

# **Towards an Efficient Property Markets in Lithuania – the Impact on Valuation**

**Steponas DEVEIKIS and Arvydas BAGDONAVICIUS, Lithuania**

**Key words:** valuation, valuation standards, property markets, Lithuania.

## **ABSTRACT**

Comparability, transparency and consistency of valuation practice in globalised property market are very important. We are presenting a review of valuation practice development in our country. The transition to market economy, an emergence property transfers and markets in Lithuania stimulated an adoption and implication of consistent valuation methodology and new professional activity.

Real estate services in a national and global business environment and investment decision are becoming of great importance. How do valuers estimate property values after 50 years of no property markets in Lithuania? How the European or globalised investors would like to see the property valuation in our country, in the Baltic States? An emerging valuation agenda drive to an opportunity for valuation standards: national law and guidance notes (1995-1999), regional standards (TEGoVA, 2000) and global valuation standards (IVSC, 2000 and 2001).

The development of the market for asset calls for security in globalised capital markets and strengthens an impact of asset valuation and the role of valuers in decision-making process. This paper describes all the contributors involved in property transfers, property markets and investments decision-making process, in exploring issues of current interest, together with expected future concerns in regional and global capital markets.

This paper includes five chapters, e.g.:

1. Property transfers from state sector to private sector and valuation aspects in Lithuania.
2. Property markets: cause or consequence of economic growth?
3. Property tax and mass appraisal issues: a need for methodology and standards.
4. Role of valuers involved in investment decision-making process.
5. Conclusions and closing remarks.

## **VERS LE MARCHÉ IMMOBILIER EFFICACE EN LITUANIE – L’IMPACT DE L’EXPERTISE IMMOBILIÈRE**

### **RESUMÉ**

La comparaison, la transparence et la conséquence de l’expertise immobilière sont les principaux en matière du marché immobilier globalisé. Nous présentons un aperçu du développement des expertises immobilières en Lituanie. Les transitions vers économie de

marché, l'évolution du marché immobilier en Lituanie ont stimulé la naissance de l'activité d'expert en évaluation immobilière ainsi que la méthode de l'expertise.

Les prestations d'un professionnel immobilier dans l'environnement d'investissement au niveau national et mondial sont indispensables. Comment l'expert fait-il l'expertise dans notre pays après 50 ans sans marché immobilier ? Comment l'investisseur européen ou mondial organise sa décision à faire dans notre pays ainsi que dans les autres pays Baltiques ? Le volume des expertises dirige vers la législation et les guides méthodologiques au sein national ainsi que régional (européen) et mondial. Les Normes régionales (TEGoVA – EVS'2000) et mondiales (IVS'2000, 2001) sont bien connues dans notre pays.

L'expert immobilier doit bien maîtriser les approches méthodologiques en matière de l'expertise pour présenter son rôle en processus de décision à faire au marché mondialisé de l'investissement ou des capitaux. Cet exposé est destiné à expliquer une contribution des experts en évaluation des biens immobiliers dans le processus d'investissement et de valorisation des biens immobiliers dans le marché des capitaux. La méthodologie en expertise puisse se changer dans le temps pour refléter la meilleure approche.

Notre document contient 5 chapitres dans lesquels nous présentons nos matériaux.

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# **Towards an Efficient Property Markets in Lithuania – the Impact on Valuation**

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## **1. PROPERTY TRANSFERS FROM STATE TO PRIVATE SECTOR AND VALUATION ASPECTS IN LITHUANIA**

The emergence of valuer's profession in Lithuania, as well as in any other Baltic or Central and Eastern European states, was inseparable from the changes in the political and economical life taking place over the last decade of the 20<sup>th</sup> century. The restoration of ownership rights, privatisation, economic reforms, and development of private sector and market relations in the transition economy demanded for a market-based valuation. It was back in 1993, when private capital-based corporations and the experts they employed first offered the service of valuation of property and business, which was primarily needed by banks and other members of the property and capital market.

The new profession members had to take over the valuation *know-how* of the Western countries, to improve their skills, introduce world-wide adopted valuation principles and methodologies. It might only be achieved through combined efforts of all the specialists involved in valuation process. The Lithuanian Property Valuers Association, which was set up in March 1994, became an institution consolidating such effort.

In the period of transition to market economy and seeking the integration in the European Union, the principles on real property valuation had to be in principle adapted to current situation and needs. If earlier the valuation was based on construction standards, now the estimation of value is based on the market value.

At present, the estimation of property value is based on the following main principles:

1. Property value is estimated observing the logic and criteria of market economy, the results of research and observation of the market and economic situation.
2. Property value is estimated very carefully and deliberately seeking to avoid the violation of the rights of property owners and the principles on property exchange and alternative use.
3. The estimation of property value is based on expected income and profit when property is used or disposed or personal needs are satisfied.
4. Property value can be estimated on the basis of selling-buying agreements, the costs for property formation and acquisition and the income generated by the use of property.

