

PRICE VERSUS VALUE – WAS OSCAR WILDE RIGHT?

2015 SME Annual Meeting & Exhibit

Valuation Session

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PRICE VERSUS VALUE

“Nowadays, people know the price of everything and the value of nothing.” (Oscar Wilde)

The Picture of Dorian Gray, Ward, Lock and Company (1891)

PRICE VERSUS VALUE

- Price – A fixed amount of money.
What you pay for something.
- Value – A perception.
Like beauty, it is in the eye of the beholder.

PRICE VERSUS VALUE (CONT'D)

- A frequent cause of substantial misunderstanding in many appraisal assignments.

PRIOR TO ACCEPTING AN ASSIGNMENT

- Determine the client's expectations –
 - ❖ Client may not have a firm value in mind, but generally has an order of magnitude value.

PRIOR TO ACCEPTING AN ASSIGNMENT (CONT'D)

- Determine the basis for client's expectations –
 - ❖ Requires a dialogue.
 - ❖ Often requires some finesse.

PRIOR TO ACCEPTING AN ASSIGNMENT (CONT'D)

- Important to make clear not attempting to determine value client wants so you can meet it.

PRIOR TO ACCEPTING AN ASSIGNMENT (CONT'D)

- If price is the client's basis, address the issue –
 - ❖ In some instances, can't be dealt with and assignment must be turned down.

ADDRESSING THE ISSUE

- Step 1 – Discuss methodology
 - ❖ Explain approaches to value and basis for your selection(s).
 - ❖ This requires that you have thought through the process before discussing with client.

ADDRESSING THE ISSUE (CONT'D)

- Step 2 – Establish likely order-of-magnitude value.
 - ❖ This is the moment of truth.
 - ❖ Appraisal assignment may have to be turned down if a satisfactory understanding can't be reached.
 - ❖ Difference is usually so profound that decision is evident.

REPRESENTATIVE ILLUSTRATIONS

- Example 1 – Pipeline ROW Across Property Underlain by Limestone.
 - ❖ Quarried previously but not within proximity to ROW.
 - ❖ Long-term mine plan contained in mining permit.
 - ❖ Insignificant corner of one pit affected by ROW.
 - ❖ Initial response by landowner cites the value of the stone calculated to lie within the ROW using price as the multiplier.

REPRESENTATIVE ILLUSTRATIONS (CONT'D)

- Example 2 – Landowner has property with known deposits of sand and gravel.
 - ❖ Extraction in area but none has been considered on subject property.
 - ❖ Landowner interested in placing a conservation easement on property (instant red flag).
 - ❖ Recites price of sand and gravel products in area and informally derives an order-of-magnitude value.

REPRESENTATIVE ILLUSTRATIONS (CONT'D)

- Example 3 – Pipeline ROW across property underlain by limestone.
 - ❖ Extraction on property by owner in past.
 - ❖ Potential for extraction to resume in foreseeable future.
 - ❖ Prepared order-of-magnitude estimate of value which obviously well under landowner's expectation.
 - ❖ Landowner response "but that stone sells for \$x a ton."

REPRESENTATIVE ILLUSTRATIONS (CONT'D)

- Example 4 – Underground coal mine crosses property line onto unleased property and mines.
 - ❖ Landowner brings suit.
 - ❖ Attorneys ask you to establish damages based on several methods, one of which includes using the selling price of the coal as the multiplier.

TWO BASIC MISAPPLICATIONS OF PRICE

- Examples illustrate the two basic forms of misapplication of price in determining value.
 - ❖ Direct application – used as the multiplier against the units of the commodity in question.
 - ❖ Indirect application – not used as the multiplier but influences client's intuitive sense of value.

RESPONSE – EXAMPLE 1 – PIPELINE ROW

- Matter was involved in litigation.
 - ❖ Representing pipeline company so issue would be determined as a matter of law.
 - ❖ Required thorough explanation of appropriate valuation techniques with particular emphasis on:
 - Probability of occurrence of mining (uncertainty).
 - Time value of money.
 - ❖ Accepted assignment because issue was not with client.

RESPONSE – EXAMPLE 2 – CONSERVATION EASEMENT

- Discussed appraisal methodology with landowner.
 - ❖ First, no expectation of mining in foreseeable future, thus income approach not appropriate.
 - ❖ Discussed order-of-magnitude values to be derived using Sales Comparison Approach.
 - Based on sales data gathered in the broad region over the years in prior appraisals.
 - Not represented to be a value that would be reached, but gives perspective.

RESPONSE - EXAMPLE 2 (CONT'D)

- Even if used Income Approach, would be modest value.
 - ❖ To be supportable, would need to factor uncertainty into process (probabilistic approach).
 - ❖ Many variables.
 - ❖ Did not accept assignment.

RESPONSE – EXAMPLE 3 – PIPELINE ROW

- Matter was involved in litigation.
 - ❖ Representing landowner.
 - ❖ Initial model runs -
 - Probability of occurrence of mining (uncertainty).
 - Time value of money.
 - ❖ Did not provide a value but functioned in an advisory capacity with entity selected to provide valuation.

RESPONSE – EXAMPLE 4 – COAL MINE TRESPASS

- Matter was involved in litigation.
 - ❖ Damages for trespass vary by venue.
 - Inadvertent trespass.
 - Willful trespass.
 - ❖ In this instance providing two values was appropriate.
 - First, using expected royalty income.
 - Second, using expected selling price.

WRAPPING UP

- Misuse of price can occur in two forms.
 - ❖ Explicit or direct application.
 - ❖ Implicit or indirect application.

WRAPPING UP (CONT'D)

- How best to address.
 - ❖ Establish client's expectations.
 - ❖ To the extent possible, develop an order-of-magnitude estimate of range of value likely to be obtained.

CLOSING THOUGHT

Wall Street and much of the investment community live by the Greater Fool Theory.

Don't be a part of it.

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