Guide to Appraisal Reports

What is an appraisal?

An appraisal is an independent valuation of real property prepared by a qualified Appraiser and fully documented in a report. Based on a series of appraisal techniques, a specific value or range of value is assigned to the property, representing the "highest and best use." The purpose of the appraisal is to establish the market value of a property for use by the owner, a potential purchaser or lender.

Perhaps the best resource on real estate appraisals is The Appraisal of Real Estate, 12th ed., published by the Appraisal Institute (2001). This book states: "An appraisal is an unbiased estimate of the nature, quality, value or utility of an interest in, or aspect of, identified real estate. An appraisal is based on selective research into appropriate market areas; assemblage of pertinent data; the application of appropriate analytical techniques; and the knowledge, experience, and professional judgment necessary to develop an appropriate solution to a problem."

While the appraisal is an opinion by a real estate professional, based on certain accepted principles, it is nonetheless only an opinion. And since supportive housing is not a traditional or necessarily well-understood form of housing, the completed value may be subject to some differences in opinion.

When are appraisals required?

Supportive housing sponsors will find that appraisals are required for their development projects in most cases including:

- Public agencies that are funding the cost of acquisition will often require appraisals to make certain that they are not making an acquisition loan in excess of the market value. It is critically important that public funds are not used to create windfalls or undue profits to private property sellers.

- Tax credit investors that are taking advantage of the "acquisition credit" will always require an appraisal as backup for their basis assumptions.

- Lender needing to establish the value of a property in order to determine the "loan-to-value ratio", that is, the relationship between the loan amount and the total value of the completed project. An appraisal will be required in almost all projects involving conventional debt, and is considered to be a key element of the lender's "due diligence."

- Sponsors themselves may commission appraisals to determine the maximum amount that they will pay for a property that they are considering purchasing. Sponsors that are using a property that they already own for a project may also conduct an appraisal to determine the amount of compensation for the property in the development financing.

Note: This document is included within the *Development and Finance* section of CSH's *Toolkit for Developing and Operating Supportive Housing*, which is available at www.csh.org/toolkit2.

It is also important to be sure an appraisal is current. An appraisal that is more than six months old is unlikely to be of use to anyone.

How do I find an Appraiser?

The best source of referrals for Appraisers is local banks in your community since they are probably the most active clients of Appraisers and require the highest professional standards. Public agencies and non-profit housing developers may also be a source of referrals, though their standards may not be as high as banks. Keep in mind that some lenders will have a list of "approved" appraisers from which sponsors must choose.

Look for an Appraiser that is a member of the Appraisal Institute (MAI), a national organization that establishes standards for appraisals and credentials for Appraisers. They also offer continuing education programs, and certification under these programs is also a desirable credential. Additionally, most states also certify Appraisers, so make sure that they are state-certified.

The cost of appraisal reports can vary, so sponsors may want to request proposals from about three equally qualified firms before deciding on the Appraiser. Non-profit organizations can inquire about whether the firm would prepare the report on a reduced-fee basis, or may be able to negotiate a lesser scope-of-services to reduce the appraisal cost. Some Appraisers will agree to do a limited report that includes the valuation analysis but does not include the narrative section. This might be fine if it is simply for the purpose of determining an offer price, but would not be acceptable to a lender. Keep in mind that some lenders have underwriting standards that dictate the maximum allowable appraisal expense. This sometimes proves a useful bargaining tool with appraisers.

Also, try to identify an Appraiser that is familiar with the subject property's real estate market, and also knows the residential market. An appraisal that works on commercial appraisals in a downtown area will not likely know the low-income housing market throughout a given city. Check with other CDC's that have used Appraisers and ask for their recommendations.

Finally, most experienced developers tend to have positive working relationships with an appraiser or two. This is often another useful route for finding one.

What is contained in an appraisal report?

Appraisal reports are fairly standardized, since they are guided by the national Appraisal Institute and Uniform Standard of Professional Appraisal Practice (USPAP). The typical format and contents of an appraisal are as follows:

Summary
A summary of the conclusions are provided up front in the report in letter form, along with a summary of the salient facts and conclusions.

Introduction
The introduction section usually includes an identification of the subject property and an explanation of the purpose of the appraisal. Generally the appraisal focuses on the "as is" market value when the purpose is to establish the current value in order to inform a buyer, seller or acquisition or construction lender. When the entity commissioning the appraisal has a long-term

interest, typically a permanent lender, a value of the completed project is also requested. This section also includes key definitions, project development timeframes, a history of the property, any special assumptions (e.g., restricted rents) and the scope of the appraisal.

Factual Data
A section entitled "Factual Data" includes information on the financing approach used, as well as a narrative on the current economic conditions and the real estate market, including a regional analysis. It also includes a detailed project description, including the neighborhood context and zoning. Information on assessed value (for real estate tax purposes) and the current property taxes, including any tax abatements or exemptions in effect, are also in this section.

Analysis of Data
The section called "Analysis of Data" is a detailed discussion of how the Appraiser arrived at the recommended value. Standard appraisal technique calls for 3 alternative methodologies for determining value – sales comparison approach, replacement value and the income approach to value. All three approaches must be fully discussed, and the Appraiser must explain why they have selected certain approaches to value and not others, and explain how they have reconciled the value indications.

The *sales comparison* approach to value is based on the principle of substitution, that is, that a buyer will pay no more for a property than a similar substitute property that offers comparable utility. The technique used here is to identify "comparables", or sites that are similar in terms of their location, condition, scale, use and zoning, and was sold recently (within the past year if possible). Since no property is an exact comparable, the properties selected are adjusted for such factors as location (more or less desirable), condition, size, zoning, utility, and any changes in the market since the sales should be factored-in. Once the comparables are adjusted, the Appraisal states an opinion on the resulting value, or range of values. This approach is typically used for "as is" value, and may not capture the value of a completed development.