We have entered the 21<sup>th</sup> century possessing a nationally adequate legal and regulatory framework for valuation of property and business, including a network of professional preparation and certification of valuers. A valuation community and a scope of valuation assignments have established themselves on the national market, whereas internationally adopted valuation principles and methods would apply. The valuation guidance and the principles of the valuation practice adopted nationally are consistent with the international, i. e. regional European (TEGoVA) and world-wide (IVSC) valuation standards.

Professional competence and maturity of our valuers is assured by the valuation and real estate management studies available from the national universities, international studies available in Sweden, Finland, Baltic States and etc., the OECD support as well as the support provided by other international agencies, a programme for continued education of valuers, and also the qualification improvement seminars held on a regular basis by the Lithuanian Property Valuers Association as well as by other agencies and corporations.

Globalisation of the property and capital markets, as well as investments, imposes new requirements and arouses new trends in the valuation practice in Lithuania that might be briefly outlined as follows:

- Switching from market value to value-in-use of property;
- Switching from value-comparison valuations to the valuations based on income or investment payback;
- Switching from valuation of an item of property to evaluation of investment risks;
- Switching from empirical analysis to forecasting techniques;
- Switching from national banks project, as a main customer, to international investment projects.

The value of real property is estimated by applying the methods approved by the International Valuation Standards Committee and the TEGoVA. A method for estimation of property value is selected considering what kind of property value is needed for a customer and what, according to valuer's opinion, reflects the property value on a market scale in a best way.

According to the Law on Basics on Property and Business Valuation (LR law No. VIII-1202, 25 05 1999), the following methods are applied for estimation of property value:

1. Sales comparison method;
2. Depreciated replacement costs (costs) method;
3. Income value method (income capitalisation or discounted cash flow method).
4. Special value method.

Mostly, first three methods are used for the valuation of real property. Special value method is mainly applied for the valuation of unique art and historical valuables, jewellery and various collections.

## 2. PROPERTY MARKETS: CAUSE OR CONSEQUENCE OF ECONOMIC GROWTH?

### 2.1. Real Property Market

Lithuania has created a favourable environment for the development of a real property market. Over 80% of properties and real rights are registered in the Real Property Register. Buildings (78%) make the major part of registered real properties while the remaining 22% are land parcels. In 2001, 4% of the formed and registered properties were transferred, inherited and mortgaged. Figure 1 illustrates the real property market in 1995-2001.

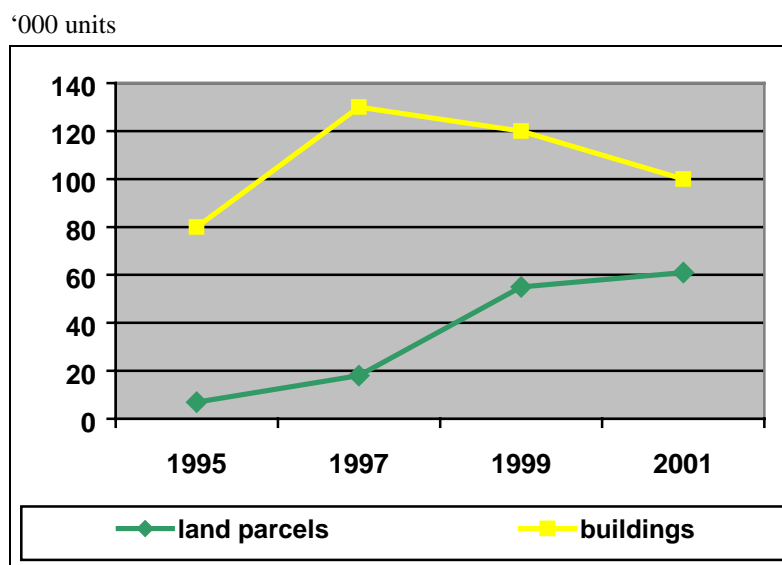


Figure 1. Dynamics of real property market in Lithuania

Statistical data shows that the market of land parcels is constantly increasing, however the land market differs very much if compared in each county. For example, almost 50 percent of all land transactions in Lithuania are carried out in Vilnius and Kaunas counties, an area that covers only 27% of the territory of Lithuania. Land market is also more active in such counties as Klaipeda, Panevezys, Siauliai if compared to other counties.

While the land market is constantly increasing, the market of flats and family houses decreased in recent years. The market of flats and family houses is most active in major cities, - as Vilnius, Klaipeda, and Kaunas, where 55% of all transactions in the country took place.

The analysis of the real property market changes in 1995-2001 shows that the real property market depends very much on the growth of the national economy, business investment, employment, density and living standard of citizens.

