comparable machinery is rarely available, so its replacement cost assessment becomes subjective.

Depreciation assessment is also subjective. Straight line method or declining balance methods are applied which give different results over short periods, though depreciation for higher age may not have much difference. There is no binding on a valuer to consider a particular method, so it is subjective judgment.

Then there is a factor of Potential profitability. Since valuation exercise does not require assessment of financial viability, judgment on potential profitability is also subjective, which, for machines of obsolete technology, may sometimes lead to higher DRC than prevailing market price of similar used machine.

Despite the difficult and complex exercise of Valuation of Plant & Machinery, valuers integrate information drawn from the verification of machinery & equipment, documents and information collected from owners, operators, market research and analysis of the data by the application of appraisal techniques to form a conclusion.

If impact of all factors considered by one valuer is on higher side while the other has considered the same on lower side the resulting depreciated replacement cost estimated by the two will have wide variation.

Overvaluation:

Overvaluation than real worth of properties causes reduction in security margin against outstanding loan and hence enhanced risk in its recovery. Instances of overvaluation of Land and building are rare but can occur if the data collection of comparable sales and inquiries about market rates are not reliable or not undertaken or non-existent. Sometimes, no sale of property is found to have taken place over last many years in the area, where property is situated, which may impact the perception of different valuers based on the local information. The difference in value in such properties could high too.

More commonly observed overvaluation occurs in plant and machinery. Many borrowers would like to get bills of machinery at higher amount than the actual cost of machinery, some do it to cover their margin against loan, while some may have evil intentions to flee after taking loan. Often, the borrowers or the lenders provide copy of bills of machines to the valuer for conducting valuation.

Overvaluation may happen due to the following:

1. The Valuer bases Valuation on the copies of Bills produced but the Bills were over-invoiced. The over-invoicing may have been done by the Supplier as per instructions of borrower or the latter may have provided fake or forge bills.

2. Discount offers on the List price of machinery by domestic and foreign suppliers, both, are quite common. If the borrower availed the discount in cash and bills were raised on list price, the depreciated replacement cost would be higher. Valuer cannot guess the extent of discount which supplier usually offers; the suppliers usually provide quotation on the list price. Used machinery dealers have knowledge of discounts offered on new machinery purchases and adjust used machinery price accordingly.

3. The depreciation considered by the Valuer for building or machinery is on the lower side than that adopted by the market.

Undervaluation:

Sometimes, estimation of depreciated replacement cost leads to undervaluation, as under:

1. The Borrower seeks funding on existing assets already acquired from own resources and cost capitalized is lower than fair value.

2. Lenders have already put the assets of borrower on auction but did not get any offer. For revaluation, lenders often tell the Valuer beforehand that no offer was received against the previous auction implying that lower value is

expected. In subsequent auction on reduced reserve price, if bidders turn up and during competition raise bids higher than original valuation, the Lender blames that Valuer had done undervaluation.

3. Many a times depreciated replacement cost of older workshop equipment – indigenous and imported both, injection molding machine, SS equipment is less than prevailing price of similar used machinery in market.

4. **Checks necessitated:**

5. The Valuer has the responsibility to the Client who trusted the former to provide the Fair Value of property. Some safeguards to avoid over or under valuation could be as under:

1. Continuous gaining the knowledge through CEPs, study of changes in development control regulations and zoning, gazette notifications on land use changes, books and publications of CBRE, Cushman & Wakefield, Knight Frank, HVS etc. Valuers of machinery need to be aware of new developments in various sectors, information at websites of industry associations, IBEF, Bloomberg, CRISIL, ICRA, CARE, policy changes for import & export etc.

2. In case fresh quotations cannot be obtained within the turnaround time, one can seek help from one's past clients to seek fresh price from suppliers, who usually provide fresh price of the machinery to their clients on phone.

3. Suppliers of similar equipment can be contacted but no supplier will help us for being a Valuer, if we cannot convince them that we may be help to them in future. Price of used machinery and scrap can also be found from its dealers.

4. Import shipment data displayed at some websites, even if old, can be useful.

Valuer's Expectations:

1. Valuers do not claim perfection but they can claim expertise in the field of Valuation because of the accreditations acquired. Lenders must study reports fully to satisfy themselves whether methodology of Valuation process is followed and satisfactory reasoning for deviations has been given. However, if some errors or omissions are observed or suspected, the same should be brought to the knowledge of the Valuer for clarification and reconsideration.

2. All banks should follow SBI's practice of assigning valuation through letters besides sending documents to valuer through email. A supportive bonding between them will best serve the purpose of lending and the public interest.