Current Issues In Commercial Real Estate Appraisal – Common Errors & Issues

How to spot common mistakes in commercial real estate appraisals.
Qualifications of the Presenters

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- Master of Science – Real Estate Appraisal & Investment
  – University of Wisconsin – Madison, 1989
- Bachelor of Business Administration – Real Estate & Urban Land Economics
  – University of Wisconsin – Madison, 1988
- Appraisal Institute – MAI Designated Member & Approved Instructor
- Wisconsin Certified General Appraiser #236
- Wisconsin Licensed Assessor II
- Wisconsin Licensed Real Estate Broker #29219
- Founder & President – North American Realty Advisors, Inc.
- Founder & President – Valuation Compliance, Inc.
Qualifications of the Presenters

Stephen G. Stiloski, MAI, CCIM

- Master of Science – Real Estate Appraisal & Investment
  – University of Wisconsin – Madison, 1989
- Bachelor of Science – Agricultural Economics
  – University of Wisconsin – Madison, 1987
- Appraisal Institute – MAI Designated Member & Approved Instructor
- National Association of Realtors – Certified Commercial Investment Member
- Wisconsin Certified General Appraiser #010
- Wisconsin Licensed Assessor II
- Wisconsin Licensed Real Estate Broker #44075
- Founder & President – Commercial Property Consultants, Inc.

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Classroom Guidelines

- Refrain from using short-range wireless technology.
- Limit use of laptops to classroom projects.
- Communicate with business associates during break time instead of class time.
- Put away reading materials such as newspapers and books that are not used in class.
- Silence (set to vibrate) cell phones and other communication devices.
Classroom Guidelines, cont.

- Use recording devices only if prior permission has been granted.
- Refrain from ongoing conversations with those seated near you and other distracting behavior.
Audience Assumptions

- Knowledge of USPAP.
- Knowledge of FIRREA.
- This is not Appraisal 101!
The Essence of an Appraisal

An interpretation of market participant calculus to arrive at an opinion of value at a SINGLE POINT IN TIME.
The Essence of an Appraisal

- Market participant calculus – Valuing a property using the same methodology as market participants.
- Units of comparison.
- Analytical tools – Direct Cap. vs. DCF.
- Local market standards.
- The more complicated the model the more prone it is to manipulation and mistakes.
Problem Identification

- Purpose – type of value
  - Market Value – Required
    - Real Property
    - Going Concern
  - Disposition / Liquidation Value
  - Value in Use
Problem Identification

- Effective Date – Do **NOT** use “as-if”
  - As Is MV – Required for **ALL** FRTs – on appraiser’s date of inspection with no hypothetical conditions
  - Prospective MV Upon Completion
  - Prospective MV Upon Stabilization
Problem Identification

- Relevant characteristics of the property to be appraised
  - Physical characteristics
  - Interest appraised
  - Other tangible / intangible items
Discussion Question

- Often, a business owner will buy a building as an individual and lease it to his company. How should the property be valued?

- Ignore the lease, it is not arm’s length. What does the bank get in event of default? A vacant building!
Problem Identification

- Relevant characteristics of the property to be appraised
  - Property ownership
  - Impairment
  - Encumbrances
Problem Identification

- Unusual assignment conditions
  - Extraordinary assumptions
  - Hypothetical conditions

  - MUST be agreed to at the initiation of an assignment…NO SURPRISES!!!
Extraordinary Assumptions

“An assumption, directly related to a specific assignment, which, if found false, could alter the appraiser’s opinions or conclusions.”

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Extraordinary Assumptions

- Not Identified – Must be conspicuously disclosed.
- Most commonly relates to a future date.
- “As Is” is also required.
Extraordinary Assumptions

Examples

- A warehouse is suspected to be contaminated by environmental hazards. The appraisal could be prepared based on the assumption that the warehouse is not contaminated.
- Completion of construction of a proposed improvement as of a certain future (prospective) date in accordance with plans and specifications reviewed by the appraiser.
- Execution of a certain lease as of a certain future (prospective) date.
Hypothetical Condition

“That which is contrary to what exists but is supposed for the purpose of analysis.”
Hypothetical Conditions

