# Current Issues in Real Property Appraisal Review

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# Current Issues in Real Property Appraisal Review

Presentation is from financial service institution client perspective and includes three parts:

***Part One*:**
Queried Review Appraiser Concerns

***Part Two:***
Three Recent Issues: Signs of the Time

# art One:

**Queried Review Appraiser Concerns**

*…in these parts, often times a man's life depends on a mere scrap of information."*

# olicited Comments from Review ppraisers:

everal review appraisers were queried on their thoughts n:

- The top three (3) most common appraisal deficiencies you see in their review work.  AND
- Any interesting stories or examples in regards to these three common appraisal deficiencies?

his portion of the presentation will highlight some of nese responses.

# ales History:

"… *appraisers failing to discuss and explain the reason for differences between the As-Is value conclusion and the recent sale, contact or listing price.*"

Incomplete documentation of subject property's sale and listing history: "…*not enough to just say*, "*Subject is in escrow for $10MM*" or "*We acknowledge the subject sold in June of 2014 for $10MM.*"

# ales History (cont)

A complete and comprehensive discussion is needed as to when and why the property was listed, pricing changes, offers, and motivations of the buyer and seller.

Comments from the broker(s) regarding the property and its pricing and placement in the market, as well as what criteria they used to value - price it.

# ales History (cont)

Because the borrower wants to obtain a loan and purchase the property, the owner wants to sell the property, and the broker wants a commission, these individuals should be motivated, and more than forth coming and helpful with information.

A commentary is needed regarding the interviews and discussion with these direct "market participants."

# ales History (cont)

*"The appraisal did not recognize the buyer and seller were related entities and the sale was not arm's length. The property was not broker listed and had no market exposure. The appraisal did not disclose how the sale came about."*

*"In a recent appraisal, there was a $500K spread between the PSA and the concluded As-Is value. Turns out the subject sold with the medical practice and the FF&E accounted for this difference."*

# rice vs Market Value:

For a pending sale, the appraiser sometimes estimates a different value than the escrow or contract price without sufficient justification.

There is often no discussion or market based support for the difference. Sometimes the difference is very minor at less than 1%.

Presented data is often not to the quality/ quantity to warrant a market based difference.

# rice vs Market Value (cont)

The appraiser often gets prideful that their market insight and understanding is better than the price agreed to by the actual direct market participants.

The appraiser in effect ignores the agreed upon price in order to stamp their mark on the transaction.

# ighest & Best Use (H&BU):

H&BU should identify the most probable buyer (e.g. user, partial user or investor?) and how they would use the property (e.g. would they occupy all or part of the property, use the improvements as they currently exist, or modify the current improvements, etc.).

Appraisal Quote: "*The subject is an existing good quality apartment complex built to condominium specifications… The existing improvements are considered the highest and best use as improved.*"

**While this may be true …**
**How should these improvements be used?**
**As apartments or condominiums or ?**

# I&BU (cont)

Appraisal Quote: "*The subject is a partially vacant 1960-built industrial building demised into three units and is in fair condition… The existing improvement program offers contributory value to the site. Therefore, the Highest and Best Use as improved is the continuation of the current use.*"

**Does this mean the H&BU as improved is to operate the property in fair condition with high vacancy (e.g. "slumlord")?**

# H&BU (cont)

Feasibility: "*If the project is not financially feasible, this needs to be addressed. It is not clear if appraisers are leery of stating a project is not financially feasible or if they just get in a hurry and skip this analysis. They have the cost information so this should be an easy analysis. Instead, they often just state the current use is the HBU. This doesn't always make sense. Why is the property being renovated if the HBU is to keep it As Is?*"

# wner Occupied Properties:

- Concerning appraisal quote: "*The subject property would be worth less if the current owner-occupant moved out*."
- Fee simple interest is As Vacant
- Current use may not dictate the H&BU
- Market value definition assumes a sale (e.g. market value in exchange)
- Discounting for lease up or pro-longed marketing time <u>may</u> be warranted

# leed Through Errors:

*"The most common appraisal error is "bleed through". This is where a portion of another appraisal is copied into the subject appraisal without proper editing."*

# athematical Errors:

*"I see errors in nearly 25% of all reports."*

Consider a manual HP-12C math check on key report areas such as direct capitalization since this the guts of the valuation: "*Worst error I ever saw was a national appraisal firm whose cell formula added rather than subtracted 10% vacancy & collection loss factor, which resulted in a -20% downward value revision.*"

*"Other common errors include miscalculating or reiterating the real estate taxes for CA properties, resulting in incorrect property tax expenses."*

# roof Read the Report:

*"…appraisers use programs to write their reports, but they need to proof read their work."*

*"…in an appraisal review, I compare the narrative vs the adjustment grid for both the sales and rent comparables. If there is an adjustment in the grid, there should be a written comment in the narrative, and visa versa and these figures should match."*

# roof Read the Report (cont)

**Direct quotes from appraisal reports:**

*"…property is in proses of being totaly remoded there are two units up and cownstaairs after remaodeling this building is in very nice condition ac and heat."* – **SPELL CHECK!**

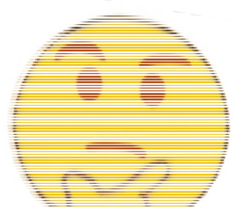
*"The subject is not located in a flood zone."* – **Zone X IS a flood zone!**

*"Land value in proportion to overall value is higher than typical. However this is somewhat common."* – **WHAT DOES "TYPICAL" MEAN?**

# roof Read the Report (cont)

"*Estimated cost to complete based on my limited knowledge as an appraiser is $750,000.*" – **I get what they are trying to say, but the appraiser is supposed to be a professional and they have just demeaned themselves to their client.**

"*There were no comparable land sales in the area. Due to the lack of data the appraiser is making a guesstimate.*" – **Hmmmm**



# onsistency:

Software like ***Narrative1*** reduces inconsistencies, but they still sometimes creep into appraisal reports. Many of the appraisers don't use this type of software, and use "home grown" copy/paste from Excel to Word.