## 2.2. Enterprises and Financial Sector in Market Economy

Financial reporting of Lithuanian enterprises is still a great problem. In some enterprises a book value of the assets on the balance sheet is reported and this will not normally reflect an open market valuation of the portfolio. An accounting body and a valuation body have a different understanding of the “fair value”. Accounting standards in our country are in a state of transition to the International Accounting Standards (IAS). Currently, the Lithuanian Association of Property Valuers recommends making the asset re-evaluations reflecting the fair/market value. The initial focus would be on agreeing on consistent measurement objectives for re-valuations at market value. A replacement cost method applies for valuation of specialised assets, for which there is no active market.

The Securities and Exchange Commission, the Ministry of Finance, the Audit, Accounting and Property Valuation Institute and other institutions discuss the implications of fair value (based on the market value) or the book value in the accounting. A variety of forces of economics are influencing the movement towards the fair/market value reporting, including: 1) the intent of the Securities and Exchange Commission to increase the transparency of information available on investments; 2) demand by Privatisation Agencies and capital market and other users of financial statements for more accurate calculation of value on assets and liabilities. In the future there will be a greater need to use cash flow information and present value concept in accounting and in valuation for financial statement.

Since the Guidance Notes and Standards (EVS, IVS) relating to measurement of market or fair value significantly involve a role of methodology, valuation profession and definitions. A many institutions are more focusing on market-based valuations, the role of a skilled valuer is increasing.

## 3. PROPERTY TAX AND MASS APPRAISAL ISSUES: A NEED FOR METHODOLOGY AND STANDARDS

Real property taxes in Lithuania mean the tax of real property of enterprises and organisations and the land tax.

This is to note that the real property tax of enterprises and organisations in 2000, if compared to that in 1995, made twice larger part of the budgets. In 1995 it made 3,94 percent of the municipal budgets while in 2000 - 6,66 percent. Correspondingly, in the national budget it made - 1,25 percent and 2.22 percent. The cash sum of the real property tax of enterprises and organisations increased from 70 667 thousand. Lt. in 1995 up to 192 081 thousand Lt. in 2000, i.e. even by 272%. Land tax collected in 1995 made 15 544 thousand Lt. and 20 840 thousand Lt. in 2000 or 154 % more. However, the share within the budgets remained nearly the same: in 1995 - 0,87 percent of the municipal budgets and in 2000 0,72 percent. Correspondingly in the national budget – 0,27 % and 0,24 %.

The current trend of real property tax reform is oriented towards the regulation of real property and land tax of companies and organisation **in one Law on Real Property Tax**,

which will reflect the world-wide experience in the area of property valuation (with reference to property market price).

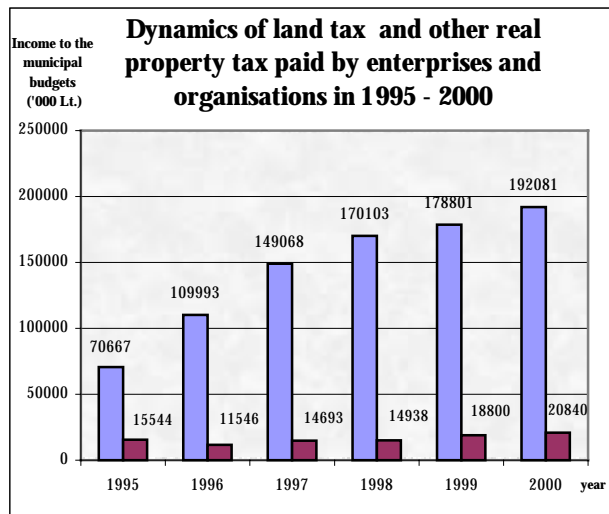


Figure 2. Dynamics of real property tax paid in Lithuania

Taxable value of real property, which is equal to the real property value estimated under the procedure set by the Law on Basics for Valuation of Property and Business of the Republic of Lithuania and applying the real property valuation method selected by the Government of the Republic of Lithuania for specific groups of real property, should make the basis for the tax. The Government of the Republic of Lithuania selects a valuer and the recalculation of real property is carried out under the procedure established by the Government of the Republic of Lithuania or the institution authorised by it.

Right now, Lithuania has no standard approved for mass valuation of real property for tax purposes. The experience gained in foreign countries and the recommendations on mass valuation that are under preparation by the International Property Valuation Standard Committee (standard) will have a great impact on the preparation of such standard.