- Not Identified – Must be conspicuously disclosed.
- Relates to a current date.
- “As Is” is also required.
- Missing “as is” value easier to disguise with a hypothetical condition.
- Difference in values must be addressed – “As Is” with and without hypothetical condition.
Hypothetical Conditions

Examples

- A manufacturing plant is known to be contaminated, but for purposes of analysis, it is assumed that there is no contamination.
- A property may currently be zoned one way but is appraised as though it has a different zoning.
- Proposed improvements are assumed to be completed as of the date of inspection.
Scope of Work

The basis of all real estate appraisals!
Scope of Work

- Identify the Problem – Seven Elements
  1. Client
  2. Intended users
  3. Intended use
  4. Objective, or type of value in an appraisal
  5. Effective date
  6. Property characteristics that are relevant to the assignment
  7. Assignment conditions
Scope of Work

- Determine the solution.
- Apply the solution.
Scope of Work Development

- Documentation available for review from client.
  - Existing property with no changes
  - Proposed projects (either owner-occupied or investment property)
  - Investment property (existing or proposed)
Discussion Question

- Do you believe that a copy of the sale contract should be provided to the appraiser? Why or why not?
USPAP requires that appraisers review all listings and sale contracts relative to an assignment “provided the information is available in the general course of business” (meaning the appraiser is required to ask for a copy of the sale documentation). The sale contract for a property in escrow or one that has recently sold is only one piece of market evidence in valuing the property.
Discussion Question

- If the bank truly wants an unbiased opinion from the appraiser, the bank may choose to withhold a copy of the purchase contract so the appraiser does not have a “target” to hit.
Other Issues & Observations

- Disclosure of Sale Price to Appraiser
  - Required by USPAP for property history.
  - Need contract to determine if there are concessions, non-market terms, personal property included, etc. Appraisers are required by USPAP to analyze a pending sale.
  - If property has had sufficient and professional market exposure, the sale price is likely market value.
Discussion Question

- What do you consider an adequate set of plans and specifications?
- Site Plan
- Floor Plan
- Elevations
- Wall Sections
Scope of Work Development

- Appraisal scope of work options
  - Property Inspection
  - Neighborhood analysis
  - Market analysis
  - Highest and best use analysis
Scope of Work Development

- Appraisal scope of work options
  - Valuation techniques
    - Vacant land – six methods
    - Improved property
      - Cost approach
      - Sales comparison approach
      - Income capitalization approach
Scope of Work To Be Reported

- Appraisal reporting options
  - Self-Contained Appraisal Report
  - Summary Appraisal Report
  - Restricted Use Appraisal Report

Key is to report “in a manner that is not misleading.”
Federal regulations require sufficient information to make an informed decision.
Discussion Question

- Many financial institutions now use a “hybrid” approach between the Self-Contained Appraisal Report and the Summary Appraisal Report.

How does your institution approach using a “hybrid” report type?
Scope of Work To Be Reported

- Report exhibits to be included
- Others terms of the agreement
  - Date documents are to be provided
  - Value type to be reported
    - Dollar estimate
    - Dollar range
    - Benchmark
Scope of Work To Be Reported

- Others terms of the agreement, cont.
  - Appraisal delivery date
  - How the report will be delivered
  - Appraisal fee payment
Highest & Best Use

The basis of the valuation.
Highest & Best Use

- Forms the basis for valuation.
- Highest & Best Use as Vacant = comparable land sales.
- Highest & Best Use as Improved = comparable improved sales.
- Does not always have to be long and detailed. (i.e. An industrial building in the middle of an established industrial park.)
- Should be detailed and test assumptions where a change in H&B Use is in progress or anticipated.
- Usually ends up somewhere in between – overkill, incomplete, or boilerplate.
Uses of Sales Comparison Approach

Can be used to value either

- Land
- Improved Property
Steps of Sales Comparison Approach

- Data Research
- Analysis
- Types of adjustments
  - Sequence of adjustments
  - Magnitude of adjustments
- Conversion to unit of comparison
- Reconciliation of final value
Types of Adjustments

