2022 Appraisal Forum

February 24, 2022

Key Discussion Topics

Quick philosophy on Freddie Mac appraisals

Tips and Hints & Dos and Don’ts:

Points of Emphasis for 2022

- Fee Simple versus. Leased Fee: The difference matters
- Better support for short-term value increases
- The focus of appraisals on As-Is value
- Capitalization Rates: Proforma NOI versus T-12 NOI
- Demonstration of geographic competency when signing appraisal reports

Appraisals for Freddie Mac Multifamily

The underlying exercise of a Freddie Mac review of a third-party real estate appraisal review is to determine if the appraiser has *adequately* supported their opinion of market value.

Job aids on the Appraisal tab on the Multifamily website: **https://mf.freddiemac.com/lenders/uw/#Appraisals**

Appraisal Report Content

What We Want To Know

What the appraiser knows about the subject property and its market

How they know it

The impact it has on the subject's market value

Not: "…based on my years of experience and knowledge of the area…"

Categories We Review

- Issues that might have an impact on Market Value
- Issues that might not affect Market Value but have an impact on the validity / credibility / veracity of the appraisal
- Issues that do not have an impact on Market Value or validity of the appraisal but are still “things”

Job aids on the Appraisal tab on the Multifamily website: **https://mf.freddiemac.com/lenders/uw/#Appraisals**

Best Practices

- ***We actually read your appraisals***, and our lending decisions are based on your data, discussions and conclusions.
- The difference between a reasonably well-written appraisal and a sub-par appraisal is the addition of a short/concise summary at the conclusion of each section.
- The addition of this verbiage can dramatically improve the efficiency of our review process by reducing the need for "go-backs" to clarify the appraiser's narrative or intentions.

Materiality Matters

Transparency Matters

Saves everyone time and money…and frees up more time for everyone in the lending chain to do additional quality transactions!

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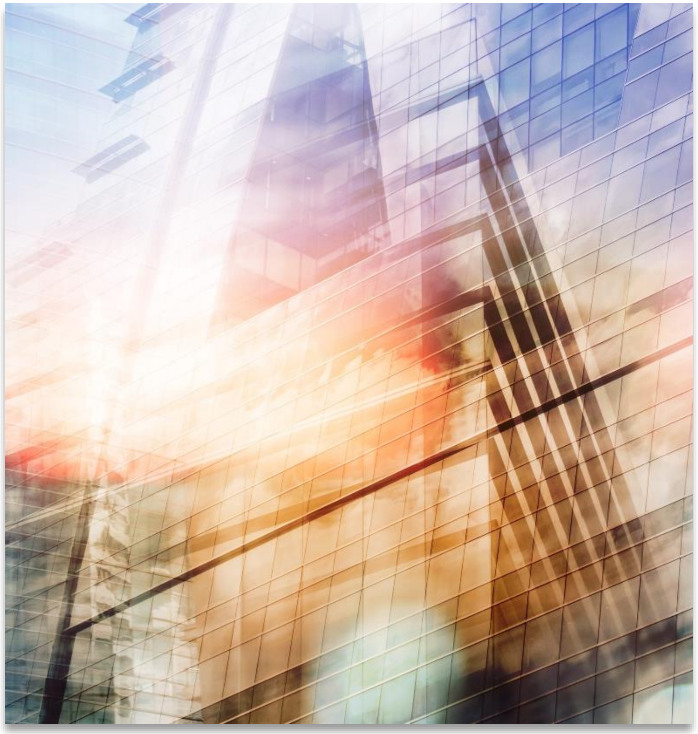
Leased Fee versus Fee Simple

This issue is a “canary in the coal mine” indicator that the rest of the appraisal report might have issues!

Many times, an appraiser will state that the appraisal in the valuation is of the “fee simple” interest or that the sales were of the fee simple ownership interests, and this is not correct!

The Appraisal of Real Estate (14th edition, page 72) states that leased fee ownership is the ownership interest held by the lessor “regardless of the duration of the lease, the specified rent, the parties to the lease, or any of the terms in the lease contract.”

If the appraiser gets this terminology wrong, there will probably be material valuation issues in the report!



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Large Increase in Value in a Short Time

Over the past year, we have seen many appraisals that indicate *remarkable* value growth in a short period of time, such as 50% over two years or 75% over three years, *<u>without</u>* adequate support.

