Real Estate Appraisals

Common Issues and Best Practices

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Common Issues

In our review of appraisal reports, we are finding that although many appraisals contain a reasonable quantity of facts and descriptions, these facts are not always related back to their impact on the valuation of the subject property.

Appraisers are generally good at extracting data from the market and analyzing that data in each of the three approaches to value. However, we have seen deficiencies in conveying valuation in a format and context that provides the client with an adequate understanding of the methodology and thought process that leads the appraiser to their conclusion.

A well-written appraisal anticipates and addresses a reviewer's questions. Many narrative reports lack a summary thread that relates how the findings of the report impact the value of the subject property. We have found that the difference between a well-written appraisal and a below-average appraisal is usually the addition of a detailed descriptive analysis in each section of the report and a concise summary at the conclusion of each section. Typically, the addition of this verbiage does not change the valuation, but it can dramatically improve the efficiency of our review process and response time by reducing the need to clarify the appraiser's thought processes.

In addition to the requirements outlined in Chapter 60 of the *Freddie Mac Multifamily Seller/Servicer Guide* (Guide), below is a list of best practices to help you select and evaluate real estate appraisers.

Key Takeaways

In this document, you'll find these key takeaways:

- Common areas for improvement
- Selecting the best appraisers
- Evaluating appraisal reports
- What is expected from the appraiser

Best Practices

Selecting the Best Appraisers

- Evaluate and select appraisers based on qualifications and quality of work — not strictly based on price or turnaround time
- Ensure appraisers are qualified, including the staff that does the site inspection:
  - The Guide requires that at least one person signing an appraisal report must have inspected the subject property.
  - Appraisal Trainees cannot be the only person that inspected the subject property.
  - The Optigo® lender should maintain an active, approved appraiser file with qualifications and performance information.
- On a case-by-case basis, select the appraisers that are most appropriately qualified and experienced to conduct an analysis of the specific property (e.g., market rate properties, affordable housing properties or mixed-use projects) as well as the property's market and sub-market.

Managing Engagement

- Optigo lenders should interact with appraisers prior to project engagement:
  - Convey any unique aspects of the transaction that would impact the appraiser's analysis or data requirements.
  - At the time of the engagement, it is the Optigo lender's responsibility to provide the appraiser with all pertinent information required to provide a supportable opinion of market value.
- Engagement letters should clearly state:
  - The definition of market value the appraiser is to use
  - The ownership interest the appraiser is to appraise (i.e., leased fee versus leasehold)
  - Whether the valuation of the property is as-is, as-complete and/or as-stabilized
- Provide feedback (positive and negative) to the appraisers in a timely manner.
- The Optigo lender should provide environmental and engineering reports to the appraiser in a timely manner so the appraiser can incorporate the findings of these third-party reports into their valuation analysis prior to the appraisal's transmittal to Freddie Mac.

Evaluating Reports

- Optigo lenders must review reports and confirm compliance with the Guide (Chapter 60) and the Uniform Standards of Professional Appraisal Practice (USPAP), as required by the Optigo lender's representations and warranties, prior to forwarding the appraisal to Freddie Mac.
  - The Optigo lender's review should be conveyed to Freddie Mac with the appraisal report.
  - The Optigo lender's appraisal review comments should be incorporated into the appraisal, if applicable, prior to its transmittal to Freddie Mac.
- Optigo lenders should not close deals with unresolved appraisal or valuation issues since the final appraisal conclusions might not conform to the draft value.

Appraisal Methodology, Analysis and Reporting

Capitalization Rate

In a period of uncertain economic conditions, the estimation of a capitalization rate becomes more difficult due to the lack of a large pool of available data but, at the same time, becomes that much more critical to an accurate valuation estimate.

- The appraiser must discuss and relate the selected capitalization rate to the subject property's particular characteristics such as market and regional issues, physical condition, economics (e.g., vacancies and operational issues), and legal constraints (e.g., zoning and ownership structure).
- The appraiser should develop the capitalization rate using each of the following techniques, if applicable (when sufficient data is not available or a particular technique is not applicable, the appraiser should explain those limitations in the report):
    - Data extracted from comparable sales
    - Published sources
    - Personal surveys and interviews with market participants
    - Band of investment method (also known as the mortgage-equity technique)
    - Debt coverage ratio model
- The selected final overall capitalization rate should be representative of the range of the results from these methodologies and not show a bias to either the low or high side of the range.

Zoning and Legal Issues

Zoning and other legal issues are important determinants of value, even for an existing, stabilized property and the appraiser must address the following at a minimum:

1. Does the parking ratio comply with current zoning code (i.e., number of parking spaces per rental unit)?
2. Does the unit density comply with current zoning code (i.e., rental units per acre)?
3. If the property experiences substantial damage or casualty loss, can it be rebuilt to the same number of units as the basis for the appraiser's value?

