

# Appraisals Are Key to Unlocking Real Estate Value

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

**M**any companies accumulate a collection of real estate holdings in the form of manufacturing plants, land parcels, warehouses, office buildings, and leaseholds. When a company becomes distressed, however, these real estate holdings may no longer be needed — if, in some cases, they ever were. Much needed cash flow can be generated through the realization of value in this real estate.

A hard-nosed assessment of the immediate needs of a troubled enterprise is the first priority, with future expansion and flexibility considerations a secondary consideration. Once a company's core competency and business line have been determined, its real estate interests should be addressed.

Does the business need office space? If so, where and how much? Will a manufacturing facility or warehouse be required? If so, where should it be located, how much space is needed, and what building features are required? Are retail locations required? If so, where are the most advantageous locations, and what is the ideal size to optimize sales and inventory turnover?

The critical processes for the business should determine the firm's real estate requirements. For example, it may be impractical to move a manufacturer from an oversized facility into a smaller one, but leasing part of the building to another business, possibly a vendor or customer, may be an option. Alternatively, the company could sell its building to an investor and lease back the portion it needs. Surplus land can be sold or leased to provide an income stream.

If a company owns office or retail space, consolidation or strategic relocations of these facilities may be indicated. Sites that can be readily sold because of demand in the local market may provide more rapid recapture of real estate value.

The assessment of a company's real estate needs should be completed in cooperation with operations staff, restructuring officers, and experienced real estate professionals. Knowledge of the marketplace for the various property types is essential, and an expert appraisal is the most certain method for determining market value. Real estate valuation services can provide key insights for a troubled company. A professional appraiser can combine extensive research, analysis, and accepted methodology in a way that directly benefits the business.

Furthermore, an experienced appraiser will take the time to understand a client's situation fully and assess what services will be most beneficial. Some questions may require an appraisal to provide satisfactory answers, while others can be answered through specialized consultation

or something less than a complete appraisal. A preliminary consultation is recommended because it allows an appraiser to assist in identifying critical issues.

## Required Information

Similar to real estate brokerage, real estate appraising is licensed, although under certain circumstances and in some states, the use of a licensed appraiser may not be required. Turnaround practitioners should become familiar with the various legal requirements that apply to real estate appraisal practices to appreciate the difference between an appraisal and an informed opinion from a broker or other real estate professional.

The appraiser is obligated to request certain information. Whether it exists and the client is willing to make it available must be documented in the appraisal report. The types of data required are determined the property type and reason for the appraisal. These items frequently include the following:

- Site plans, surveys, floor plans, and other construction details
- Title policy information, including details regarding encumbrances to the full use of the property, such as deed restrictions and easements
- Construction costs and purchase information for work or transactions that occurred during the three years prior to the effective date of the appraisal
- Transactions pertaining to the subject property within the prior three years
- Income and expense information to date and for the last full year or, if the property is fully owner-occupied, only expense information
- Details regarding the property's condition, including any deferred maintenance or scheduled capital expenditures, as well as any recent repairs or replacements
- Recent environmental site assessments and details concerning any environmental issues

## Types of Appraisals

Since the advent of the Uniform Standards of Professional Appraisal Practice (USPAP), appraisals are either full or limited (see USPAP sidebar, left). A full appraisal analyzes a property's

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value using the traditional sales, cost, and income comparison approaches to estimate value. A limited appraisal does not use all three of these approaches and must clearly identify departures from the process that result in a full appraisal.

For example, for a 50,000-square-foot warehouse that was recently built in an urban market, the cost, income, and sales comparison approaches all would be used to complete a full appraisal. Sometimes, however, a client does not need a full appraisal. He may want to lower the cost of the appraisal, establish a value for the company's internal purposes, or meet a lender's relaxed underwriting standards, so one or two of the approaches could be eliminated. The result would be a limited appraisal, which would be clearly acknowledged in the report, as would any resultant likelihood of inaccuracy in the opinion.