Example: Appraisal with a poor explanation for a large value increase

	Sale Date	Value Date	Value Change
Sale Date:	January 28, 2019	February 19, 2021	2 years
Sale Price:	**$62,400,000**	**$95,900,000**	**54%**
Appraiser's Explanation:	*"Since the prior sale, rents have increased, and capitalization rates have compressed. In addition, the owner has continued to renovate the property.* *Since the 2019 sale, the owner has spent **$3,556,000** or $7,408 per unit on renovations. The renovations include updates and upgrades to the common areas and unit interiors. These factors have resulted in the subject increasing in value since the most recent sale."*		

Appraisals with Large Value Increases (cont.)

Note: An “off-market” sale *does not* necessarily mean that the buyer got a “good deal” and/or that the price is abnormally low.

Remember the definition of market value:

“Willing buyer/Willing seller, each acting in its own best interest”

Why would a property owner purposely leave $XXX,XXX at the closing table just because someone came to them directly with an offer to purchase?

Large Increase in Value in a Short Time (cont.)

Be aware of value growth in a short period of time and of your responsibility to *explain and support* that growth in terms of:

- Rent growth, *and/or*
- NOI growth, *and/or*
- Capitalization rate changes, *and/or*
- Capital improvements and renovation, *and/or*
- Examples of value growth with period-over-period re-sales in your market

This is both a Uniform Standards of Professional Appraisal Practice (USPAP) and Freddie Mac requirement.

Sample: Support for Appraiser's Validation of a Material Value Increase

Property name	
Property location (City, St Zip)	
Freddie Mac Loan #	
Appraisal date of value	

Value Contributory Item	**Previous** (as of: X date)	**Current** (as of: X date)	**% or $ Change**
Value and/or Sales Price	$	$	
Date of previous value or price			
Subject's recent renovation costs	$	$	
Subject's actual rents	$	$	
Appraiser's market rents	$	$	
Subject's occupancy	%	%	
Subject's property taxes	$	$	
Subject's operating expenses	$	$	
Market capitalization rate	%	%	
Subject's capitalization rate	%	%	
Area unemployment			
Other indicator / metrics (specify):			

Appraiser's commentary and support for the above market observations:

-
-
-

Targeted Affordable Housing

As-Is Estimates of Market Value

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For Affordable Housing Appraisals

The appraiser <u>must</u> focus on the *As-Is* value

We underwrite to the <u>*As-Is*</u> market value, not 100% market rent, so we will:

- Review *Freddie Mac Multifamily Seller/Servicer Guide* requirements
- Discuss that Loss-to-Lease is not appropriate

For Affordable Housing Appraisals

The appraiser <u>must</u> focus on the *As-Is* value

Section 60.24(5) of the Guide

> *"If the Property has restricted units, the appraiser must include an estimate of market value with the restricted units in place and an estimate of hypothetical market value without the restricted units."*

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As-Is Value versus 100% Market Rent

For both affordable and conventional properties, if the appraiser develops their income scenario based on 100% market rents, they have incorporated a *Hypothetical Condition* into their analysis which, by definition, is not an As-Is estimate of market value.

And, if they develop a value based on 100% market rents and do not call it out as a *Hypothetical Condition*, they have a USPAP compliance issue.

This applies to conventional properties, too!

For Affordable Housing Appraisals (cont.)

Guide Section 60.24 (*Use of comparable sales*)

3. Freddie Mac requires the use of comparable properties that were purchased, developed or leased as affordable housing. If comparable affordable housing properties are not available in the local market, the appraiser may use comparable regional affordable housing properties. These requirements apply to building sales, land sales, rental comparables and capitalization rate comparables.

4. If a sufficient number of comparable local or regional affordable housing properties are not available for analysis, non-affordable housing may be used as a comparable property. However, the appraiser must discuss in sufficient detail the adjustments necessary to correlate non-affordable housing to the affordable housing Property, including, but not limited to, differences in local demographics, investor considerations and marketing time.

Comparable Sales for Affordable Valuations

Real-world example of a poor explanation:

> We should note that all sales reflect conventional apartment communities that do not include income/rent restrictions. Though our research revealed several complexes throughout the state which sold with income/rent restrictions in place, it is our experience that due to varying motivations and intricacies of each particular deal (LIHTC acquisition/rehab, non-profit ownership, tax abatements, etc.), these sales are not well suited for direct comparison. As such, we have estimated values of the subject "Hypothetical Without Restrictions", and have made line-item adjustments to account for any potential impact that the income/rent restrictions and/or tax abatements have on the subject's market value.

