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Appraisers Sort Through Myriad Factors to Estimate Value

BY JAMES B. MATTHEWS, PRESIDENT, PRIME LOCATIONS, LLC,
AND JOE MILKES, MAI, CCIM, PRINCIPAL, MILKES REALTY VALUATION

Considerable value can be found in leaseholds, depending on the lease terms, for an industrial property, office space, or a ground lease. This is especially true for retail leases.

Appraising a property involves an orderly, logical process that can best be compared to a funnel. Initially an appraiser considers the broad economic environment that affects the property and then gradually narrows the focus to specific factors and indicators of value. The interaction of four basic forces that influence human activity is reflected in real property value:

- Social trends
- Economic circumstances
- Governmental controls and regulations
- Environmental conditions

An appraiser researches and analyzes each of these forces in relationship to a subject property. Traditionally, the land with any permanent improvements upon it is valued. Improvements can change over time; the land is permanent. An appraisal provides an opinion of value of this based on the bundle of rights the owner possesses.

A fee simple owner has control of the property in perpetuity. A tenant's interest depends on specific items in its lease — the time period, rental rate, and terms. In many cases, if a property is leased and is being appraised for the property owner, the fee simple interest subject to the lease — or in other words, the leased fee interest — is also being appraised. Considerable value can be found in leaseholds, depending on the lease terms, for an industrial property, office space, or a ground lease. This is especially true for retail leases. An appraisal or real market valuation report can provide an estimate of the value of this interest.

In an appraisal the specific economic factors that affect a property's value are described and evaluated in an area analysis. This includes demand generators, roadways and other improvements that affect property value, and appreciation. The type of economic environment (urban, suburban, exurban, or rural, for example) and the general stage of development occurring in the area are generally characterized as stable, growing (slow or rapid), or deteriorating (slow or rapid).

Property features are considered, including property tax assessments and other tax burdens, as well as zoning and other restrictions on a property's use, such as easements and deed restrictions. Site features that factor into an appraisal include utility availability and related costs, probability of flooding, environmental issues, topography, access, street visibility, types of roadways serving the property, availability of rail service (if a heavy industrial property), demand generators, and others, depending on the type of use. Other factors include improvements to the raw land, which can include:

- Site development
- Layout of the property
- Utilities brought within the property
- Parking
- Building description and features
- Landscaping, fencing, and outdoor lighting
- Security features
- Various other specialized improvements, such as retention ponds, radio towers, underground tanks, rail sidings, special-purpose structures, and permanent attachments to buildings

The utility and condition of the improvements are also analyzed to estimate the incremental value they bring to the land. For example, a lessee in bankruptcy was current on the ground rental payments for a manufactured home sales lot in a Phoenix suburb. In an attempt to block a sale of the leasehold interest, the landlord claimed that the property value suffered because the tenant removed an old roadway. If the sale was blocked and the lease was rejected, the landlord would recapture the property, which was located in what was rapidly becoming a popular residential area.

The debtor's legal counsel retained an appraiser to value the property on a fee simple basis today and

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as of the date when the lease was initiated, some 15 years before. The appraisal revealed that the value had not been negatively affected by the lessee's use of the property. In fact, the property had been improved with a paved parking lot, utilities, landscaping, and other improvements.

During his study, the appraiser discovered that the site was located in the flight path and noise cone of training missions from Luke Air Force Base in Glendale, Arizona, which would preclude more intensive development. As a result, the landlord dropped its objection to the sale of the lease, and the client was able to transfer the lease to a user who would increase sales of its manufactured homes.

Highest and Best Use

An important component of the appraisal process is the highest and best use analysis. This must be done correctly prior to completing research specific to value. For example, an older industrial building houses a manufacturing business and is located at a corner in an inner-city location. Over the years, the area has become gentrified. Should this property be appraised as an industrial building? Should the plant be viewed as a shell suitable for renovation as urban living/work lofts? Should the lot be considered as a vacant site, less the building demolition costs?