- Although the appraiser's interpretation of the local zoning code is important, the appraiser should provide an authoritative reference or zoning office source to support their analysis and conclusions.
- If the local code is available online, the appraisal should include a URL reference.
- A comparison with competing properties would be appropriate to better understand any market advantage or disadvantage the property might have in parking, unit size or unit density.
    - For example, a discussion and analysis of parking comparables might be required if the subject property has insufficient parking (either as a comparison with competing properties or based on zoning regulations).
    - This deficiency is an obsolescence issue that must be considered in all three approaches to value.

Comparables

- Adjustments to comparables, either in the Sales Comparison Approach or for rental comparables, must be sufficiently discussed by the appraiser.
- Appraisers should provide a description of the factors that differentiate the comparable from the property when making comments such as, "the comparable was adjusted upward for inferior condition".
- Without statistical analysis or a paired sale analysis, adjustments to comparable sales and comparable rents can typically be subjective and imprecise. If appraisers make precise adjustments to a comparable sale or rent — 1%, 3% or 7%, for instance — sufficient data or discussion should be provided to support their analysis.
- Appraisers should discuss each attribute or component adjustment separately for maximum clarity.
- When applicable, economies of scale should generally require a very small adjustment to the comparable, typically in the 5% range, as larger adjustments would suggest the property may not be truly comparable to the subject property.
- Unit mix is oftentimes an overlooked item of comparison that affects the economics of the subject property, which is sometimes mistaken by the appraiser as a representation of unit size.
- The appraiser should not use atypical sales transactions (e.g., allocated sales that were part of a portfolio transaction) as comparables either in the Sales Comparison Approach or for the capitalization rate.

Valuation Approaches

- As stated in *The Appraisal of Real Estate* (15th edition), a net income multiplier analysis is simply the reciprocal of the capitalization of net income from the Income Approach and is not an appropriate analytical tool for the Sales Comparison Approach.
- Multiplying market rents by the number of units to derive potential gross income without adjustment or consideration for actual contract rent is not appropriate appraisal methodology for a leased fee analysis nor compliant with the Guide.
- Both the expense ratio and the expense-per-unit should be provided for each expense comparable in the analysis and review of operating expenses under the Income Approach.
- Appraisers should estimate the leased fee interests in the subject property, regardless of whether the subject's leases are at current market levels. "Fee simple" is the incorrect term.
- If the ownership of the property is subject to a ground lease, then the appraisal is of the leasehold interests, even if the ground lease is only for a nominal amount, such as $1.00 per year.
- The Cost Approach is not always applicable to some older properties with concerns about estimating depreciation or the availability of comparable land sales, however, the elimination of this valuation method from the appraisal requires that the appraiser discuss the rationale for its exclusion.
- If the appraiser does choose to include the Cost Approach in the appraisal, then the analysis should include the following:
    - The replacement cost estimate and the structure classification of the property must match the description of the building provided by the appraiser
    - The source and date of the replacement cost data must be disclosed
    - A comparison of the property's actual construction costs to the replacement cost data for new or recently constructed properties

- Temporary market conditions, such as unusual vacancy or concessions, should not be capitalized in perpetuity but should typically be considered as a present value deduction from the valuation, either from each approach to value them separately or from the overall value conclusion after reconciling the three approaches.
- A discounted cash flow analysis may be required for a property that is experiencing destabilized operations. If a discounted cash flow analysis is included in the appraisal, the appraiser should discuss and provide adequate support for the model's inputs including income and expense assumptions, financial/yield rate assumptions, and the holding period. Generally, extending the analytical period to only the first full year following stabilized operations will produce the most accurate value.

Report Format and Documentation

In our reviews, report format and documentation quality are clear indicators of an appraiser's attention to detail, professionalism and ultimate service value.

- The following are common signs of below average performance:
    - Incomplete or non-germane data
    - Spelling or math errors
    - Formatting inconsistencies
    - Poor choice, placement, quantity or quality of exhibits
    - Catchall disclaimers such as, "The appraiser did not observe any easements during the inspection" or "A legal description (or plat, survey, and/or construction drawings) was not provided to the appraiser." Easements must be documented by a plat reference, title policy or other documentation.
- The appraiser should document which units they inspected for the report, when the inspection took place and a description of the condition of each unit.
- The appraiser should document that they have reviewed an environmental report as part of the appraisal process (i.e., date of the consulting report, who prepared the report and a summary of the report's conclusions).
- The appraiser should compare its estimate of the improvements' remaining economic life with the mortgage loan term.
- Repayment of the loan may be in jeopardy if the remaining economic life of the property is shorter than the loan term.
- Sources of the appraiser's assumptions (e.g., building size or acreage) should be documented and referenced in the report.
- Occupancy surveys of competing properties should clearly indicate whether the appraiser is measuring vacancy in terms of number of units empty on a particular date or income lost due to vacancy at a particular point in time.
- Surveys of any type should be dated (i.e., month and year) and the assumptions or methodologies of the surveys should be clearly explained.