Comparable Sales for Affordable Valuations (cont.)

<u>All multifamily sales</u> (conventional, affordable, student housing, seniors, etc.) ***have varying motivations and intricacies***, and very, very few sales of any type are immediately/directly "*well suited for direct comparison*" unless the appraiser does some analysis.

However, this is the job for which the appraiser is engaged: To analyze the appropriate market data and derive a value for the As-Is status of the subject property as an affordable housing property.

If you accept an engagement to appraise the market value of a rent-restricted property, you are bound by the Competency Rule of the (USPAP).

Capitalization Rates

Proforma vs. T-12

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Development of Capitalization Rates: Proforma NOI versus T-12 NOI

First, let's start with Industry Best Practices (quoted from *The Appraisal of Real Estate* (15th edition), pages 460 and 462):

- *"…appraisers must make certain that the net operating income of each comparable property is calculated and estimated in the same way that the net operating income of the subject property is calculated."*
- *"Both income and expense data in the 12 months after the date of valuation and the structure of expenses in terms of replacement allowances and other components should be similar to those of the subject property."*
- *"Sale properties used as sources for calculating overall capitalization rates should have current date of sale and future market expectations…"*

The potential overvaluation from erroneous development of the capitalization rate is indicative of a higher valuation risk from Freddie Mac's use of that appraisal report.

Development of Capitalization Rates: Proforma NOI versus. T-12 NOI (cont.)

- For the development of the capitalization rate, industry best practices require an apples-to-apples comparison of the comparable sales' NOI to the subject property's NOI.
- The estimate of the subject property NOI should be forward-looking, i.e., aligned with the Principle of Anticipation.
- The appraiser should not substitute their expectations of market performance for the buyer's or seller's rationalization for entering the sales agreement.
- Applying a capitalization rate developed with T-12 NOI (or any backward-looking NOI estimate) to the appraiser's proforma NOI will yield a potentially aggressive result and a potential overvaluation of the subject property.

The potential overvaluation from erroneous development of the capitalization rate is indicative of a higher valuation risk from Freddie Mac's use of that appraisal report.

Development of Capitalization Rates: Proforma NOI versus. T-12 NOI (cont.)

Some examples:

Revenue Type	Pro Forma Stabilized	Trailing Actuals
Period Ending	N/A	N/A
Source	Appraiser	Buyer
Price	$29,400,000	$29,400,000
Potential Gross Income	$2,437,520	$2,211,933
Economic Occupancy	96%	96%
Economic Loss	$109,688	$87,371
Effective Gross Income	$2,327,832	$2,124,562
Expenses	$833,965	$783,302
Net Operating Income	$1,493,867	$1,341,260
NOI / sf	$13.68	$12.28
NOI / Unit	$10,374	$9,314
EGIM	12.63	13.84
OER	35.83%	36.87%
Net Initial Yield/Cap. Rate	5.08%	4.56%

Revenue Type	Pro Forma Stabilized	Trailing Actuals
Period Ending	N/A	10/31/2019
Source	N/A	Buyer
Price	$80,350,000	$80,350,000
Potential Gross Income	$6,769,980	$5,769,729
Economic Occupancy	95%	93%
Economic Loss	$358,809	$380,802
Effective Gross Income	$6,411,171	$5,388,927
Expenses	$2,404,160	$2,203,503
Net Operating Income	$4,007,011	$3,185,424
NOI / sf	$13.56	$10.78
NOI / Unit	$11,926	$9,480
EGIM	12.53	14.91
OER	37.50%	40.89%
Net Initial Yield/Cap. Rate	4.99%	3.96%

The potential overvaluation from erroneous development of the capitalization rate is indicative of a higher valuation risk from Freddie Mac's use of that appraisal report.

