Guide to Appraisal Reports

What is an appraisal?

An appraisal is an independent valuation of real property , which a qualified appraiser prepares and fully documents 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 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 it is considered to be a key element of the lender's "due diligence."

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

It is also important to be sure an appraisal is current. An appraisal older than six months is of little use.

How do I find an appraiser?

The best source of referrals for appraisers is local banks, since they are probably appraisers' most active clients and require the highest professional standards. Public agencies and non-profit housing developers also may 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 a desirable credential. Ensure the appraiser is state-certified.

The cost of appraisal reports varies, so sponsors may want to request proposals from about three equally qualified firms before deciding on an 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 prepare a limited report, which includes the valuation analysis but does not include the narrative section. This may suffice, if only for the purpose of determining an offer price, but it 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 appraiser who works on commercial appraisals in a downtown area likely will not know the low-income housing market throughout a given city. Check with other organizations that have used appraisers and ask for recommendations.

Finally, most experienced developers tend to have positive working relationships with appraisers. This is often useful in 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:

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 identifies the subject property and explains 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 three 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 a buyer will pay no more for a property than a similar property that offers comparable utility. This technique identifies "comparables," or sites that are similar in terms of their location, condition, scale, use and zoning, and were 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, condition, size, zoning, utility and any changes in the market since the sales. 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 Appraisal Institute defines replacement value 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," which is offered in the appraisal.

The last valuation technique is the income approach, which also is 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" (used to discount income to arrive at value, reflecting investors' risk and expectations for inflation). This converts 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 to determine 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 also will review 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 in which 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 help make your case) that the appraiser did not include and ask that they be considered. 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 unfamiliar with low-income communities and may simply not know the market 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 it may preclude the loan. A 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 in which the completed value is too low, 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.

The lender must approve any challenge of the appraisal and subsequent revisions, so it is advisable to engage the lender in this review process so they 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.

Appraisers also can offer useful advice to sponsors that are negotiating the purchase of land or buildings as to the reasonable value. This advice 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 particularly useful, since many sponsors do not know market values well, and could overpay for property. It also gives the sponsor a certain amount of leverage in negotiations to be able to say that a qualified appraiser supports their opinion.

Conclusion

The appraisal can be a key development milestone, so be careful in selecting an appropriate appraiser. 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.