JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

D. The Legal Profession

3. "Appraisal Process and Legal Strategy", a one day seminar for the American Bar Association Convention. Includes handouts, a full transcription of the seminar, and organizational correspondence. Presented in Chicago, IL on August 7, 1984

Index

American Bar Association

324 South Hamilton Street
P.O. Box 631
Madison, WI 53701

November 10, 1983

Paul E. Roberts, Chairman
Continuing Legal Education
Trubin, Sillcocks, Edelman & Knapp
Attorneys at Law
375 Park Avenue
New York, NY 10521

Re: Re-education of Lawyers in the Basics of Appraisal

Dear Paul:

This will confirm our conversation in New York in which I recommended that you consider working with Professor James A. Graaskamp, Chairman, Real Estate and Urban Land Economics, of the Graduate School of Business of the University of Wisconsin-Madison, in developing a course in the education of lawyers in the basics of appraisal.

Enclosed is a copy of a letter from Professor Graaskamp indicating his interest. Also enclosed is the brochure referred to in Professor Graaskamp's letter on "How to Purchase and Critique Appraisal Services," which I am sure you will agree is very timely.

I have known and worked with Jim for several years, and you will find him an outstanding teacher. As is indicated, he has done extensive courtroom work throughout the United States and is recognized internationally for his talents.

For several years I did the legal work in organizing the Educare Foundation created to be an educational joint venture of the American Society of Real Estate Counselors, Society of Real Estate Appraisers, and the American Institute of Real Estate Appraisers. Educare is an acronym for the Educational Foundation for Computer Applications to the Real Estate Industry, Incorporated. The Educare Foundation was funded by the three organizations to fund research by Professor Graaskamp to enable him develop courses for their members. I believe that this is one of the few, if not the only time, that the three organizations cooperated in such a joint venture.

Jean and I enjoyed the picnic at your house. Please give our regards to your wife.

Cordially yours,

ROSS AND CHATTERTON

Bill
William A. Chatterton

WAC/kg
Enclosures
cc William B. Dunn, Chairman
American College of Real Estate Lawyers
Clark, Klein & Beaumont
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1600 First Federal Building
Detroit, MI 48226

Brian J. Strum, Director
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John A. Gose, Chairman
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Seattle, WA 98101

Professor James A. Graaskamp
University of Wisconsin--Madison
The School of Business
1155 Observatory Drive
Madison, WI 53706

American Bar Association

324 South Hamilton Street
P.O. Box 631
Madison, WI 53701
(608) 256-2355

February 3, 1984

Paul E. Roberts, Chairman
Continuing Legal Education
Trubin, Sillcocks, Edelman & Knapp
Attorneys at Law
375 Park Avenue
New York, NY 10521

Dear Paul:

Enclosed is copy of outline and covering letter from Professor Graaskamp for the one-day seminar on Appraisal Logic, Law & Litigation for the ABA meeting in Chicago this summer.

Professor Graaskamp suggested that we put the emphasis on litigation in this area. He has had a lot of experience appearing as an expert witness and suggested that this would make an interesting program. I note that he has included some case studies in the seminar. He normally puts on two-day seminars so there should not be any difficulty in having plenty of useful information for the one-day seminar.

I have taken the liberty of sending a copy of the outline to Ted Taub, Chairman of the Real Property Litigation Committee and Jan Guben, Chairman of the State and Local Taxation Committee, which authored the report "Realistic Appraisal Techniques of Large Income-Producing Properties," which appeared in the spring, 1983, Real Property Probate and Trust Journal, for any comments they might have on the outline. In looking over the Real Property Division Committees, I note that there are a number of other committees which would have an interest in the seminar. You may wish to circulate those committees also.

Professor Graaskamp also notes that the college's program this spring does not conflict with our seminar.

It looks like it should be a very attractive and interesting seminar.

Very truly yours,

ROSS AND CHATTERTON

William A. Chatterton

WAC/mg
Enclosure
cc Brian J. Strum
Division Director, Real Property
John A. Gose, Chairman
Real Property, Probate and Trust Law Section
Ted Taub, Chairman
Real Property Litigation Committee
Jan Guben, Chairman
State and Local Taxation Committee
Professor James A. Graaskamp
Jackson M. Bruce, Jr., Chairman-Elect
Real Property, Probate & Trust Law Section

American Bar Association

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May 15, 1984

Magdeline Mailman
Staff Liaison
American Bar Association
1155 East ~~60th Street~~ 750 N. Lakeshore Dr.
~~Chicago~~, IL 60637
Chicago, IL 60637

Dear Ms. Mailman:

This will confirm our telephone conversation in which I advised that Professor Graaskamp will require one bedroom with a king-size bed and adjoining bedroom with twin beds for the evening of Monday, August 6, which is the evening before the program he is giving on August 7.

Thank you.

Very truly yours,

ROSS AND CHATTERTON

William A. Chatterton

WAC/mg
cc Professor James Graaskamp

750 N. Lakeshore Dr.

APPRAISAL PROCESS AND LEGAL STRATEGY

One Day Seminar For

REAL PROPERTY PROBATE AND TRUST LAW SECTION

American Bar Association Convention
The Drake Hotel
Chicago, Illinois
August 7, 1984

Presented By

Professor James A. Graaskamp, Ph.D., CRE, SREA
University of Wisconsin - Madison
School of Business

APPRAISAL PROCESS AND LEGAL STRATEGY

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I. APPRAISAL LOGIC AND STATUS