In an analysis of highest and best use, an appraiser must correctly estimate the use that brings the highest yield to the land. Even though a building may be suitable for continued use by its occupant, the value of real estate is dictated by the marketplace. Without the analysis of the highest and best use, a value opinion could vastly understate or exaggerate market value.

A cardinal principle in appraising is that cost alone does not equal market value. Merely because a building would cost a specific amount to construct does not signify that the marketplace would pay that amount for property. A current example is the office-tech sector. Numerous high-quality buildings were designed and built for telecom businesses during the boom of the 1990s. These structures are now selling in many markets for a fraction of their replacement cost. Their use for another purpose usually does not fully utilize the property's features and amenities.

A highest and best use analysis can involve much more than market observations. A financial analysis of alternative uses is completed to determine which would provide the highest yield to the land. The approaches to value are then implemented based on the results of the analysis.

In dealing with large tracts or parcels, each section of the property should be analyzed individually for its highest and best use. For example, a potential bidder for a bankrupt Alabama aluminum plant was primarily interested in the equipment. However, the bidder also needed to know the value of the real estate holdings that could be spun off. In addition to a more than 300,000-square-foot plant, the site included several hundred acres of scenic, tree-covered land that fronted a picturesque river but was not needed for the plant. One section of the plant had been sold years earlier, and a conveyor system provided a physical barrier to accessing some of the land area. The appraiser's task was to estimate the value of the property, both the plant-related facility and the surplus land, so the client could have an accurate understanding of the value of the whole property.

Estimating Value

Appraisers use three methodologies to estimate the value of a property: the cost approach, the sales comparison approach, and the income approach.

Cost Approach. The first step in the cost approach is to estimate the value of a property, based on its highest and best use, as if it were vacant and available for development. The process includes researching recent sales of similar parcels and comparing them to the subject. The comparison initially takes into consideration the following factors regarding the comparable sales:

- Was the purchase of the property an arm's length transaction that accurately reflected market conditions? To qualify, participants should have had average amounts of motivation, with each desiring to obtain the "best deal." Even if the parties were somehow related, the transaction could conceivably be arm's length.
- Did financing affect the sale price? In some instances, financing availability or terms can affect the purchase price of a property. If sellers agree to take back financing, the typical fees and the complexity of obtaining third-party institutional financing can be avoided, which can provide a benefit to the purchaser. Also, the interest rate may not be at the going market rate.
- Did the transaction take place under different market conditions? Frequently, appraisals are done some time after the original purchase of the site. If market conditions have changed over time, these must be considered.

Adjustments are made for all of these factors prior to adjusting for other property-specific factors. The partially adjusted sales prices of the comparable land sales are then further compared to the subject property based on differences for that type of site. For example, a retail site is influenced by a very different set of factors than is a heavy-industrial tract. An analysis of predominate value range for the land as if it were vacant then results in a market value opinion of the site.

Next, the estimated depreciated cost of improvements is added to the value of the vacant site. For new construction, the actual cost may be an accurate indicator after verification with industry norms because only negligible depreciation may have occurred. With older or special-purpose properties, the actual cost may not be available, or it may be irrelevant because of a property's age. In these cases, industry sources provide a norm for the replacement cost.

By using replacement cost rather than reproduction cost, an adjustment for the differences is taken into consideration. By modern standards, older construction may be obsolete, inadequate, or superadequate — a valuation term that means improvements are overbuilt compared to current construction techniques. Older industrial buildings often feature brick veneer over block walls or structural brick, for example. Both are considerably more costly to build than the tilt-wall masonry type that is typically used in many locales today. Superadequacy is not recognized by the marketplace and is discounted from an analysis through replacement cost estimation.