*"I had one report with the APN listed in three places in the appraisal. All three places had different APNs."*

*"I called an appraiser this morning. The Argus output did not match the discussion of the DCF."*

# Veasel Word Abuse:

ppraisal Quote: "*On June 21, 2016, I drove by the ubject property and it appeared to be tore down*."

**he appraiser should definitively state if the roperty was there or not? Beware of weasel vords (e.g. appeared).**

*I*" vs "*We*" vs "*The Appraiser*": When possible, onsider writing in the first person.

**f something is factually obvious commit to it vithout disclaiming.**

# ead the Contract:

ppraisers need to address all RFP contract items:

- SBA as addressee and intended user
- Missing value premises
- Missing an Extraordinary Assumption – often one the client requested (related party lease is voidable or void)
- Missing something client requires – data sheets for land sales, rental adjustment grid, flood zone for the comps, etc.
- Insurable Replacement Cost – some clients need ALL structures

# ommunication:

*"Appraisers need to monitor their messages and emails during the day. I need calls returned within four hours. Even if to say a detailed answer will be forthcoming tomorrow."*

*"In addition to good quality work, I really need good service."*

# orrower &
# larket Participant Interviews:

*Appraisers need to interview parties to the ransaction, review listing history and find the tory. Uninformed buyer is a bad answer. In today's nowledge world, buyers are very informed and have ccess to experts for advice. 'The comps indicate a ifferent value' is not sufficient until we know the vhole story."*

# verleveraged Appraisal Staff:


*"A chain is only as strong as its weakest link"*

# )verleveraged Appraisal Staff:

*…the senior appraiser did not read the report and let wo junior level appraisers essentially complete the aluation. Multiple "bleed-through" errors from the rior report were noted which made the accuracy of he analysis questionable. A recent lease was also mitted from the initial analysis. Furthermore, the key hallenge to value was that 93% occupancy was rojected – the same as in the prior report – even hough occupancy had declined from 87% to 84%…*

# )verleveraged Appraisal Staff (cont)

*…All the immediate comparables in the area showed ccupancy less than 90%. The appraiser said they were ery busy which is why the bleed-through errors, the nissed lease, and the unrealistically high occupancy vere concluded. Don't let your refrain be, 'Never nough time to do it right, but always enough time to lo it over.' It is a money-losing proposition. The report vent through two major revisions and the appraisers ee was penalized for tardiness."*

# Overleveraged Appraisal Staff (cont)

Typical scenario: "*Senior appraiser gets draft from less experienced field appraiser on due date. The due date is met but the report is sloppy in quality. Senior appraisers need to supervise the field appraiser throughout the assignment and take accountability for their work.*"

"*Appraisers occasionally bite off more than they can chew – especially in portfolio valuations.*" Consider the credo: "*Under promise and over deliver.*"

# ntrepreneurial Profit:

elationship between: (a) acquisition price, (b) renovated and/or e-positioned future value, (c) current As-Is value, and (d) profit.

urrent phenomena occurring with all property types, usually with n acquisition price of $15MM–plus which were listed for sale, eceived multiple offers, followed by a round of "best and final" ubmittals.

**XAMPLE:**

20MM acquisition price with a $6MM planned cap-ex and upgrade" budget. Prospective As-Renovated & Stabilized value = 32MM. Less cap-ex, stabilization costs & profit @ $9MM reflects $23MM As-Is value by residual method.

# ntrepreneurial Profit (cont)

uestion:

the final As-Is Market Value the $23MM by the residual analysis r the $20MM acquisition price since the renovation and re-ositioning costs & profit expectations are “baked in the cake”?

Investors/developers are pushing the extra $3MM for an As-Is value of $23MM. Appraisers need to consider these types of value-related circumstances and, if necessary, make the case that the $3MM accrues to profit and not necessarily As-Is value.

he spread reflects a market based profit, risk and a contingency ncentive in assuming the risks of these estimated costs.

# ncome Approach:

*“Projected expenses should be supported by: 1) the subject’s historical expenses and/or 2) Operating expense comparables and/or 3) industry standard expenses (BOMA, IREM, etc.)... Should appraisal projections differ from historic trend an explanation is warranted.”*

*“NNN leases: Are they really able to ‘stick everything’ on the tenant?”*

*“How much space will roll over within the next five years and does this impact value?”*

# ncome Approach (cont)

*"Using excessively high discount rates for absorption rent loss instead of a nominal 'safe' rate."*

*"Insufficient explanation of the basis and/or calculation method for expense reimbursements (i.e., taken from DCF or manually calculated from off-report spreadsheet). Reviewers need to know how expense reimbursements are calculated. Appraisers often shortcut the narrative of this revenue component."*

# ncome Approach (cont)

*"Insufficient entrepreneurial profit applied to lease-up costs. Appraisers will oftentimes use a fixed % of 'hard' absorption costs without regard for total risk impact on value. Comparing profit component to total overall value is a good reasonableness check.*

**XAMPLE:**

*ofit = $30,000 on a $12MM deal, equates to a nominal 25% of value. An extra month of rent loss could negate all ofit. Appraisers need to examine profit's relationship to erall value."*

# hree Recent Issues - A Sign of the Times:

his week "three" issues crossed my desk which are ndicative of the times:

. Developer projects "oversell" parking at 120% of capacity

. Developer projects "load factor" 15% higher than gross building area

. Ratio Utility Billing System (RUBS) income from tenants in a B grade apartment complex in an unproven market.

# The End