A. Intended to serve as a benchmark for a decision. (See Exhibit 1.)

1. Fiscal equity
2. Validation
3. Benchmarking
4. Counseling changes in real estate commitments

B. Different functions require different definitions which then control the appraisal process. (See Exhibit 2.)

1. Certainty
2. Probability
3. Possibility

C. Three approaches to value are evolving with the techniques of business forecasting and financial reporting.

1. Historical three approaches

    a. Market comparison approach
    b. Income approach
    c. Cost approach

EXHIBIT 1

PURPOSE	ECONOMIC INTERESTS TO BE VALUED	DEFINITION OF VALUE
A. Social Equity		
1. Real Estate Taxes	Economic surplus attributable to land and buildings.	Highest Cash Market Value before Income Tax.
2. Legal Compensation	Compensable real estate elements taken.	Cash Market Value reasonable for both seller and buyer.
B. Validation		
1. Regulation of Lending	Exit value of asset in liquidation.	Cash Market Price under duress
2. Auditing of Assets	Historical value of asset acquisition.	Confirmation of book value or equated value.
3. Income Taxation	Financial surplus allocated to reflect economic substance.	Capital asset pricing limited by market behavior and tax code definitions.
4. Insurance	Insurable interest in burnable components of real estate.	Cost to replace or defined cash value
C. Benchmarking Performance		
1. Pension Fund Adequacy	Exit value of asset in liquidation. (Involuntary conversion value)	Market price under duress
2. Comparative Management Adequacy	Entry value of asset in normal course of business cycle for next investor.	Most probable sales price at terms characterisitc of market for combined real estate and personalty.
3. Management Compensation	Marginal value added attributable to management after deductions for cost of capital from economic surplus.	Most probable cash sales price
D. Counseling Changes in Real Estate Commitments		
1. Setting Market Prices	Future economic surplus, income and positioning to control tax shelter appreciation, and related profit centers.	Most probable price and terms
2. Forecasting Purchase Prices	Market perception of future surplus and positioning for control of other profit centers.	Most probable price and terms
3. Life-Cycle Costing of Alternatives	Present value of net outlays for public buildings. Present value of all future outlays.	Cost to create and operate
4. Constructing Risk/Payoff Matrices Under Uncertainty	Present value sensitivity arrays of combined land, building, and management contributions.	

Critical Issues That Define Appraisal Process

Function of the Appraisal	Property Rights	Relevant Definition of Value	Allocation of Productivity	Buyer Motivation Presumed
Tax assessment	Fee simple private rights unencumbered	Cash market present value (As opposed to most probable selling price)	Present value income attributable to land and structures only	Purchase of economic productivity
Mortgage loan (nonparticipating)	Encumbered fee simple private rights plus additional rights pledged	Regulations - market value Underwriting - solvency price or liquidating value	Fixed income pledged from all sources less costs of creative management	Share of economic productivity contributed by capital
Mortgage loan (participatory)	Encumbered title plus nonvested interest in selected future revenues	Present value of all future cash flows	Variable income pledged plus share of reversionary interest	Share of economic productivity contributed by capital plus share in selected management returns plus positioning against devaluation due to changing conditions
Sale of an investment	Encumbered title plus vested entitlements plus going concern profit center opportunities	Most probable price above minimum acceptable alternative opportunity	Returns from land, structures, personalty, and selected entitlements	Increase in spendable cash Increase in liquidity value of estate Positioning to maximize probability of survival of benefits despite changing conditions
Purchase of investments	Encumbered title plus positioning for access to entitlements	Most probable price within perceived peril point limit	Land, structure, personalty, and intangible assets less profit centers for management	Increase in spendable cash Increase in liquidity value of estate Positioning to maximize probability of survival of benefits despite changing conditions
Going concern purchase of a business	Encumbered title plus positioning for access to entitlements plus reduction in risk for business start-up plus control of monopolistic market position controls	Most probable sales price within perceived costs of creating an alternative	Land, structure, personalty, and intangible assets and good will plus artifactual profit centers for management	Increase in spendable cash Increase in liquidity value of estate Positioning to maximize probability of survival of benefits despite changing conditions

EXHIBIT 2

2. Contemporary three approaches

    a. Market inference
    b. Market simulation
    c. Normative

3. Philosophical approach

    a. Probability
    b. Beauty
    c. Order

D. To provide a standard of performance, it was necessary to stylize the content and form of appraisal and condition the decision maker to demand that format.

1. Initially substance was achieved through form.

2. Today form has taken the place of substance and the appraisal process has been corrupted by the consumer to be an instrument of disinformation.

3. The intellectual conditions to control the appraisal model as an economic model have been converted to a subtle set of hold harmless defenses. You name the value conclusion and the appraiser might name the specific conditions when that price might prevail.

E. The decline in the status of the appraisal process can be directly attributed to three ethical problems.

1. Accounting systems fail to measure the cost of faulty appraisal and to assess it on the individuals involved. Instead it is concealed by the time lag of workouts, the eventual losses to bank deposit insurance corporations, and subtle miscarriages of equity for individuals in an advocacy process.

2. American ethics apparently condone apathy on the part of the consumer or silent conspiracy where a third party is willing to sign his name to a work of incompetence or misrepresentations.

3. The user of appraisal services is well-intentioned but ignorant of the appraisal process. He assumes a designated appraiser is technically competent just as we assume a doctor or a lawyer is technically competent. The difference is that malpractice by the appraiser is generally favorable to the purposes of his customer who uses the report in his relations with a third party who generally lacks privity of contract to sue the appraiser.

F. The purpose of today's session is to improve the critical ability of lawyers to purchase appraisal services in a way that is both ethical and effective.

G. Appraisal and accounting are very much interrelated and both will be subject to higher standards of performance as a result of professional standards now in the process of importation from the European Common Market.

H. An appraisal is a systematic analysis of the economic potential of a specific property in order to estimate the probable sales price under specific conditions and limiting constraints. Fair market value is a base number with very specific implicit and explicit conditions and constraints and may not be relevant to many issues. It implies:

   1. A statistical marketplace in which buyers and sellers have acceptable alternatives.

   2. An informed marketplace so that the availabilitly of the property had been widely circulated and known before an offer was accepted.

   3. Both parties were aware of probable use and immediate trends affecting the location and probable use of the property.

   4. See Exhibit 3 for definition of fair market value.

COFFEE BREAK

EXHIBIT 3

FAIR MARKET VALUE DEFINITION

A current definition of market value is

The most probable price in cash, terms equivalent to cash, or in other precisely revealed terms, for which the appraised property will sell in a competitive market under all conditions requisite to fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.