Depreciation is estimated based on the effective age of improvements. It also takes into account a property's condition and inadequacies, such as low ceilings in industrial buildings, inadequate truck turning areas, and docks that are too small for present-day trailers. External obsolescence (a technical appraisal term) in the form of inferior market conditions that do not allow for sufficient income production to justify the construction results in an additional type of depreciation.

Some types of depreciation can be corrected, such as a roof or pavement that is in poor condition. Other types, such as column spacing and ceiling height in warehouses, cannot be justified financially. The cost approach estimate is adjusted for these factors. The depreciated cost of the improvements is added to the land value estimate to produce the cost approach indication of value.

Sales Comparison Approach. The sales comparison method follows a process similar to that of estimating the land value in selecting recent sales of similar improved properties and first adjusting for motivation, financing, and market conditions. Then the most similar recently sold properties are compared to the subject property for those factors significant in the marketplace. The factors usually included in the adjustment process are location, construction quality, property condition, overall utility for the intended use, land-to-building ratio (parking ratio), and anything else that is important in a particular market.

As in the land valuation, the comparison should be based on the market — what factors participants consider to be important for that particular property type. The range is narrowed and a predominant value is selected as indicative of the sales comparison approach.

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Retaining an Appraiser

A turnaround professional should ascertain whether an appraiser is licensed. If an appraiser is licensed in one state but the subject property is located in another, the appraiser is obligated to comply with regulations in force in the state where the property is located.

This can involve obtaining a temporary or full license, although some states do not require that as long as the appraiser is licensed in another state. However, licensing is necessary if an appraisal is for a federally related transaction or agency. If such an appraisal is for underwriting purposes by a corporate lender or for a business, then a license may not be necessary. However, if it is to be completed for a U.S. Bankruptcy Court or trustee, then some type of license in that state would be required.

Typically, an appraiser is hired under a retention or engagement letter that, at minimum, should set forth the following:

Client Name. If the client is someone other than the addressee for the report, that should be divulged.

If the appraiser is a member of the Appraisal Institute or another professional organization, the statement should specify that the appraisal will comply with the Institute's code of ethics and standards or with those of other professional organizations.

Property Identification. The letter should include the address and, ideally, a legal description of the subject property. If the property is a large-scale facility, an address alone may not be adequate. If necessary, a plat should be included.

Reason for the Appraisal. The appraiser is required to state the reason for the appraisal in the final report and, hence, requires it in the retention agreement. The reason for the assignment could be litigation support, independent verification of market value, loan underwriting, or negotiations with other parties, among others.

Appraisal Type and Reporting Format. Whether the scope of the work involves a full or limited appraisal and the reporting format – verbal, restricted use, summary, or self-contained – must be delineated in the engagement letter.

Regulatory Compliance. A statement should be included that the appraisal will comply with the Uniform Standards of Professional Appraisal Practice (USPAP) regulations as of the date of the report. If the appraiser is a member of the Appraisal Institute or another professional organization, the statement should specify that the appraisal will comply with the Institute's code of ethics and standards or with those of other professional organizations, if any. In addition, if the appraisal is to be completed for a lender's benefit, a notice that it will be completed in accordance with the lender's requirements and, if appropriate, with federal and/or state bank regulations should be included.

Ethical Considerations

An appraisal can only be completed for a specific client and should be free of both bias and the appearance of bias. Client influence on the valuation process is of major concern and is strictly disallowed by USPAP regulations. For this reason, an appraiser's compensation cannot be related to the opinion of value – that is, fees cannot be a function of the stated value – under any circumstances.

Usually, the retention agreement contains language similar to the following:

> **Retention Assumptions and Limiting Conditions.** Retention of X firm and any other parties involved in completion of this assignment has not been based on any predetermined conclusions regarding the feasibility, marketability, or property value. Certain general assumptions and limiting conditions are requisite to our appraisal of the property and will be included. Should you require a review of these assumptions and limiting conditions prior to our retention, please contact us immediately. CR

- James B. Matthews and Joe W. Milkes

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The Income Approach. For the income approach, the quality and quantity of income production is evaluated. For existing leased property, the contract (actual) lease terms are compared to the market. If the rental rate and terms are significantly different, then the market's attitude toward this property, whether negative or positive, is analyzed.