Geographic Competency

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Demonstration of Geographic Competency

This is a USPAP compliance issue

- We have found a high correlation with out-of-the-area and sub-par review scores.
- Just because an appraiser is Certified in a state, does not mean that they have Geographic Competency
  - Out-of-state office/location for the appraiser
  - In-state, but in a different part of the state
- **A sentence or two in the appraiser's statement of qualifications addressing this would be appropriate.**

<u>Remember</u>: This is something that we are looking for

Appraisal Resources

Appraisal Resources

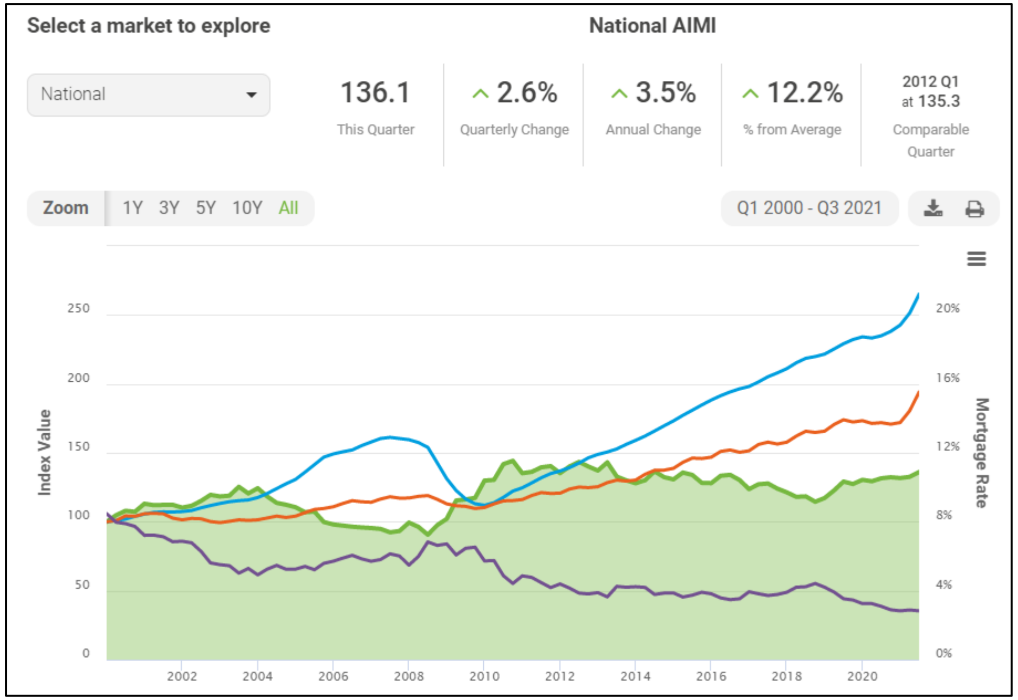
The Appraisal tab on the Multifamily website:
https://mf.freddiemac.com/lenders/uw/#Appraisals

- PDF Real Estate Appraisals Best Practices 6/4/2021
- PDF 2021 Appraisal Forum Presentation Deck 2/18/2021
- PDF Sample Appraisal Review Form 2/17/2021
- PDF Top 25 Ways to Improve Appraisal Review Scores 2/17/2021
- PDF Appraisal Team Contact List 5/29/2020
- PDF Appraisal FAQs 5/22/2020
- PDF COVID-19 Virtual Property Inspection Guidance 4/21/2020
- PDF COVID-19 Property Inspection Guidance 3/30/2020
- PDF Loss-to-Lease Suggestions for Appraisals 8/6/2019
- PDF Top 5 Appraisal Issues 8/6/2019
- PDF SBL Appraisals: 50 Pages or Less Guide 8/6/2019
- PDF TAHX Appraisals: 75 Pages or Less 8/6/2019
- PDF Multifamily Guide Chapter 60 - Appraiser and Appraisal Requirements

Appraisal Resources

Freddie Mac's **Apartment Investment Market Index®** (AIMI®):
https://mf.freddiemac.com/aimi

The Freddie Mac Multifamily Apartment Investment Market Index (AIMI) can help you determine how the relative value of investing in multifamily properties in select major metros, and nationally, has changed over time.



Employment		Multifamily Permits		Net Operating Income		Property Price	
-5.6%	0.6%	-3.9%	117.4%	12.9%	2.7%	12.8%	4.6%
Annual Growth	Historical Avg Growth	Annual Growth	Current Level to Historical Avg	Annual Growth	Historical Avg Growth	Annual Growth	Historical Avg Growth

Panel Discussion Perspectives from Freddie Mac Underwriting

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Insights and Perspectives from Freddie Mac Underwriting

Benjamin Barash

Manager,
Underwriting & Credit,
Seniors Housing

Deona Epps

Manager,
Underwriting & Credit,
Targeted Affordable Housing

Galina Ivanova-Tozeva

Manager,
Underwriting & Credit,
Conventional

Rick Farmer

Director,
Underwriting & Credit,
Small Balance Loan

Karen Clark

Manager,
Underwriting & Credit,
Risk Distribution & Credit

Takeaways: Underwriting Panel

A peek behind the curtain at Freddie Mac Underwriting to see how their work product fits into the larger picture.