Fundamental assumptions and conditions presumed in this definition are

1. Buyer and seller are motivated by self-interest.

2. Buyer and seller are well informed and are acting prudently.

3. The property is exposed for a reasonable time on the open market.

4. Payment is made in cash, its equivalent, or in specified financing terms.

5. Specified financing, if any, may be the financing actually in place or on terms generally available for the property type in its locale on the effective appraisal date.

6. The effect, if any, on the amount of market value of atypical financing, services, or fees shall be clearly and precisely revealed in the appraisal report.

Source: American Institute of Real Estate Appraisers, The Appraisal of Real Estate, Eighth Edition, Chicago, IL, 1983, p. 33.

II. DEFINITION AND CONTROL OF APPRAISAL ASSIGNMENT

A. The basic appraisal process differs from the narrative appraisal report format. The narrative report suggests that appraisal is deductive rather than inductive along the following lines:

1. Understand the issues as to why appraisal is required as a benchmark.

2. Define the appraisal problem in terms of legal interests, definition of value, date of sale, and conditions of sale.

3. Analyze the property to determine alternative uses before selecting most probable use.

4. Having defined most probable use, profile the most probable buyers.

5. Given most probable buyer research availability of sales for comparable inference, pricing formulas for simulation and normative approaches to value.

6. Evaluate preliminary price forecasts for possible influence for externalities which should be considered, such as unforeseen economic events, probable buyer/seller duress, special financing or changes in the tax law.

7. Having corrected preliminary estimate of value for externalities, test for reasonableness of conclusion in terms of market patterns.

8. Set final value opinion and specific conditions of financing and interests appraised.

B. The relationship of the lawyer and the appraiser is complicated protocol, appraisal training, and confusion of advocacy versus relevancy.

1. Taking nothing for granted about the property, the appraiser, or the assumptions inherent in the appraisal process.

2. The appraiser is taught not to interact with the lawyer and to avoid learning about the law of the case in order to remain as an advocate of his independent appraisal opinion.

3. Independence comes as a cost of relevance, and worse--it assumes both parties know what they are doing.

C. Hire an appraiser as a consultant first to help define the problem and the real estate opportunities and limitations and then determine a specific appraisal problem and fee. This assumes the lawyer and the appraiser treat each other as professional equals and understand some limits on the relationship.

1. The attorney is an advocate of his client's position while the appraiser is an advocate only of his opinion of value.

2. The lawyer can deal in disinformation while the appraiser must deal in a combination of facts and assumptions to hypothesize future events. The appraiser must be careful that he is not placed in a position of rationalizing his number with assumptions generated from the lawyer's bias of advocacy.

D. Many basic assumptions require other professionals for confirmation. The traditional appraiser was a generalist who rationalized ignorance by claiming to avoid encroaching on his professional cousins in law, engineering, architecture, or environmental sciences.

1. Today appraisal of complex problems requires a team of professional skills as a joint venture or clinical office.

2. Good appraisal work anticipates discretionary allowances in the budget for other professional fees.

3. Even the most modern income property requires CPA review to interface accounting and evaluation of an income stream.

E. Selection of appraisal talent generally begins with interviews that insult the professional by suggesting both the value he should seek and the fee to be paid. Today we evaluate the legitimacy of the opposition's case by the professional character of the appraisers they have selected.

   1. Gresham's Law is operating to drive out the best appraisers from the courtroom.

   2. Much high cost litigation is caused by faulty appraisal values in the first place so that the parties did not have an appropriate payoff matrix to evaluate the wisdom of litigation.

F. Miscellaneous issues when retaining an appraiser not unlike those in the AIA contract:

   1. Program development phase (problem defined and value theory)

   2. Schematic phase (field work and rough notes)

   3. Working drawings (written report)

   4. Shop drawings (courtroom exhibits)

   5. Project supervision and inspection

G. To control appraisal quality, financial institutions are beginning to look at letters of engagement for appraisal services. It's like rewriting the AIA contract to define work product and methods as well as scope of services. (See Exhibit 4.)

H. Appraisers are also finding greater need for letters of engagement. Consider guidance notes for Royal Institute of Chartered Surveyors in Exhibit 5.

First Asset Realty Advisors

Exhibit 4

First Bank Place
Minneapolis MN 55480

Appraisal Engagement Letter - Preliminary Draft

TO:

RE: Property Identification

Dear ______________:

On behalf of First Asset Realty Advisors (FARA), we would like to engage your services for the appraisal of the above property to determine the fair market value of the legal interests owned by a Commingled Fund as of (date of appraisal). To that end and before accepting the assignment, the appraiser should consider the following requirements as to definition and procedure:

1. Fair market value shall be defined as the most probable price at which the property would sell to a knowledgeable buyer on a given date if placed on the market for a reasonable length of time by a well informed seller assuming:

   a. Cash to the seller or cash plus debt owed or assumed by the buyer, where appropriate.
   b. Fee title will be encumbered by leases in place and possible other covenants. Appraiser must indicate remaining market value of these other leasehold or non-possessory interests.
   c. The appropriate exposure on the market has occurred prior to the date of sale.
   d. Buyer motivation is profiled as an assumption by the appraiser.

2. Fee title may be encumbered by leases, mortgages as well as possible conditional use permits and private covenants. FARA is obligated to provide access to all of the appropriate documents at the office of ______________ ______________ located at ______________ ______________ during normal business hours. The appraiser is expected to read the leases, mortgage instruments and other encumbrances and relate to them appropriately. If existing debt is assumable by another buyer, then the appraiser can value the sale as cash to the seller with the buyer accepting the mortgage(s) already in place if that would be consistent with the most probable buyers self interest. Otherwise the trustees of the Commingled Fund management (FARA) are interested in a value which is the most probable cash price to the seller and with the buyer accepting the existing encumbrances in terms of leases and covenants, etc.