Even for full appraisals, one or more of the approaches may not be applicable or useful in the valuation. For a special-purpose property such as a steel mill, for example, excluding the income approach would not constitute a departure from a full appraisal because these properties are typically owned by the operating company and therefore are seldom considered income-producing properties. Although excluding the income approach would not likely constitute a departure, an explanation would be provided in the final report concerning its exclusion.

### Reporting Formats

The appraisal report can be delivered in any of the following formats: verbal, restricted use, summary, or self-contained.

In a verbal report, an appraiser provides an opinion of market value and often explains the research and analysis to the extent required by the client. Although the report is delivered orally, the appraiser is required to have all of the data and analysis on file before providing an opinion of value. A certification as required by USPAP must be maintained in the appraiser's file, which is made available to the client.

In matters involving litigation, a verbal report can be delivered initially, and the client can decide whether to go forward with a written report. Although verbal reports are often requested by attorneys who hope to avoid discovery of an adverse report, an appraiser's legal requirement to keep a file may undermine this effort.

A restricted-use report is extremely limited in that only the value opinion is provided, along with summary comments on the highest and best use, identification of the property, limiting conditions, assumptions that were made, and the USPAP certification. As the name implies, the restricted-use report is only intended for the named client.

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## Impartiality, Integrity Are USPAP's Goals

The Uniform Standards of Professional Appraisal Practice (USPAP) govern real estate appraisals and related activities performed by licensed appraisers. After the savings and loan debacle in the United States in the 1980s, Congress committed itself to protecting financial institutions and federal agencies. The resulting legislation protects the public as well with annual updates and other modifications that affect the services licensed appraisers can provide and the methods they may legitimately use.

Although USPAP is not intended to provide a "cookbook" approach to appraising, it does delineate a process that an appraiser must follow. Limited departures from the process may be allowed, but they always must be clearly identified.

USPAP seeks to maintain and reinforce the impartiality and integrity of appraisals while separating other services, such as consulting and property tax appeals, which typically involve an advocacy role for a client. The legislation recognizes that most appraisers are also engaged in other real estate services, but USPAP's purpose is to guarantee that an appraisal is prepared in an independent manner, unhindered by client pressure.

All assignment conditions must be set forth in the retention agreement, and the appraiser will, in turn, set them out in the final appraisal. Although USPAP is not intended to provide a "cookbook" approach to appraising, it does delineate a process that an appraiser must follow. Limited departures from the process may be allowed, but they always must be clearly identified.

Real estate appraising is regulated in each state by an agency that is obligated to follow the standards established by The Appraisal Foundation. Although funded in part by federal grants, the foundation is a private, nonprofit educational organization. Some state agencies, such as the Texas Appraiser Licensing and Certification Board, are free-standing. Others fall under the umbrella of a licensing agency. Illinois, for example, has the Real Estate Appraisal Administration Division under the Office of Banks and Real Estate.

Whatever their structure, state regulatory bodies must ensure that their qualification processes, testing, and enforcement efforts must meet certain federal guidelines. Among other requirements, appraisers must gain experience under the guidance of a licensed appraiser, successfully complete a competency test, and comply with USPAP, in addition to meeting other state regulations. Although the various state agencies monitor and enforce compliance, the style and quality of the process and the level of enforcement varies considerably from state to state.

Regulations for real estate appraisals are more strict and comprehensive than those that govern valuations of businesses; mechanical and equipment (M&E); furniture, fixtures, and equipment (FF&E); inventory; personal property, such as appreciable art; furniture; gems; intellectual property; and other tangible and intangible property. Although appraisals of these items are included under USPAP, the intent of the applicable standards is that the valuations are done competently and honestly. Furthermore, among valuation professionals, only real estate appraisers are licensed. [RE](#)

— James B. Matthews and Joe W. Milkes



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A summary report provides an executive summary of only the major components of the valuation process. The research and analysis is presented in summary fashion, and little explanation of the valuation process is provided. This type of report can usually be produced more quickly, and the format provides flexibility in the presentation. A detailed summary report format can often suffice for many business situations. The brevity of the report type does not imply a reduction in research and analysis.

A self-contained report is often referred to as “a full-blown” appraisal report. This type of report includes comprehensive explanations of the process, the research and analysis, and the economic and demographic features of the property. Frequently used by lenders in connection with loans for more than \$1 million, self-contained reports are also often used for litigation purposes.