The *replacement value* is defined by the Appraisal Institute as "the estimated cost to construct, at current prices, a building with utility equivalent to the building being appraised using modern materials and current standards, design and layout." This approach is particularly useful for arriving at the value of new or recently-constructed projects. The technique involves estimating the total construction cost (using standard published costs, e.g., Marshall Valuation Service) plus land value and profit, less the depreciation. This results in a "completed and stabilized cost" that is offered in the appraisal.

The last valuation technique is the *income approach*, which is also used to determine the "completed and stabilized" value. This technique defines "value" as the stream of income that the property owner receives over a period of time. This is particularly useful in appraising supportive housing since it recognizes the restrictions on rental income (due to below market rents and the low incomes of the tenants). Essentially, the income approach takes the net operating income (effective gross income less operating expenses) and applies a "capitalization rate" (this refers to the rate used to discount income to arrive at value, and reflects the investors' risk and expectations for inflation.) to convert the annual income into a value of the property.

Once these three approaches are analyzed, the Appraiser explains how they have reconciled the resulting values into a final value estimate.

How do I review the appraisal report?

Supportive housing sponsors should review the completed appraisal with an eye toward whether the Appraiser used proper assumptions in determining value. For example, were the comparable sales well selected or were the construction costs used in the replacement cost approach reflective of the current market? If the Appraiser used the income approach, did they use reasonable income and operating expense assumptions and apply an appropriate capitalization rate?

The bank and/or public agency involved in your project will also be reviewing the appraisal, so responsibility does not fall to the sponsor solely. Contact the person(s) reviewing the report to "compare notes" to see whether they have any issues.

Can I challenge the appraisal?

There are several circumstances when a supportive housing sponsor may wish to challenge the conclusions of an appraisal.

There may be situations where the lender or funding agency has requested an appraisal to support an agreed-upon purchase price. As noted earlier, the lender needs to make sure that their loan does not exceed the value of the land (collateral that is securing its loan), and public agencies generally have a policy not to use public funding to pay over appraised value. If the appraisal comes in lower than the price that the owner is requiring, this could scuttle the deal if the owner is not flexible and re-negotiates a lower price. Here it becomes particularly important to evaluate the appraisal and consider challenging it if you can make the case that they have undervalued the property. For example, they may have selected comparable sales that you believe are inferior to the subject site, or perhaps they do not sufficiently adjust for the differences. In other cases, the Appraiser may not have recognized trends in the real estate market since the comparable sales closed, and you then need to document these changes.

In challenging the appraisal, you cannot simply counter that it is too low, but must document your case carefully if you are to get reconsideration. For example, submit comparable sales (that presumably help make your case) that the Appraiser did not include and ask that they be considered for inclusion. Or if some of the sales used in the appraisal are too old or are not in comparable locations, cite those specific cases. Often the Appraisers are not familiar with low-income communities, and may simply not know the market well enough to select appropriate comparables.

When the objective of the appraisal is to arrive at a completed value that can support a prospective loan, a lower than expected value can complicate underwriting, and may preclude the loan. That is because the conventional lender will generally not want to make a loan in excess of about 80% of value. This gives the lender a cushion against declines in future real estate values (so that the loan can't exceed the collateral). In situations where the completed value is too low, you might want to consider challenging the appraisal, perhaps with the assistance of the lender. Here you are trying to document a case that the value should be higher, so you may be able to identify comparable sales that the Appraiser missed that would help your case. Or the Appraiser may have understated the construction cost (for replacement value) and you may be able to document this with recent construction cost information from similar projects. Since the Appraiser would most likely rely on the income approach for completed value, make certain that the correct income and expense

projections were used, and ask the Appraiser to justify their choice of capitalization rates. Again, a lack of knowledge in the subject market may result in a capitalization rate that is too low and does not recognize the neighborhood's strength.

Any challenge of the appraisal, and subsequent revisions, will have to be approved by the lender, so it is advisable to engage the lender in this review process so they can "buy in" and fully understand the rationale for the changes. The lender may ultimately need to defend the changes to their investment committee, so it is very important to have them on board through this process.

Are there other roles or services that an Appraiser can provide?

Appraisers can play other roles beyond preparing formal appraisals, including conducting market studies and advising purchasers on values for offers. Market studies can be useful for establishing the feasibility of projects before they are packaged. For example, if the project includes market rate housing, or if there has been demand for new subsidized housing, you may be required to conduct a marketing study. Projects involving Low-Income Housing Tax Credits may also be required to conduct market studies as part of the application process.

CSH *Toolkit for Developing and Operating Supportive Housing* a piece regarding market studies that may be helpful, and which can be found under *Assembling the Financing* in the *Development and Finance* section of the *Toolkit*, at www.csh.org/toolkit2development.

Appraisers can also offer useful advise to sponsors that are negotiating the purchase of land or buildings as to the reasonable value. This advise can be either formal, in the form of a letter of value or informal, based on a limited analysis of "as is" value (e.g., reviewing comparables and offering a range of values). This can be a particularly useful role, since many sponsors do not know market values well, and could otherwise end up overpaying for property. It also gives the sponsor a certain amount of leverage in negotiations to be able to say that their offer is supported by the opinion of a qualified Appraiser.

Conclusion

The appraisal can be a key development milestone, so be sure to be careful in selecting an appropriate Appraiser, and don't be reticent to challenge any assumptions of the report if you feel that they have misunderstood the market. And be certain to keep the lender and/or public funder "in the loop" so that they buy into the outcome.