3. When using the market comparison approach the appraiser must document each comparable sale as to grantor, grantee, public record, plot plan and photograph as well as basic details of construction and existing encumbrances, terms of sale, and seller motivation. All calculations necessary to adjust engineered prices to cash equivalencies must be documented and explained as well as any and all adjustments to relate the comparable price to the subject property must be itemized and explained so that the reader can repeat the mathematical adjustments possible.

4. The income approach must use discounted cash flow from a ten year forecast (and your own forecast if different) in which all major leases are detailed individually and minor leases classified into groups if appropriate. The rationale for roll-over vacancies, absorptions, and expense projections must be itemized with a series of footnotes in the manner of a fully detailed accounting income and balance sheet statement. Normalized income methods including investment bond, Ellwood, or net income multipliers are not acceptable.

5. The appraiser must document his opinion as to the appropriate discount rate applied to each segment of the cash throw-off and after tax cash flow as appropriate, together with financing terms assumed.

6. A cost approach by a responsible service or professional should be supplied with the initial appraisal. If it is not used in the final valuation, then a discussion on why it is not used is required. The appraiser is expected to carefully inspect the property and report his own independent views on the quality of maintenance, deferred maintenance, and tenant housekeeping.

7. The appraiser is regarded as the eyes and property inspector of FARA. To put the property in context the appraiser must supply and evaluate a list of projects which are competitive alternatives in the market areas of the appraiser and indicate rent structures, vacancy rates, turnover rates, and in the case of the new building, coming on stream or about to be built, some indication as to their rentup success and the source of their tenants. Wherever possible the appraiser is to indicate the ownership and character of investment position in these competitive properties and the property management or leasing term involved with each.

Following the initial appraisal at the time of acquisition, the appraiser will be asked to submit a letter of review 180 days after the date of the original appraisal indicating if he would modify any of his critical assumptions at that time, and if so, indicating how this might affect his original value estimate as a specific dollar adjustment, up or down.

At the end of 360 days the appraiser would be expected to perform a thorough review of his original appraisal, specifically focusing on the market approach (Item 3), adjustments indicated for the income approach (Item 4 & 5), and additions and amendments to market data, (Item 7). Aside from the specific instructions provided in paragraphs 1-7 above, it is anticipated that all work will be done according to the standards of the American Institute of Real Estate Appraisers, and it is further understood that the client for whom the appraisal is done for purposes of professional accountability is both First Asset Realty Advisors, Inc. and its operations agent, The Center Companies of Minneapolis, Minnesota. Purpose of the appraisal is to meet the asset valuation requirements of an open-ended, commingled real estate fund suitable for investment by pension fund programs subject to ERISA.

Please return both copies of this letter together with an indication of your fee for the appraisal services above, with a separate quote for the initial appraisal, the 180 day review, and a 360 day reappraisal. If this is your first assignment for FARA, please include a sample of your work, preferrably of a similar property, in which you have provided for the necessary cash flow projections.

Guidance Note No. GN 4

CONDITIONS OF ENGAGEMENT

1.1 The Royal Institution of Chartered Surveyors has published a leaflet entitled 'The Valuation of Commercial and Industrial Property: Conditions of Engagement' which is reproduced in the Annex to this Guidance Note. The principles dealt with in that leaflet are equally applicable to asset valuations.

1.2 Guidance Note No. GN 2 refers to Caveats that should be incorporated in the valuation report in respect of such matters as structure, non-publication and responsibility to third parties. Further reference is made in the Guidance Notes to the Hedley Byrne principle relating to liability to third parties.

See GN 2

See GN 5

1.3 Many members have adopted the practice of incorporating in their valuation reports standard forms of caveat which are used within the profession or in their own offices. Among the various clauses defining, restricting or excluding liability which members use from time to time, the most important and commonly used are:

(a) a clause indicating that a valuation is not a structural survey;

(b) a 'latent defects' clause;

(c) a clause relating to high alumina cement concrete and other deleterious materials;

(d) a clause excluding liability to third parties under the principles of Hedley Byrne *v* Heller;

(e) a restriction on publication clause;

(f) general assumptions as to title.

1.4 In the past it was not unusual for instructions from clients for valuations to be accepted with a minimum of formality as to the terms and conditions on which the service was to be provided.

1.5 In the November 1977 issue of the 'Chartered Surveyor' members were informed that the Institution had received legal advice that unless certain of the caveats included in surveyors' reports were agreed at the time of accepting instructions, and thereby included in the contract for services between the client and the surveyor, such caveats may not provide any defence for the surveyor in any subsequent action in relation to his advice.

1.6 The Unfair Contract Terms Act 1977 has extended liability in this area and any caveats and exclusion clauses must pass the test of reasonableness, although it may be some while before the Courts interpret in practical or specific terms what caveats are reasonable in particular circumstances.

1.7 It is therefore recommended that a member, on being requested to make a valuation of a property, should write to the client indicating that the acceptance of any instructions will be subject to various clauses defining, restricting or excluding liability in respect of various aspects of the valuation and that the valuation will be subject to those terms, unless otherwise agreed.

1.8 Unless covered by a previously agreed standing arrangement, written agreement to the terms of the valuation should be obtained from the client prior to commencing the valuation. In exceptional circumstances it may be appropriate to obtain a certified copy of a Resolution of the Board or Executive Committee authorising the valuation.

1.9 Counsel has advised that the report to the client should also reiterate:

(a) the purpose of the valuation;

(b) any qualification to which it is subject;

(c) the form of caveats used by the member.

Annex to Guidance Note No. GN 4

THE VALUATION OF COMMERCIAL AND INDUSTRIAL PROPERTY

Conditions of Engagement

Conditions of Engagement

This leaflet sets out the terms on which a Chartered Surveyor will normally undertake the valuation of commercial and industrial property in England and Wales. It does not cover every aspect of valuation nor does it deal with individual problems.