- Qualitative adjustments
  - Equal
  - Better
  - Worse

- Quantitative adjustments
  - Dollar amount
  - Percentage adjustment
Magnitude of Adjustments

- Individual adjustments
- Gross adjustments
- Net adjustments
Sequence of Adjustments – First Set

- First set – transactional adjustments
  - Real property rights conveyed
  - Financing terms
  - Conditions of sale
  - Expenditures immediately after purchase
  - Market conditions
Sequence of Adjustments – Second Set

- Second set – property adjustments
  - Location
  - Physical land or improvement characteristics – size, shape, frontage, topography, soils, view, quality of construction, age, etc.
  - Utilities – water, sewer, power, etc.
  - Zoning
Derivation of Value Opinion

- Conversion of adjusted comparables to a common unit of comparison
  - Square foot
  - Acre
  - Front foot

Application to subject
Sales Comparison Approach – Appraisal Review Issues

- Strengths of approach
  - Widely used by market participants
  - Reliable indicator when data is available indicating market is active
Sales Comparison Approach – Appraisal Review Issues

- What is the availability of data?
- How recent are sales?
- What has happened since?
- What’s going on now?
Sales Comparison Approach – Appraisal Review Issues

- Support for adjustments – how derived
  - What is matched pair analysis?
  - Statistical analysis?
  - Broker surveys
  - Other market participant surveys
Sales Comparison Approach – Appraisal Review Issues

- Magnitude of adjustments?

  These will indicate how comparable the comparable data really is.
Sales Comparison Approach – Appraisal Review Issues

- Approach most useful for?
  - Raw land
  - Improved site
  - Owner-occupied improved property
Sales Comparison Approach – Appraisal Review Issues

- Appraisal review resources
  - www.costar.com
  - www.loopnet.com
  - Local brokerage firms
  - Local data bases (small markets)
Cost Approach – Appraisal Review Issues

- Land Valuation is separate from the Cost Approach
- Land value is utilized in the cost approach
- Scope of Work issue whether to include land value when not including Cost Approach
Cost Approach – Appraisal Review Issues

- Cost Estimates
  - CoStar for closed land sales – www.costar.com
  - Banker or appraiser files
    - Recent cost comparables
    - Budgets and contracts
Cost Approach – Appraisal Review Issues

- Depreciation Estimates
  - Standards Rule 1-4(b) requires depreciation information to come from comparable data.
  - Depreciation is a theoretical concept that is difficult to support.
  - Age/life ratio does not comply.
Cost Approach – Appraisal Review Issues

- When is the approach most useful?
  - Proposed improvements
  - New(er) improvements
  - Unique Improvements
  - Highest and Best Use
Cost Approach – Appraisal Review Issues

- What are some secondary uses?
  - Using a cost index as a test of reasonableness
  - Insurable value
  - Evaluations performed in-house at the bank
  - When other approaches cannot be used due to unavailability of credible data
Cost Approach – Appraisal Review Issues

- Dangers?

Failure to recognize and account for functional and external obsolescence, which, without market data are difficult to recognize and quantify.
Cost Approach – Appraisal Review Issues

- The cost approach is least reliable for:
  - Older improvements; or
  - No longer the highest and best use
- Banks may choose to advance against land only to mitigate risk.
- Banks could ask appraiser to do a broker survey if cost approach is the only approach considered.
## 5.1 Example

<table>
<thead>
<tr>
<th>Step</th>
<th>Procedure</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Estimate the <strong>direct</strong> and <strong>indirect</strong> costs of the improvements.</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>2</td>
<td>Estimate the <strong>entrepreneurial incentive</strong> (for example, 10%).</td>
<td>+$100,000</td>
</tr>
<tr>
<td>3</td>
<td>Add Steps 1 and 2 together to obtain the total current cost.</td>
<td>$1,100,000</td>
</tr>
<tr>
<td></td>
<td>Estimate the depreciation from three sources:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- <strong>Physical</strong> depreciation</td>
<td>20% -220,000</td>
</tr>
<tr>
<td></td>
<td>- <strong>Functional</strong> obsolescence</td>
<td>15% -165,000</td>
</tr>
<tr>
<td></td>
<td>- <strong>External</strong> obsolescence</td>
<td>5% -55,000</td>
</tr>
<tr>
<td></td>
<td><strong>Total depreciation – All causes</strong></td>
<td>40% -440,000</td>
</tr>
<tr>
<td>5</td>
<td>Deduct the depreciation estimate from the total current cost to</td>
<td>$660,000</td>
</tr>
<tr>
<td></td>
<td>derive an estimate of the depreciated cost of improvements.</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Add the contributory (as is) value of any site improvements.</td>
<td>+$10,000</td>
</tr>
<tr>
<td>7</td>
<td>Add the value of the site to the total depreciated improvement costs</td>
<td>+$200,000</td>
</tr>
<tr>
<td></td>
<td>(previously estimated by the appraiser).</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Indicated value by the cost approach</td>
<td>$870,000</td>
</tr>
</tbody>
</table>
Income Estimates