For example, if the lease rate is substantially above the local market and the company has very strong credit, then purchasers may not expect a premium and may not perceive any additional risk of default. An example is appraisals of properties with Starbuck's leases. Although those properties' lease rates tend to be well above the surrounding market, the rates of return that investors will accept are quite low. Owing to Starbuck's strong credit, the market perception is that the lease terms will be fully honored. Therefore, the income approach has a higher value than the other two approaches would ordinarily reveal.

Conversely, if a tenant's credit and creditability are questionable, investors expect a much higher rate of return. This can be obviated by using a rental rate that is likely to be sustained for some period of time — a market rate adjusted by a vacancy factor. Even with a fully occupied property and a strong-credit tenant, some amount of vacancy and collection loss risk is common during a holding period. Consequently, if a tenant defaults, the purchaser would have acquired the property at a relatively low price and can then re-lease it at the expected rate of return.

If the property is not subject to a lease, an appraiser estimates the market rent based on area rates for like-kind property. An income pro forma is completed by estimating a vacancy/collection loss factor and property expenses. These factors and amounts are based on actual historical data from the property, in addition to industry norms. Expenses are estimated based on the property type, such as office, industrial, or retail, and on lease terms, such as who is responsible for maintenance and other costs.

Depending on the property type and lease terms, the expense allocation between tenant and landlord can vary significantly. At one end of the spectrum are multi-tenanted office buildings, whose landlords usually pay operating costs, although the direct electric costs are sometimes added to the rents. Tenants also frequently pay increases above the first lease-year expenses.

At the other end of the spectrum are larger industrial buildings. Tenants of these properties frequently pay most of the expenses, including property taxes, property insurance, maintenance and cleaning, utilities, and sometimes property management expenses. Even with leases, a landlord can incur expenses during periods of vacancy. In addition, a landlord incurs marketing and commission costs, accounting expenses, and some incidentals.

These are included in the income statement pro forma. The result is a net operating income figure that models the market and considers normalized property expenses and other deductions. This analysis should not represent a favorable or unfavorable year of operation but one that is typical of current operations.

In some situations, a discounted cash flow (DCF) analysis is completed based on a holding period, which can account for changes in the operation over a period of time. The income and future estimated sale proceeds can be discounted back to the present value at a rate of return dictated by the marketplace. This method is useful when significant changes are expected in a property's operation near-term and can be used to model alternative scenarios.

In creating such a model, assumptions are made about future rental and occupancy rates and expenses and, very importantly, sale prices and rates of return expected in five or 10 years. Furthermore, only a small shift in the discount rate has a great affect on the present value, due to the compounding effect.

Some investors take the position that future events cannot be predicted accurately and focus instead on the current cash flow, property condition, and qualitative factors such as tenant characteristics and quality, location potential, and building utility and condition. Others like the benefit of being able to try a range of variables and develop a confidence level for a sufficiently narrow range of values.

The current actual cash flow and a normalized pro forma of it should always be considered, even if the DCF model is implemented, because a discounted cash flow can be too easily manipulated to produce preconceived results. It is not unusual for clients to request the electronic data input as well as program generated reports to evaluate the income approach.

Net operating income is estimated and capitalized using a rate of return derived from the market. The source of this rate is usually comparable improved sales, but it can also include other regional or local data. For specialized properties, risk factors can be applied to a base rate as well. Some appraisers also use a debt-equity model in which the prevailing debt rate, the pay-off rate of the note, and market-derived equity returns are weighted based on typical debt-to-value percentages. This results in a fairly sophisticated range of values from the income approach.

Value Opinion

In the correlation section of the appraisal report, the value indications are analyzed, and a single value point is usually estimated based on an analysis of the results. Merely averaging the results or picking the midpoint is not always the appropriate means of selecting a single value point.