PART I – RELATIONSHIP BETWEEN CLIENT AND CHARTERED SURVEYOR

1. The Nature of a Valuation

A valuation is the individual opinion of a valuer based on the relevant facts known to him and subject to any limitations imposed by the client. Because a valuation is a subjective exercise there will inevitably be scope for differences of opinion, even between experienced valuers. Where for statutory or other purposes valuations require the application of hypothetical conditions then a further widening of views may be expected.

The most common forms of valuation required are 'open market value' and 'open market rental value'. These may be defined as the best price or the best rent which might reasonably be expected to be obtained for an interest in a property at the date of valuation assuming:

(a) a willing seller or lessor;

(b) a reasonable period in which to negotiate the sale or letting;

(c) that values will remain static during that period;

(d) that the property will be freely exposed to the market; and

(e) that no account will be taken of any higher price or rent that might be paid by a person with a special interest.

Whilst 'open market value' is usually required there are cases where a client will need a different basis of assessment. For example, an owner may be under pressure to realise certain of his assets, in which case a 'forced sale value' would be appropriate.

All the provisos referred to above would apply except that of the time scale. Another basis of value is 'depreciated replacement cost' which may be adopted in certain instances in relation to the value of the company assets.

Where a valuation is for the purposes of, say, Capital Gains Tax, Development Land Tax or compensation following compulsory acquisition, it will be subject to statutory rules.

The range of purposes for which a valuation may be required is substantial and includes sale, purchase, letting, obtaining finance, accounting, rating, compulsory purchase, and tax reasons.

The interest to be valued may be freehold or leasehold or some incorporeal estate or interest, such as an easement or a restrictive covenant, and may be subject to other interests.

Even apparently minor differences in the purpose for which a valuation is to be used (for example, one tax calculation rather than another) can produce significantly different figures. Similarly, what may appear to a client to be relatively minor variations in lease terms or small variations in planning assumptions can dramatically alter the final figure.

2. The Valuer

In most cases there are no legal restrictions as to who can undertake a valuation, but in his own interests the client should instruct someone with the necessary skill, knowledge and experience. Chartered Surveyors in general practice are qualified in these skills, both by training and experience, although some surveyors may specialise in certain types of valuation.

In certain cases, such as a valuation for insurance company solvency purposes, there is a statutory requirement that the task must be carried out by a qualified valuer, such as a Chartered Surveyor, whilst in the case of a valuation for Stock Exchange purposes that body requires the work to be done only by those with appropriate professional qualifications.

3. Confidentiality

A valuation is a confidential report for a particular client and for the special purposes of that client. The purpose for which a valuation is prepared is fundamentally important.

As a result the valuation should only be used within the context of the instructions under which it is prepared. An obvious example is that of a fire insurance valuation based on cost of rebuilding which may bear no relation to the open market value of the property.

There will be cases where the valuation will be specifically prepared for more than just the instructing party, as, for example, a bank providing a loan facility. Generally, however, the valuer will accept a liability only to the person or company instructing him, and will accordingly make his report confidential to that client and incorporate a paragraph on the following lines:

> "This report is confidential to the Client for the specific purpose to which it refers. It may be disclosed to other professional advisers assisting the Client in respect of that purpose, but the Client shall not disclose the report to any other person."

There may be instances where the client will wish to make reference to the valuation in company accounts and/or directors' reports on some company statement or circular.

In appropriate circumstances the valuer will generally agree to such reference, subject to his approval of the form and context in which it may appear. The report or valuation certificate may, therefore, incorporate a paragraph on the following lines:

> "Neither the whole nor any part of this report/valuation certificate or any reference thereto may be included in any published document, circular or statement nor published in any way without the valuer's written approval of the form and context in which it may appear."

4. Scope of the Valuation

The quantity and nature of information available to the valuer in preparing his report will depend on his instructions and the time and conditions under which he is allowed to carry out his work. For example, a client may require a valuation based only on an external inspection, in which case the valuer must rely on information provided in relation to floorspace and other matters.

Normally, however, the valuer will carry out an inspection of the premises and make such enquiries and investigations as he deems necessary. These may entail informal enquiries of the Local Planning Authority and other authorities. Although the valuer may sometimes obtain written confirmation of details provided informally by such authorities, it will usually be necessary for the client's solicitor to make formal enquiries.

The valuer will often have to rely upon information provided by the client, his solicitor or accountant, as, for example, in the case of legal restrictions or tenancy agreements or where the valuation is by reference to accounts. There will also be instances where the valuer will need personally to examine copies of appropriate legal documents, such as leases, and where these are not available his report will refer to the assumptions he has made or the information with which he has been provided.

It is important to appreciate that a valuation is not a structural survey. In a valuation the valuer will not examine the structure in depth nor will he, when reporting to the client, necessarily detail all the defects from which the property apparently suffers. He will, however, take into account the age and nature of the building under review.

There are various defects which can influence the value of a property significantly but which are undetectable unless substantial specialist investigation is carried out; the incidence of high alumina cement concrete is an example. Where a property is of such an age and design that it is possible it contains such potential defects, then the report may refer to the possibility, emphasising that a specialist investigation has not been undertaken and that the valuer has assumed that the results of such an investigation would not adversely affect the value he has placed upon the building.

Paragraphs on the following lines may therefore be included with valuation reports: "We have not carried out a structural survey nor have we inspected woodwork or other parts of the structure which are covered, unexposed or inaccessible and we are therefore unable to report that any such part of the property is free from defect;" and

"We have not arranged for any investigation to be carried out to determine whether or not high alumina cement concrete or calcium chloride additive or any other deleterious material has been used in the construction of this property and we are therefore unable to report that the property is free from risk in this respect. For the purpose of this valuation we have assumed that any such investigation would not disclose the presence of any such material in any adverse conditions".

If the client wants not just a valuation but also a structural survey many Chartered Surveyors will be prepared to undertake such a survey if so instructured and will be able to arrange for specialist investigations if the client so wishes. Such additional work and responsibility will normally involve a higher fee.