- **Income stream**
  - Quality
  - Quantity

**Contract rent**
- Occupied space (lease exceeding one year)

**Market rent**
- Vacant Space
- Non-arm’s length lease
- Lease with less than one year remaining
Types of Leases

- The type of lease determines the party responsible for expenses
  - Gross lease
  - Modified gross lease
  - Net lease
  - Note that capital expenditures and lease rollover expenses must still be accounted for in analyzing net leases
Types of Leases

- How to handle certain lease issues
  - Expense stops
  - Expense and CAM reimbursements
  - Effective rent (see example)
Problem

- Tenant A negotiates a lease on 1,000 SF for a 5-year term at a rate of $20/SF. However, due to market conditions, the tenant is given a period of six months free rent initially.

What is the effective rent?
## Problem Solution

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sq. ft. rented</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>Rent per sq. ft.</td>
<td>$20.00</td>
</tr>
<tr>
<td>Annual rental</td>
<td>$20,000.00</td>
</tr>
<tr>
<td>Total rental to be paid over lease</td>
<td>$100,000.00</td>
</tr>
<tr>
<td>Monthly rent</td>
<td>$1,666.67</td>
</tr>
<tr>
<td>No. of months rent to be paid</td>
<td>54</td>
</tr>
<tr>
<td>Actual rent paid</td>
<td>$90,000.00</td>
</tr>
<tr>
<td>Effective rental paid per sq. ft.</td>
<td>$18.00</td>
</tr>
</tbody>
</table>
Problem Solution, cont.

- If tenant is now paying contract rent, and the concession is “in the past,” should the effective rental rate or the contract rental rate be utilized?

- Current leasing concessions
### Example – Income and Expense Analysis

**Income and Expense Analysis**

**Income analysis**

**Contract rental analysis - Occupied space**

<table>
<thead>
<tr>
<th>Letter</th>
<th>Sq. Ft.</th>
<th>Rate per Sq. Ft.</th>
<th>Total</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>1,000</td>
<td>$8.00</td>
<td>$8,000</td>
<td>Review any existing leases.</td>
</tr>
<tr>
<td>B</td>
<td>1,000</td>
<td>$10.00</td>
<td>$10,000</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>1,000</td>
<td>$12.00</td>
<td>$12,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3,000</td>
<td>$10.00</td>
<td>$30,000</td>
<td>Estimate contract rent.</td>
</tr>
</tbody>
</table>

**Market rental analysis - vacant space**

<table>
<thead>
<tr>
<th>Letter</th>
<th>Sq. Ft.</th>
<th>Rate per Sq. Ft.</th>
<th>Total</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>D</td>
<td>1,000</td>
<td>$12.00</td>
<td>$12,000</td>
<td>Search market for rent comparables; make any adjustments warranted.</td>
</tr>
<tr>
<td>E</td>
<td>1,000</td>
<td>$12.00</td>
<td>$12,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2,000</td>
<td>$12.00</td>
<td>$24,000</td>
<td>Estimate market rent.</td>
</tr>
<tr>
<td></td>
<td>5,000</td>
<td>$10.80</td>
<td>$54,000</td>
<td>PGRI (Contract + market rent)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Add other income.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Add PGRI to other income.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Deduct a vacancy allowance.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>EGI estimate</td>
</tr>
</tbody>
</table>