For example, for many larger, older industrial properties with accumulated depreciation, the sales comparison approach is probably more representative of the market. These types of properties are not typically sold as income properties to investors. For that reason, the appraiser may place more emphasis on the sales comparison indication of value.

There is no USPAP requirement that a value opinion be a single value point, which is a specific number. In fact, an appraiser could provide a range of value. For the majority of commercial properties, this is the reality. Real estate is not a commodity. Each parcel has different characteristics. The market is not sufficiently homogenous or consistent that a single value opinion is right and another slightly different one is wrong.

Limiting Conditions, Assumptions, Certification

This section, or sections, of the report should clearly list the limiting conditions of the appraisal and any assumptions that were made. It should also certify that the report meets USPAP requirements.

A client should consider the limiting conditions and assumptions carefully because these have a very direct impact on how the value was estimated. For example, if the title is clouded or there are restrictions to use that were not provided to the appraiser, then the value opinion may not reflect an accurate portrayal of the property. This also applies to hidden defects that are present or environmental conditions that were not disclosed.

Occasionally, clients mistakenly think that they are helping themselves by not disclosing such information. However, the usefulness of an appraisal can be impaired if full information is not provided. In one instance, an industrial property that was appraised was located adjacent to a U.S. Environmental Protection Agency superfund site. Although the client was probably aware of this, the appraiser had to learn it independently.

As of the appraisal date, the client had not conducted its own environmental site assessment, even though it had a significant amount of uncovered land located adjacent to the Superfund site and within the danger zone. The prior user of the contaminated site was known to have dumped contaminants on adjacent properties and on others throughout the neighborhood when the plant was operational. Consequently, the appraiser clearly indicated in the report that the value opinion could be invalidated if information indicated that the property had significant environmental issues.

Controlling the Process

Appraisals are critical tools for the turnaround professional and often determine conflicting parties' security interests in a company's assets. When properly used and commissioned, appraisals can reveal substantial value. Conversely, turnaround professionals who do not understand the various terms of art used by appraisers and who cannot critically evaluate an appraisal risk subjecting themselves to unwelcome surprises.

In seeking an appraisal, a turnaround professional should know what to request and how to control the process. Otherwise, the process the real estate professional uses will control the turnaround professional and his or her clients. CR

Jim Matthews is President of Prime Locations, LLC, and has more than 25 years of legal and real estate experience. He has held various local and international leadership positions in TMA and was awarded the association's Outstanding Individual Contribution Award in 2003.

Joe W. Milkes, MAI, CCIM, is the principal of Milkes Realty Valuation and provides real estate valuation, litigation support, and consulting services. He is also on the staff of Prime Locations, LLC. Milkes serves is a board member of TMA's Dallas Chapter and serves as its Membership Chair. He has held various positions in The Appraisal Institute, including chair of both the Ethics and Experience Review Panels.

Want to Know More?

Additional information is available on the following Web sites:

- www.appraisalfoundation.org. Portions of the Uniform Standards of Professional Appraisal Practice (USPAP), as well as advisory opinions on the standards, can be viewed on The Appraisal Foundation's Web site. USPAP can be downloaded for a fee, and paper copies of the regulations also can be purchased.
- www.appraisers.org. The American Society of Appraisers is an organization that includes professionals involved in appraisal review and management, business valuation, gems and jewelry, machinery and technical specialties, personal property, and real property.
- www.appraisalinstitute.org The Appraisal Institute offers designations in commercial and residential real estate appraisal (MAI and SRA) and has a strict code of ethics and standards which is maintained through a disciplinary process. The Institute publishes books and literature on appraisals and has a readily searchable electronic library available to the public at a nominal cost.
- www.naifa.com. The National Association of Independent Fee Appraisers provides a designation process for both residential and commercial real estate appraising. CR