Freddie Mac MULTIFAMILY

Market Value Impact of Fire, Water, Wind, Flood or Other Catastrophic Damage

Valuation Situation

The subject property has catastrophic damage (fire, water, wind, flood, etc.), and the appraiser's analysis assumes that insurance proceeds will pay for the repairs, or that money in a bank account will pay for the repairs, or the repairs are already completed. That is, the appraiser is not considering the time and costs it will take to make the repairs and lease the property, so this is not an As-Is estimate of the property's market value.

Note: This is real estate appraisal/valuation advice for how the appraiser should treat this type of situation, and not underwriting guidance or credit policy.

The foundation of this issue is covered in section 60.12(f) of the *Freddie Mac Multifamily Seller/Servicer Guide* (Guide):

> *The appraiser must derive the Property's market value in as-is condition on the date of value. Therefore, even if an escrow account with cash or insurance proceeds has been established to address a Property condition issue, the appraiser must still consider that issue's effect on market value since the availability of cash to the Property owner for repairs or renovations should not affect the Property's market value.*

Also, Section 60.2 of the Guide states:

> *Appraisals must estimate the as-is leased fee market value of the Property ("leased fee" as defined in the current edition of The Appraisal of Real Estate, published by the Appraisal Institute) as of the effective date of the Appraisal, subject to stated assumptions and limiting conditions.*

Guidance

- The appraiser must derive the property's market value in as-is condition on the date of value
- Insurance proceeds in a bank account earmarked to address property condition issues are/is not real estate so insurance proceeds do not affect the market value of the real estate secured by the loan. Cash is not real estate.
- The appraiser's estimate of market value must only consider the real estate asset. If the borrower has a boat or some stock holdings registered in the name of the property's ownership, these might be considered as security for the repayment of the loan, but they are not part of the real estate or a component of its value.
- The appraiser is valuing the property as if it sells today to a third-party and is trying to estimate the most probable price that the buyer will pay for the real estate – that's the definition of "market value". The cash account might be a negotiating chip in the sale negotiations and it might or might not be included as part of the transaction, but the cash or potential insurance proceeds are not real estate.

- The appraiser is not relieved from the requirement to consider the damage's impact on market value regardless of cash/payment availability for repairs or renovations; the amount of cash in an account or the potential for insurance proceeds would not affect a property's market value.
- The preferred analytical method is for the appraiser to develop a discounted cash flow analysis (DCF) to account for the variables associated with the repair and lease-up of the property. The appraiser must consider the time and cost it would take a new buyer, today. Items to consider include:
  - The time and costs secure the necessary repair permits
  - The schedule of repair activity
  - Any occupancy lost due to down units during repair
  - Any additional vacancy caused by tenants moving out due to construction noise and activity
  - The lease-up of repaired units
  - Any additional real estate taxes due to a reassessment based on improved physical condition of the property
  - The rent differential, if any, for units in repaired condition
  - The length of time to lease the inventory of repaired units
  - Additional marketing costs to attract tenants to a property undergoing renovation and/or charging higher rents, and
  - An appropriate discount/capitalization rate and discounting period (monthly or quarterly; annual discounting is probably not appropriate for this type of analysis)
- If the appraiser does not account for the costs and timing of repair and subsequent unit lease-up, they have not provided an appraisal of the property's actual physical or economic circumstances, and have actually given us a "Hypothetical Value", not As-Is Market Value, and is not acceptable for Freddie Mac underwriting.

The following chart is a general outline of how to map this analysis in a DCF format:

Sample DCF layout for properties with catastrophic damage				
	Period 1	Period 1	Period 3	Etc, etc.
Income				
Rentals /income / vacancy from non-damaged units				
Lease-up of damaged units				
Add'l vacancy due to construction noise/activity				
Expenses				
Property tax change due to higher rents and renovations				
Marketing -- extra costs to attract market-rate tenants				
Other typical operating expenses				
Net Operating Income				
Construction/Repair costs plus entrepreneurial profit				
Monthly (or quarterly cash flow)				
Discount rate (monthly or quarterly)				
= Net Present Value of periodic cash flow = As Is Market Value				
Plus: Supported assumptions for rent and expense growth/changes				