- Gross potential rental income $54,000
- Other income 3% $1,620
- Gross potential income $55,620
- Less vacancy & collection loss 5% $(2,781.00)
- Effective gross income $52,839
Example – Income and Expense Analysis

<table>
<thead>
<tr>
<th>Expense analysis</th>
<th>$ PSF</th>
<th>% EGI</th>
<th>$ Amt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real estate taxes</td>
<td>$ 1.00</td>
<td>9.46%</td>
<td>5,000</td>
</tr>
<tr>
<td>Insurance</td>
<td>$ 0.15</td>
<td>1.42%</td>
<td>750</td>
</tr>
<tr>
<td>Management fee</td>
<td>$ 0.32</td>
<td>3.00%</td>
<td>1,585</td>
</tr>
<tr>
<td>Utilities</td>
<td>$ 1.00</td>
<td>9.46%</td>
<td>5,000</td>
</tr>
<tr>
<td>M &amp; R</td>
<td>$ 0.25</td>
<td>2.37%</td>
<td>1,250</td>
</tr>
<tr>
<td><strong>Subtotal oper. exp</strong></td>
<td><strong>$ 2.72</strong></td>
<td><strong>25.71%</strong></td>
<td><strong>13,585</strong></td>
</tr>
<tr>
<td>Replacement res.</td>
<td>$ 0.15</td>
<td>1.42%</td>
<td>750</td>
</tr>
<tr>
<td>Rollover expense</td>
<td>$ 0.30</td>
<td>2.84%</td>
<td>1,500</td>
</tr>
<tr>
<td><strong>R/R &amp; rollover</strong></td>
<td><strong>$ 0.45</strong></td>
<td><strong>4.26%</strong></td>
<td><strong>$ 2,250</strong></td>
</tr>
</tbody>
</table>

**Effective gross income** $ 52,839 **EGI estimate**

**Total expenses** **$ (15,835)** **Deduct total expenses.**

**Net operating income** $ 37,004 **NOI estimate**

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<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net operating income</td>
<td>$37,004</td>
</tr>
<tr>
<td>Overall rate</td>
<td>8%</td>
</tr>
<tr>
<td>Indicated value</td>
<td>$462,548</td>
</tr>
<tr>
<td>Rounded to</td>
<td>$460,000</td>
</tr>
<tr>
<td>Value per SF</td>
<td>$92.00</td>
</tr>
</tbody>
</table>
Discussion Question

- Where does the appraise get data for estimating income and expenses?
Discussion Question Solution

For existing projects, the appraiser looks at

- Actual lease data
- Current budget
- Historical expenses
- Expense
- Comps
- Industry Standard Data

Oftentimes, these expenses are analyzed on the basis of either:

- $ Per square foot;
- $ Per unit; or,
- % of EGI

The data is then projected on a stabilized basis for each category of expenses.
Some appraisers will compare historical actual data with survey data to see if the property is in line with market expectations.

Tax returns and rent rolls are other sources.
Income Approach Resources

Expense Survey Data
- Office – [www.boma.org](http://www.boma.org)
- Office – [www.sior.com](http://www.sior.com)
- Ind’l – [www.sior.com](http://www.sior.com)
- Apts – [www.irem.org](http://www.irem.org)
- Retail – [www.uli.org](http://www.uli.org)
- Hosp. – [www.hvs.com](http://www.hvs.com)
- [www.strglobal.com](http://www.strglobal.com)

Market Analysis
- [www.stdbonline.com](http://www.stdbonline.com)
- [www.loopnet.com](http://www.loopnet.com)
- [www.ncreif.com](http://www.ncreif.com)
- [www.twr.com](http://www.twr.com)
- [www.costar.com](http://www.costar.com)
Capitalization

Two models or methods to process NOI into a value estimate

- Direct capitalization
  - Stabilized “for lease” properties
- Yield capitalization (aka DCF Analysis)
  - Non-stabilized “for lease” properties
  - “For sale” properties (i.e., condos, etc.)
# Comparison of Two Models for Processing NOI