5. Instructions

It is important that a client clearly defines the terms of reference within which he wishes a valuation to be carried out. Often a preliminary discussion with the valuer will be of benefit so that areas of potential uncertainty may be resolved prior to any work being undertaken. The conditions on which, in the absence of express agreement to the contrary, the valuer will undertake the valuation are set out in Part II of this leaflet.

6. Valuation Fees

The fees for a valuation will vary according to the nature of the work and a Chartered Surveyor will quote the appropriate fee for the particular valuation requested. VAT and out-of-pocket expenses are usually payable in addition.

PART II – CONDITIONS OF ENGAGEMENT

The Valuer shall advise the Client as to his opinion of the value of the relevant interest in the property, as specified by the Client.

The purpose for which the valuation is required shall be as agreed between the Client and the Valuer.

Unless otherwise specifically agreed the value advised by the Valuer shall be the open market value current at the date of valuation.

The Valuer shall give his opinion using all reasonable professional skill and care.

Subject as hereinafter provided, the Valuer shall carry out such inspections and investigations as are, in his professional judgement, appropriate and possible in the particular circumstances.

The Valuer shall unless otherwise expressly agreed rely upon information provided to him by the Client or the Client's legal or other professional advisers relating to tenure, tenancies and other relevant matters.

The Valuer shall have regard to the apparent state of repair and condition of the property but shall be under no duty to carry out a structural survey of the property nor to inspect woodwork or other parts of the structure of the property which are covered, unexposed or inaccessible; neither shall he have a duty to arrange for the testing of electrical, heating or other services.

Unless otherwise expressly agreed the Valuer shall, in arriving at his valuation of the property, assume that:

(a) good freehold or leasehold title (as the case may be) can be shown and that the property is not subject to any unusual or onerous restrictions, encumbrances or outgoings;

(b) the property is unaffected by any statutory notice and that neither the property nor its use or its intended use gives rise to a contravention of any statutory requirement;

and

(c) the property is free from dry rot, woodworm and latent defects and that no deleterious materials have been used in the construction of the property.

The Valuer shall be under no duty to verify these assumptions.

The Valuer shall provide to the Client a report setting out his opinion of the value of the relevant interest in the property. This report will be confidential to the Client for the specific purpose to which it refers. It may be disclosed to other professional advisers assisting the Client in respect of that purpose, but the Client shall not disclose the report to any other person.

The Client shall pay to the Valuer in respect of the said professional advice a fee to be agreed between the Client and the Valuer. In addition the Client will reimburse the Valuer the cost of all reasonable out-of-pocket expenses which he may incur and pay the amount of any Value Added Tax on the fee and expenses.

Apologies – Original not very legible pp. 19–21

CONDITIONS OF ENGAGEMENT

(Scottish version – based on the law and practices of that country)

1.1 The Royal Institution of Chartered Surveyors has published a leaflet entitled 'The Valuation of Commercial and Industrial Property in Scotland: Conditions of Engagement' which is reproduced in the Annex to this Guidance Note. The principles dealt with in that leaflet are equally applicable to asset valuations.

1.2 Guidance Note No. GN 2 refers to caveats that should be incorporated in the valuation report in respect of such matters as structure, non-publication and responsibility to third parties. Further reference is made in the Guidance Notes to the Hedley Byrne principle relating to liability to third parties. See GN2 See GN5

1.3 Many members have adopted the practice of incorporating in their valuation reports standard forms of caveat which are used within the profession or in their own offices. Among the various clauses defining, restricting or excluding liability which members use from time to time, the most important and commonly used are:

(a) a clause indicating that a valuation is not a structural survey;

(b) a 'latent defects' clause;

(c) a clause relating to high alumina cement concrete and other deleterious materials;

(d) a clause excluding liability to third parties under the principles of Hedley Byrne v Heller;

(e) a restriction on publication clause;

(f) general assumptions as to title.

1.4 In the past it was not unusual for instructions from clients for valuations to be accepted with a minimum of formality as to the terms and conditions on which the service was to be provided.

1.5 In the November 1977 issue of the 'Chartered Surveyor' members were informed that the Institution had received legal advice that unless certain of the caveats included in surveyors' reports were agreed at the time of accepting instructions, and thereby included in the contract for services between the client and the surveyor, such caveats may not provide any defence for the surveyor in any subsequent action in relation to his advice.

1.6 The Unfair Contract Terms Act 1977 has extended liability in this area and any caveats and exclusion clauses must pass the test of reasonableness, although it may be some while before the Courts interpret in practical or specific terms what caveats are reasonable in particular circumstances.

1.7 It is therefore recommended that a member, on being requested to make a valuation of a property, should write to the client indicating that the acceptance of any instructions will be subject to various clauses defining, restricting or excluding liability in respect of various aspects of the valuation and that the valuation will be subject to those terms, unless otherwise agreed.

1.8 Unless covered by a previously agreed standing arrangement, written agreement to the terms of the valuation should be obtained from the client prior to commencing the valuation. In exceptional circumstances it may be appropriate to obtain a certified copy of a Resolution of the Board or Executive Committee authorising the valuation.

1.9 Counsel has advised that the report to the client should also reiterate:

(a) the purpose of the valuation;

(b) any qualification to which it is subject;

(c) the form of caveats used by the member

Annex to Guidance Note No. GN 4.1

THE VALUATION OF COMMERCIAL AND INDUSTRIAL PROPERTY IN SCOTLAND

Conditions of Engagement

Conditions of Engagement

This leaflet sets out the terms on which a Chartered Surveyor will normally undertake the valuation of commercial and industrial property in Scotland. It does not cover every aspect of valuation nor does it deal with individual problems.

PART 1 – RELATIONSHIP BETWEEN CLIENT AND CHARTERED SURVEYOR

1. The Nature of a Valuation

A valuation is the individual opinion of a valuer based on the relevant facts known to him and subject to any limitations imposed by the client. Because a valuation is a subjective exercise there will inevitably be scope for differences of opinion, even between experienced valuers. Where for statutory or other purposes valuations require the application of hypothetical conditions then a further widening of views may be expected.