Preparatory activities for the implementation of real property tax reform. The following preparatory activities foreseen for the implementation of reformed real property taxation:

1. To introduce the real property tax, it is necessary to establish a system for valuation of real property for taxation purposes.
2. Methods and approaches for estimation of value based on market principles must be applied for the estimation of real property taxable value. The experience of other countries shows that mass valuation is to be used for real property taxation. Individual property valuation could be applied for special and unique objects (special purpose property), for instance, TV tower, Ignalina Nuclear Plant and etc. The Law on Property

and Business Valuation Basics describes the specific property valuation approaches, which are harmonised with the international valuation system.

3. The approach of sales comparison values (analogue of sales prices) could be the basis for estimation of taxable value of administrative offices, land and other marketable objects. Capitalisation and replacement value approach could be applied for valuation of premises generating economic and other income. Seeking to achieve that the replacement value is as close as possible to the market value it is necessary to update the price-lists that are applied for the estimation of replacement value.

Property valuation, especially mass valuation, means the collection, sorting and processing of information about real properties and real property market.

Analysis that is necessary for the development of the models derived from formulas, their calibration and quality control include computer operations, which require many data necessary to be processed. The implementation of these tasks requires applying computer-analytical systems, i.e. computer-aided valuation. Computer-assisted valuation is important not only for mass valuation but also for special valuation of property units and for the analysis of real property and market dynamics.

The simplest forms of computer-assisted valuation are considered to be the information database management systems having the functions of data storage, retrieval, accountability and use, which enable the implementation of simplified models. To speed up the valuation process by applying computer-based valuation systems it was necessary to use the analytical potential of computer in order to develop more sophisticated models, which helps to estimate property within the market in a more precise way and to evaluate the quality of estimated values.

The analysis of the world-wide experience shows that the data about real property and real property market can be processed and analysed quickly and effectively only applying computer information-analytical systems.

For that purpose in Lithuania, the existing computer-based information system of real property cadastre and register administered by the State Land Cadastre and register can be used.

The implementation of mass valuation system can be split into two main parts:

- Supplementation of the existing database model (to supplement the DB model seeking to enter the information necessary for property valuers);
- Development of a model for analytical system (to the develop the relational analytical system model part; to develop a multiple analytical system, i.e. the development of the multiple database and an appropriate application).



#### **4. ROLE OF VALUERS INVOLVED IN INVESTMENT DECISION-MAKING PROCESS**

The investment usually starts with the investment in real property and expands in technologies and other fields. The valuation is not limited to the valuation of real property but it also demands for consultation, preparation of investment projects, market researches and forecasting activities. The scope of customers asking for these services are expanding and becoming more international.

The Lithuanian valuers community is able to operate successfully in all the above mentioned fields by providing the service to domestic as well as international investors. Investors want as extensive studies as possible on the investment environment.

A valuer should become an important and reliable consultant for a investor and should embrace the fields traditionally covered by financial analyst, urban planner, engineering infrastructure analyst, lawyer, civil engineer and architect. The need for expanded scope of activities and services asks for reforming the work mode. In this situation one should become a team leader (manager), being able to present the report prepared by a team of experts, instead of being an individual expert.

Usually the service include the main parts: a study of legal opportunities of investment, an engineering study of the physical state and renovation options of real estate, an economic feasibility study, final remarks and conclusions. The different scenarios are estimating for a conclusion.

#### **5. CONCLUSIONS AND FINAL REMARKS**

Land and other real property are valuable asset and fundamental element of the national economy. Therefore, the development of efficient and transparent real property administration system (cadastre, register, mortgage, etc) supports the economic development of the country and attracts investment. Valuation is a very important tool in a market economy. Valuer should become an important consultant for the local and international investor. Real estate expert should provide the expertise in the fields traditionally covered by financial analyst, urban or rural planner, engineering infrastructure analyst, lawyer, civil engineer and architect. The expanded scope of activities asks for work mode based on team collaboration.

Harmonisation of valuation systems and improved transparency are the keys making the sector of real property more accessible, leading to better coverage and greater investment values. From other point of view is very important to harmonise different approaches for property revaluation for taxation and accounting. The implementation of mass appraisal system based on market value will be a very important element stimulating the effective use of property in a market economy and developing a transparent and coherent tax system in Lithuania.

Clients ask the valuer to have deep knowledge in many fields. Integration of the disciplines in valuation is a feature of the best practice of valuation. Similar requirements are put by the European Valuers Certification Network to the valuers who are seeking to be "approved by TEGoVA". In Lithuania it is achieved through combination of academic (university) education with continued professional education.

The legal framework of Lithuania integrating the valuation of property and the valuation of business should be improved in line with the requirements of the new Civil Code, the EU *acquis communautaire* requirements, the requirements imposed by the globalisation of property and capital market. There is a new draft edition of the law on Fundamentals of Property and Business Valuation prepared. The Lithuanian valuation Guidance (1996) should be updated in essence during 2002 and adjusted to IVS 2000 and ECS 2000.

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## BIOGRAPHICAL NOTES

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