General takeaways from our panel of underwriters:

- We want transparent discussions and analyses.
- We need an adequately supported opinion of market value.
- ***We read your reports!***

We use your analyses in our underwriting, and we discuss your material with internal and external users.

We spend time with your reports because we want to reduce valuation risk in our underwriting by being conversant and knowledgeable about your analyses and conclusions.

Takeaways: Underwriting Panel

Seniors Housing (Ben Barash)

- The COVID-19 pandemic has had a material impact on seniors housing in terms of:
  - Occupancy declines
  - Rental rate declines or increased use of concessions
  - Expenses, particularly those related to staffing and wage levels
  - NOI/Valuation gap
  - Fewer sales
- These factors are improving but will take 12 to 24 months (or more) to stabilize
  - It is unlikely operations will revert to pre-Pandemic levels in 2022
  - Appraisers should discuss and support the immediate 12-month proforma and impacts on value
- Seniors housing value is impacted by the quality/experience of the operator
  - Operator quality is something that appraisers do not tend to discuss in their reports, but it affects investor considerations
- Market and acuity differences must be considered and appropriate adjustments made when analyzing comparable data

Takeaways: Underwriting Panel

Targeted Affordable Housing (Deona Epps)

- For our affordable housing underwriting, we underwrite to the appraiser's ***As-Is*** estimate of market value:
    - ***As-Is*** means that the appraiser **must** consider rent restrictions
    - Depending on the loan product (i.e., forwards, rehabilitations) and/or affordable component (i.e., HAP contract, LIHTC), we also require additional valuation scenarios
- Too many appraisals are focused on the *hypothetical market-rent scenario* and just broad-brush the As-Is rent-restricted estimate of market value
    - The focus of the report **must** be on the restricted-rent value!
- The appraiser **must** use affordable housing sales in their Sales Comparison Approach and capitalization rate development

Takeaways: Underwriting Panel

Conventional Underwriting (Galina Ivanova-Tozeva)

- Unsupported value growth could be a material valuation and underwriting risk
  - Appraisers are typically doing a sub-par job of supporting significant growth over a short (two or three year) time period
  - Just saying "*This is a reasonable conclusion*" does not help us understand **<u>why</u>** the property's value has materially accelerated
  - We need discussion in terms of:
    - Detail on the terms and conditions of a recent sale
    - The scope of recent renovations and capital expenditure amounts
    - Rent growth in the submarket and rent premiums, if any, on renovated units
    - Detail on changes to area cap rates, not just *"We are seeing cap rate compression"*
- In the Sales Comparison Approach, we need explanations about **<u>why</u>** these sales have been chosen, not just a generic statement *of "These are the best comparables available"*
- And we need some color around the expense comparables.
  What is it about these four or five examples that make them similar to the subject property?

Takeaways: Underwriting Panel

Small Balance Loans (Rick Farmer)

- These smaller properties pose different underwriting challenges than conventional properties due to:
  - Fewer instances of professional property management
  - More instances of less sophisticated financial records and rent rolls
  - Less money spent by owners/managers on marketing and tenant retention
  - For properties sometimes having limited historical information, Freddie Mac underwriters may weigh heavily on the appraiser’s proforma conclusions
  - Regional and national data, especially comparable sales and capitalization rate data, is/are not as available or as well supported as with conventional multifamily property
- Data for SBL properties (rents, operations, etc.) may be available from non-traditional sources such as StreetEasy.com in NYC. There might be other local sources in their markets that the appraiser can tap into.

Takeaways: Underwriting Panel

Risk Distribution and Credit (Karen Clark)

- Risk Distribution & Credit (RDC) acts as a liaison between our underwriting teams and the capital markets investment community.
  - RDC becomes involved with all the Freddie Mac property types
  - 95% ± of Freddie Mac loans get bundled into a securitization
  - RDC follows up with our Underwriters, with the Optigo lender, and/or with the appraiser to clarify questions from the investment community
  - Report transparency and adequate support for valuation conclusions reduces the risk that RDC will reach out to the appraiser 6-12-18 months *after* the report was submitted
- Capital markets investors read the appraisal report and are focused on sales comparables and capitalization rates that support the concluded value.

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