<table>
<thead>
<tr>
<th></th>
<th>Direct Capitalization</th>
<th>Yield Capitalization</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of projection periods</strong></td>
<td>Single – Stabilized year</td>
<td>Multiple – 5 to 10 years typical</td>
</tr>
<tr>
<td><strong>Uses</strong></td>
<td><strong>NOI</strong> divided by a capitalization rate or <strong>NOI</strong> multiplied by a factor <em>(GIM, GRM, EGIM, NIM)</em></td>
<td><strong>Multiple NOIs</strong> multiplied by a discount rate</td>
</tr>
<tr>
<td><strong>Values cash flow</strong></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Values reversion</strong></td>
<td>Implied</td>
<td>Specific</td>
</tr>
<tr>
<td><strong>Most useful for</strong></td>
<td>Simple “for lease” projects - stabilized</td>
<td>1) Simple “for lease” projects – not stabilized</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2) Complex “for lease” projects</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3) “For sale” projects</td>
</tr>
<tr>
<td><strong>Advantages</strong></td>
<td>Simple to apply and understand</td>
<td>More precise analysis for complex multitenant properties</td>
</tr>
<tr>
<td><strong>Disadvantages</strong></td>
<td>May be unreliable for complex multitenant properties</td>
<td>Time consuming to prepare, more difficult to understand</td>
</tr>
</tbody>
</table>

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Direct Capitalization

Four methods of overall rate derivation ($R_o$)
1. Market extraction
2. Survey method
3. Band of investment
4. Debt coverage ratio method
Direct Capitalization

Overall Rate Derivation #1

Extraction from market sales

\[
\text{NOI} \div \text{Sale Price} = R_o
\]
Direct Capitalization

Overall Rate Derivation #2

Survey method – national perspective

- Korpacz.com ($465.00)
- RealtyRates.com
  - Investor, Developer, & Market Surveys ($89 each or $189 for all three)
- RERC.com ($100 to $275)
- CB Richard Ellis (CBRE.com)
## Overall Rate Derivation

### Band of Investment

### Overall Rate Derivation #3

<table>
<thead>
<tr>
<th></th>
<th>Investment %</th>
<th>× Investment First-Year Return</th>
<th>=</th>
<th>Blended Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage</td>
<td>0.7500</td>
<td>× 0.0800</td>
<td>=</td>
<td>0.0600</td>
</tr>
<tr>
<td>Equity</td>
<td>0.2500</td>
<td>× 0.1200</td>
<td>=</td>
<td>0.0300</td>
</tr>
<tr>
<td>Total investment</td>
<td>1.0000</td>
<td>Calculated overall rate</td>
<td>=</td>
<td>0.0900</td>
</tr>
</tbody>
</table>

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## Band of Investment Calculating Equity Dividend Rate

<table>
<thead>
<tr>
<th>Step 1</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>NOI projection</td>
<td>$50,000</td>
</tr>
<tr>
<td>Less first year’s annual debt service (ADS)</td>
<td>40,000</td>
</tr>
<tr>
<td>First year’s cash flow to equity</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Step 2</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>First year’s cash flow to equity</td>
<td>$10,000</td>
</tr>
<tr>
<td>Divided by</td>
<td>/</td>
</tr>
<tr>
<td>Original equity</td>
<td>$100,000</td>
</tr>
<tr>
<td>First year’s cash-on-cash return</td>
<td>10%</td>
</tr>
</tbody>
</table>
Overall Rate Derivation
Debt Coverage Ratio Method

Overall Rate Derivation #4
Banker’s favorite method!

\[
(R_o) = DCR \times M \times R_M
\]

\[
\begin{array}{|c|c|c|c|}
\hline
7.20\% & = & 1.20 & \times \ 75\% & \times \ 0.08 \\
\hline
\end{array}
\]
Direct Capitalization – Factor or Multiplier Method

Multiplier Derivation

- GRM
- PGIM
- EGIM
- NIM

Where do these come from?
Extracted from recent sales just like $R_o$
Discussion Question

Most applicable for:

- Single or multitenant income-production
- Secondary or backup analysis for owner-occupied property
- Both stabilized and non-stabilized properties
- No applicability for limited use or special purpose properties (rarely leased)
Income Approach Appraisal Review Issues