### Types of Value

Estimating market value inherently assumes an orderly and sufficient sales process that provides adequate exposure to the market. It also assumes that a seller has an average amount of motivation, is not under duress, and is willing to invest the time necessary to sell the property.

For commercial properties, this can be a period of exposure ranging from six months to a number of years, especially for some large-scale special-purpose facilities located in rural locations. An additional 60 days or more should be considered to allow for inspections and for a buyer to obtain financing. This marketing time prior to the effective date of the appraisal, known as “exposure time” in the USPAP, is estimated by the appraiser and is integrally tied to market value opinion.

Sometimes a client needs an opinion based on concepts of value other than market value. Thus, disposition or liquidation value assumes that the client is highly motivated or requires a very short exposure time. Despite the limited exposure, a potential purchaser — even one proposing to pay cash for the property — nevertheless may need additional time to conduct title research and obtain title insurance, complete a survey, and perform inspections and environmental site assessments.

A shortened exposure will influence the value opinion. Obviously, the interaction between the amount of exposure time and the property type is significant. Because an exposure time of 30 to 45 days may be adequate for disposition of a small industrial property, the reduction in value from a normal exposure time may be minimal. However, this amount of time to sell a 1 million-square-foot obsolete facility could be almost nonsensical and extremely difficult to justify.

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An appraiser may be asked to offer an opinion on the worth of a property for a particular purpose, which is referred to as use value. For example, the lender on a music hall in Branson, Missouri, engaged an appraiser to value the special-purpose property based on a specific use as a religious facility, which was one of the highest and best uses for the site. However, due to building modifications that would be required, the lender wanted a realistic third-party validation of market value based on this specific use.

Frequently, clients may desire both market value and disposition or liquidation value opinions. The owner of a specialized manufacturing facility may want to obtain two sets of values — its use value for its intended use and its market value in the broader real estate market.

Investment value relates directly to the value of the property to a particular owner or group of owners. In the case of a distressed company, a property may have a much higher value to their ongoing business than for any other party. The major difficulty with this concept is that it does not necessarily recognize market forces — what the property is worth in the marketplace, which is the common concept of value. However, there are circumstances when this concept has some valid uses.

*The Appraisal of Real Estate (12th edition)* defines going concern value as “the market value of all the tangible and intangible assets of an established and operating busi-

ness with an indefinite life, as if sold in aggregate.” Some examples of businesses that are appraised for going concern value include hotels, restaurants, mini-warehouse facilities, athletic clubs, and some types of manufacturing enterprises. The valuation can involve separating the overall value into its various components — real estate, M&E, FF&E, inventory/ personal property, and the business interest.

*The Appraisal of Real Estate* defines limited market and special purpose properties as “property that has relatively few potential buyers at a particular time, sometimes because of unique design features or changing market conditions.” Estimating the market value of a limited market or special purpose property may be difficult if not impossible. Examples include large manufacturing plants, processing plants, railroad sidings, large churches, and some types of research and development facilities that were designed for specific research.

Consequently, it may be more appropriate to offer an opinion of the use value, as opposed to the market value. In such a case, the report would need to state this distinction clearly. Although special-purpose facilities are frequently very costly to build, much of the value is lost if the original use is no longer viable for the company or its industry. Alternative uses may recognize only a fraction of the original cost.

### Taking Time

An appraisal is not a commodity. It represents the answer to the client’s question(s). Understanding the alternatives — in terms of whether the appraisal is a full or limited valuation, the different reporting formats and the inherent limitations — is important in terms of the cost, completion time and the ultimate use for the appraisal.

The appraiser has an obligation to explain the limitations and benefits of different assumptions and conditions used in valuing the property. Sufficient time and care should be taken to fully understand the client’s situation and questions regarding the real estate. That is, what is expected from the appraisal or consultation, and what does the client want to accomplish? If this requires some amount of pre-valuation consultation regarding the property and the client’s requirements and goals prior to the assignment being undertaken, this nominal expenditure is well worth it.

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