The most common forms of valuation required are 'open market value' and 'open market rental value'. These may be defined as the best price or the best rent which might reasonably be expected to be obtained for an interest in a property at the date of valuation assuming:—

(a) a willing seller or lessor;

(b) a reasonable period in which to negotiate the sale or letting;

(c) that values will remain static during that period;

(d) that the property will be freely exposed to the market; and

(e) that no account will be taken of any higher price that might be paid by a person with a special interest.

Whilst open market value is usually required there are cases where a client will need a different basis of assessment. For example, an owner may be under pressure to realise certain of his assets, in which case a 'forced sale value' would be appropriate. All the provisions referred to above would apply except that of the time scale. Another basis of value is depreciated replacement cost which may be adopted in certain instances in relation to the value of company assets.

Where a valuation is for the purposes of, say, Capital Gains Tax, Development Land Tax or compensation following compulsory acquisition, it will be subject to statutory rules.

The range of purposes for which a valuation may be required is substantial and includes sale, purchase, letting, obtaining finance, accounting, rating, compulsory purchase and for various tax purposes.

Valuations may also relate to different interests in property (e.g. the right of ownership or the interest of a tenant under a lease) and may have to take account of other interests to which the property is subject, such as leases, rights of way, etc.

Even apparently minor differences in the purpose for which a valuation is to be used (for example, one tax calculation rather than another) can produce significantly different figures. Similarly, what may appear to a client to be relatively minor variations in lease terms or small variations in planning assumptions can dramatically alter the final figure.

2. The Valuer

In most cases there are no legal restrictions as to who can undertake a valuation, but in his own interests the client should instruct someone with the necessary skill, knowledge and experience. Chartered Surveyors in general practice are qualified in these skills both by training and experience although some surveyors may specialise in certain types of valuation.

In certain cases, such as a valuation for insurance company solvency purposes, there is a statutory requirement that the task must be carried out by a qualified valuer, such as a Chartered Surveyor, whilst in the case of a valuation for Stock Exchange purposes that body requires the work to be done only by those with appropriate professional qualifications.

3. Confidentiality

A valuation is a confidential report for a particular client and for the special purposes of that client. The purpose for which a valuation is prepared is fundamentally important. As a result the valuation should only be used within the context of the instructions under which it is prepared. An obvious example is that of a fire insurance valuation based on cost of rebuilding which may bear no relation to the building's open market value.

There will occasionally be cases where the valuation will be specifically prepared for more than just the instructing party, as, for example, a bank providing a loan facility. Generally, however, the valuer will accept a liability only to the person or company instructing him, and will accordingly make his report confidential to that client and incorporate a paragraph on the following lines:—

> This report is confidential to the Client for the specific purpose to which it refers. It may be disclosed to other professional advisers assisting the Client in respect of that purpose, but the client shall not disclose the report to any other person.

There may be instances where the client will wish to make reference to the valuation in company accounts and/or directors' reports or some company statement or circular. In appropriate circumstances the valuer will generally agree to such reference, subject to his approval of the form and context in which it may appear. The report or valuation certificate may, therefore, incorporate a paragraph on the following lines:—

> Neither the whole nor any part of this report/valuation certificate or any reference thereto may be included in any published document, circular or statement nor published in any way without the valuer's written approval of the form and context in which it may appear.

4. Scope of the Valuation

The quantity and nature of information available to the valuer in preparing his report will depend on his instructions and the time and conditions under which he is allowed to carry out his work. For example, a client may require a valuation based only on an external inspection, in which case the valuer must rely on information provided in relation to floorspace and other matters.

Normally, however, the valuer will carry out an inspection of the premises and make such enquiries and investigations as he deems necessary. These may entail informal enquiries of the Local Planning Authority and other authorities.

In relation to planning matters these will be restricted to such enquiries (e.g., what planning permissions exist and what proposals have been made public) as are reasonably practicable in the time available.

The valuer will often have to rely upon information provided by the client, his solicitor or accountant, say, for example, in the case of legal restrictions or tenancy agreements or where the valuation is by reference to accounts. There will also be instances where the valuer will need personally to examine copies of appropriate legal documents, such as leases, and where these are not available his report will refer to the assumptions he has made or the information with which he has been provided.

It is important to appreciate that a valuation is not a structural survey. In a valuation the valuer will not examine the structure in depth nor will he when reporting to the client necessarily detail all the defects from which the property apparently suffers. He will, however, take into account the age and nature of the building under review and will draw attention to important defects which are readily apparent.

There are various defects which can influence the value of a property significantly but which are undetectable unless substantial specialist investigation is carried out. Where a property is of such an age and design that it is possible it contains such hidden potential defects, then the report may refer to the possibility, emphasising that a specialist investgation has not been undertaken and that the valuer has assumed that the results of such an investigation would not adversely affect the value he has placed upon the building. Paragraphs on the following lines may therefore be included with valuation reports:–

'We have not carried out a structural survey nor have we inspected woodwork or other parts of the structure which are covered, unexposed or inaccessible and we are therefore unable to report that any such part of the property is free from defect'; and

'We have not arranged for any investigation to be carried out to determine whether or not any deleterious material has been used in the construction of this property and we are therefore unable to report that the property is free from risk in this respect. For the purposes of this valuation we have assumed that such investigation would not disclose the presence of any such material in any adverse conditions'.

5. **Instructions**

It is important that a client clearly defines the terms of reference within which he wishes a valuation to be carried out. Often a preliminary discussion with the valuer will be of benefit so that areas of potential uncertainty may be resolved prior to any work being undertaken.

6. **Valuation Fees**

The fees for a valuation will vary according to the nature of the work and a Chartered Surveyor will quote the appropriate fee for the particular valuation requested. VAT and out-of-pocket expenses are usually payable in addition.