- How recent and how comparable are the rent comparables selected for comparison
- Were the lease transactions confirmed, or did appraiser use only “asking rents?”
- What has been going on in the market since the date of rental of the comparables?
Income Approach Appraisal Review Issues

- Has the market been stable, trending upward, or declining?
- How large were individual adjustments?
- What are the gross and net magnitudes of total adjustments?
Income Approach Appraisal Review Issues

- Was historical operating expense data available as part of SOW?
- Did appraiser compare with
  - Expense comparables?
  - Industry resources?
Income Approach Appraisal Review Issues

- Was capitalization rate of multiplier extracted consistently?
  - Historical data
  - Current data
  - Future projection
Reconciliation

The chance to tie it all together.

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Reconciliation

- Is the reconciliation discussion and analysis meaningful? (or boilerplate?)
- Has the appraiser commented on current trends and values for the subject type?
- Do the value indications of the three approaches reconcile within a reasonable range?
- Has the appraiser deducted for any outstanding deferred maintenance? (or added for any excess land?)
Reconciliation

- Has the appraiser discussed and reasonably concluded the reasonable exposure time linked to the concluded value?
- Based on the data and analysis presented, is the final market value conclusion reasonable?
- Is the report written in any way that could be interpreted as misleading?
Reconciliation Process

- Look at which approach(es) were used.
- Which approach(es) had the best data?
- Place most emphasis on that or those approach(es).
- Narrate the reasoning.
- Does the reader agree?
Reconciliation – Which Approach is Best

- Cost approach – Best for valuation of new(er) properties that do not suffer greatly from depreciation
- Sale comparison approach – Best for owner-occupied properties (primary); investment properties (secondary)
- Income capitalization approach – Best for investment or income-producing properties (primary); owner-occupied (secondary)
Certification

- Every appraisal requires a signed certification.
- If the certification is wrong, there are bigger problems inside the report!
Proper Certification

- Improper certification = lack of understanding of USPAP.
- USPAP Standard Rule 2-3 – NO EXCUSE!
- Nothing on inspecting the property.
- Signed but without state license number.
- Not a certificate of value – relates to the premise of the assignment & the overall manner in which it was prepared.

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Technical Items

Universal issues of basic appraisal conformance!
Technical Items

- Intended Use – Standard 1-2(b).
- Intended User(s) – Standard 1-2(a).
- Scope of Work Rule.
- Type of Report – Self Contained, Summary, Restricted.
Technical Items

- Appraiser Competency – Not addressed!
- Personal Property – Incomplete/Not analyzed.
- Property History – Incomplete.
- Excess Land/Surplus Land – Misidentified.
- Functional & External Obsolescence.
Bulk Value

- Bulk value = aggregate of retail values
- Aggregate of retail values = the sum of the appraised values of the individual units in a subdivision, as if all of the units were completed and available for retail sale, as of the date of the appraisal. The sum of the retail sales includes an allowance for lot premiums, if applicable, but excludes all allowances for carrying costs. Also call *gross retail value*.
- Does not involve discounted cash flow analysis
Stabilized Value

- A value opinion that excludes from consideration any abnormal relationship between supply and demand such as is experienced in boom periods, when cost and sale price may exceed the long-term value, or during periods of depression, when cost and sale price may fall short of long-term value.

- A value opinion that excludes from consideration any transitory condition that may cause excessive construction costs, e.g., a bonus or premium for material, the abnormal inefficiency of labor, the cost of delay or an excessive sale price, e.g., a premium paid due to a temporary shortage of supply.
Question?

- Can an appraisal that meets all professional standards and complies with all regulations still report an unreliable value conclusion?
- YES!!! Usually results from a lack of understanding of the property economics i.e., using square feet to value a C-Store
Questions Please?
Useful Websites

- Appraisal Institute
  - http://www.appraisalinstitute.org
- Wisconsin Chapter of the Appraisal Institute
  - http://www.wisai.com
- The Appraisal Foundation
  - http://www.appraisalfoundation.org
- Wisconsin Department of Regulation & Licensing
  - http://drl.wi.gov
- American Society of Appraisers
  - http://www.appraisers.org