Valuing Non-stabilized Multifamily Properties

The definition of Market Value assumes that the subject property is being purchased on the date of value by a willing buyer, offered by a willing seller. That is, what would a buyer pay for the property in the marketplace? The appraiser needs to put themselves into the shoes of a typical buyer and consider:

- What would a buyer's inspection look like given the current environment?
- What data would a buyer consider in making their purchase decision given the current environment?
- What is the most probable price that the property should bring if sold on the date of value?

Reasons for a Different Valuation Procedure

A property that is not operating at stabilized operations (notice we didn't say "stabilized occupancy") may require additional analysis to ascertain the impact of non-stabilization on as-is market value because of:

- Renovations – current or proposed
  - Costs and the timing of the proposed renovation
  - Occupancy issues before, during, or after renovation
- Quality of management
- Local market phenomena such as unemployment, competing developments, and the like
- Changes in the structure or levels of rent
  - i.e., a HAP contract expiring or being renegotiated at different rent levels than present
- Changes in operating expenses, most notably, real estate taxes, repairs and maintenance, and reserves for replacements

As-Is Market Value

Freddie Mac requires the **as-is estimate of market value** as of the date of value (typically, the date of the appraiser's inspection) for most of its underwriting (*Freddie Mac Multifamily Seller/Servicer Guide* Section 60.2). Other value scenarios that might be helpful include:

- *Prospective* market value as of the date when the property achieves stabilization
  - In this scenario, the appraiser is required to report Extraordinary Assumptions to be in compliance with USPAP and Freddie Mac requirements
- *Hypothetical* market value is if the property's renovations are complete and operating at stabilization today
  - The appraiser is required to report Hypothetical Conditions in the appraisal to be in compliance with USPAP and Freddie Mac requirements
  - This analysis might help the underwriter/analyst compare the renovation costs with the actual increase in value to determine the risk if the renovation project is financially feasible

Valuation Methods

Method #1

To estimate the as-is market value, the appraiser can start with the current operations (PGI, EGI, OE, NOI) and develop a cash flow model accounting for changes into the future, then discount the periodic NOI to present value at an appropriate discount rate (Internal Rate of Return or IRR).

This requires the appraiser to discuss Extraordinary Assumptions in the appraisal report (a USPAP and Freddie Mac requirement).

Method #2

To estimate the as-is market value, the appraiser can start with the future stabilized value and subtract the present value of costs, income losses, and expenses at an appropriate discount rate (Internal Rate of Return / IRR) to result in a current As-Is value.

This too, requires the explanation of Extraordinary Assumptions in the appraisal.

Method #3

Capitalize the as-is NOI at an appropriate capitalization rate (Note: This rate is not necessarily the capitalization rate used for properties operating at stabilization).

Normally, the appraiser only needs to develop one of these analytical methods but if the data is available, triangulating two or three methods would provide additional support for identifying any valuation risk. That is, each of these three methods should result in a similar valuation and more than one method would be appropriate for unusual properties or market conditions.

General Appraisal Observations for Non-stabilized Properties

- The discussion and analysis of the effects of not operating at stabilization should not be a one-or two-paragraph boiler plate blurb in the appraisal report; the analysis might be complex.
- This methodology should not be developed with a series of disclaimers from the appraiser; they are being asked to do this work because of their expertise in this market and with this specific property type. Credible assumptions based on market data and discussions are required.
- It is neither good nor bad if a property cannot achieve 95% to 100% leasing, and we would expect the appraiser to call it like it is and not paint a rosy, non-realistic leasing or renovation scenario.
- The appraiser has to provide sufficient detail for the reader to understand the purpose and need of doing this type of analysis, the methodology the appraiser is using, the assumptions and structure of the analysis and cash flow, and the conclusions and impact on market value.

Considerations

A reason for a value difference between what is in place today versus stabilization is not only occupancy — the key phrase is “stabilized operations” not “stabilized occupancy” since occupancy is only one component to be considered in determining a value differential, and might be impacted by:

- The subject property’s stabilized occupancy could be at any level, and would depend on:
    - Overbuilt local market / excess submarket supply
    - Changes in local economy/employment that created surplus occupancy
    - Property characteristics that keep it from achieving a higher occupancy, such as
        - low ceiling heights,
        - outdated appliances,
        - a suboptimum location
    - **Defaulting to a predetermined conclusion of 95% occupancy at stabilization is not necessarily the right number for every property in every market. Sometimes ‘stabilization’ can be 70%, 85% or whatever is appropriate for that property in that market for that date of value, given specific conditions and circumstances**

- Change of rent structure such as an expiring or new HAP contract or changing rents due to renovations
- If occupancy is less than 100%, then Other Income and variable expenses might also be affected
- Property taxes: Changes in the underlying assessment by the local assessor
    - Due to a sale of the subject property
    - Due to a regularly schedule county-wide or district-wide revaluation
    - Due to a change in tax rates due to changes in local government budgets
    - Due to the assessor capturing renovations that increase value
    - Due to capturing lease-up that increases value
    - Due to recognition of a below-average physical condition or externalities
- Future repairs and renovation expenses should not be at the current non-renovated level
- Reserves for replacements might need to be re-evaluated due to a revised property condition
- Marketing costs might have to increase to generate new tenants over the lease-up period
- Management fee would fluctuate based on changes in EGI as units become renovated and occupancy increases

Other Issues for the Underwriter to Consider

- Does the length of time for renovation and lease-up make sense given the scope of the work?
- Do the renovation costs make sense, given the scope of work?
- Does the appraiser adequately support the absorption estimate?
    - Based on market comparables
    - Based on the subject's history
    - Based on discussions with market participants
    - Other (for example, maybe an evaluation of area-wide multifamily building permits and/or single-family home construction)
- The valuation of a property that is currently operating at 100% occupancy is not the same as a property that is operating at some number less than 100%:
    - Without showing their math, the appraiser cannot simply declare that the difference is accounted for by the final rounding of the value. The appraiser has to show their analysis.
    - If the appraiser's value is based on the assumption that a property is operating at 100% occupancy today (or 95%, or whatever), even though it is not, without consideration of actual property operations, then that is a *hypothetical* valuation and not an as-is market value, and is not in compliance with Section 60.2 of the Guide.
- The value differential for non-stabilized operation should be considered in the Income Approach and in the Sales Comparison Approach.
    - Are the comparable sales also non-stabilized properties?
        - If not, how did the appraiser account for non-stabilization in the Sales Approach?
    - The consideration for value differential might be made in the adjustment grid or as a deduction in the conclusion to each approach to value.

Discount Rates and Capitalization Rates

Discount rates (sometimes referred to as IRR) and capitalization rates are measures of the anticipated investment risk.

- Generally, capitalization rates reflect the rate of return for a single NOI capitalized into perpetuity acknowledging that the NOI does not materially fluctuate period over period.
- Discount rates / IRRs are used when there are uneven or irregular cash flow, and the timing of the irregular cash flows will affect the present value.

- The discount rate and discounting period should be reflective of the risk of the period of non-stabilization.
- The appraiser must adequately explain the development of the discount rate. That is, how did the appraiser arrive at that particular number for this report?
  - Discussions with market participants
  - Benchmarked by published surveys or comparable sales
  - Incremental risks due to the short-term nature of DCF should be discussed