PART II – CONDITIONS OF ENGAGEMENT

1. The nature of the interest to be valued and the purpose for which the valuation is required shall be as specified by the Client and agreed by the Valuer or, failing such specification, as reasonably understood by the Valuer from the instructions given by or on behalf of the Client.
2. Unless otherwise agreed or understood as in Condition 1, the Valuer shall give his opinion of the value of the right of ownership of the property concerned in the open market at the date of the valuation.
3. The Valuer shall use all reasonable professional skill and care in arriving at his opinion and, subject as herein provided, shall carry out such inspections and investigations as are, in his professional judgement, appropriate and possible in the particular circumstances.
4. The Valuer shall have regard to the apparent state of repair and condition of the property but shall be under no duty to carry out a structural survey of the property nor to inspect woodwork or other parts of the structure of the property which are covered, unexposed or inaccessible; neither shall he have a duty to arrange for the testing of water supply, drainage, sewage, gas, electrical, heating or other services.
5. Unless otherwise expressly agreed the Valuer may rely upon information provided to him by the Client or the Client's legal or other professional advisers relating to tenure, tenancies and other matters considered relevant by the Valuer and may assume that:
   (a) a good title can be shown to the interest which is being valued and that the property is not subject to any unusual or onerous restrictions, encumbrances or outgoings;
   (b) the property is unaffected by any statutory notice and that neither the property nor its use gives rise to a contravention of any statutory requirements; and
   (c) except as apparent in accordance with Condition 4 the property is free from dry rot, woodworm and latent defects and that no deleterious materials have been used in the construction of the property.

   The Valuer shall be under no duty to verify these assumptions.

6. The Valuer shall provide to the Client a report setting out his opinion of the value of the property. This report will be confidential to the Client for the specific purpose to which it refers. It may be disclosed to other professional advisers assisting the Client in respect of that purpose, but the Client shall not disclose the report to any other person and the Valuer shall not in any circumstances have any liability to any person other than the Client.

7. The Client shall pay to the Valuer in respect of his services such fee as shall have been agreed between the Client and the Valuer or otherwise as may be reasonable and appropriate in the circumstances. In addition the Client will reimburse to the Valuer all reasonable out-of-pocket expenses and pay the amount of any Value Added Tax on the fee and expenses.

July 1981

III. APPRAISAL AS A LOGIC SYSTEM DEPENDS ON KEY DEFINITIONS WHICH, IF APPLIED CONSISTENTLY, CAN WIN OR LOSE CASES

A. Lawyers would do a better job of cross examination if they understood key definitions and continually revealed the sloppiness of many appraisers in applying these definitions.

B. Appraisers are not permitted to alter the basic definitions with special qualifications that suit client purposes. Nevertheless, they often do so and the form and language then imply one value when, in fact, something very different has been done and they fail to make careful case by case distinctions.

C. Definition of highest and best use (See Exhibit 6) requires the appraiser to demonstrate:

   1. Physical feasibility

   2. Legal/political acceptability

   3. Effective demand

   4. Viable financial plan

   5. Compatibility with community goals, environment, and fiscal self interest

D. Many appraisers specify the problem as limited to justification of existing use or anticipation of next use and further distinguish between sale in the ordinary course of business or forced sale.

E. Some case examples of highest and best issues:

   1. A new apartment project on land down-zoned from industrial

   2. Scenic quality versus marginal timber

   3. Worthless mining claims or energy farm

   4. Flop house, office, or apartment building (See Exhibit 7.)

EXHIBIT 6

HIGHEST AND BEST USE

That reasonable and probable use that supports the highest present value, as defined, as of the effective date of the appraisal.

Source: Byrl N. Boyce, Real Estate Appraisal Terminology, Revised Edition, AIREA, SREA, Ballinger, Cambridge, Mass., 1981, p. 126

FEASIBILITY OF ALTERNATIVE USES

Feasibility Factor	Scenario 1 Return to Former Use	Scenario 2 Purchase by Welfare Agency	Scenario 3 Conversion to Class B/C Office	Scenario 4 Conversion to Apartments with Office on 1st Floor	Scenario 5 Conversion to Apartments with Existing Bar	Scenario 6 Demolition and Sale of Site
Market Demand Risks	Demand very elastic relative to price unless room rates subsidized by welfare agencies	Welfare agencies lack capital resources to purchase and remodel facilities, given the absence of government funding	Office market becoming more price sensitive; would not accept neighborhood and lack of parking unless rents were lower than necessary to support remodeling	Strong demand for spacious two bedroom units in CBD area	Though there is a strong demand for affordable downtown housing, consumer survey shows tenant reluctance to live above noisy/potentially malodorous bar-restaurant	Soft market for vacant sites which cannot be assembled into larger plottage; parking revenues from 20 spaces inadequate to carry clearance costs
Legal/Political Acceptability	Inconsistent with long term City goals for Olin Place	Mixed acceptability as interim use as housing for transient males by some groups; favored by welfare advocates and disfavored by local residents	Neighborhood resistance to increased demand for street parking	Preferred use, given need for downtown housing and political statements by alderpersons for reduction of bar business in residential neighborhoods	Preferred use for housing is compromised by existing bar management agreement	Inconsistent with constituency favoring landmark designation
Technical Construction Problems and Capital Cost Risks	Failure to repair within one year may have jeopardized grandfathered non-conforming building conditions. Otherwise this use has lowest construction risks of Scenarios 1 through 5	Capital costs of renovation to state standards excessive for short term use	Variance needed for parking requirement of 1 stall per 300 SF to 1 stall per 2,500 SF of office space	Spacious apartments with views provide favorable rent/cost per SF ratio—housing code creates more remodeling risk than commercial code	Apartment mix cheapened by retaining existing bar operation—smaller units require more plumbing and bring less favorable rent/cost per SF ratio	None
Relative Investment Power Based Upon Revenue Generation Potential	$192,765	$120,380	$80,331	$103,220	($10,513)	$13,778
Special Income Tax Advantages or Public Subsidies Available	None	None	Rehabilitation tax credit of 20% for older commercial building conversion plus possible industrial bond financing	Possible historic landmark status for 25% rehabilitation tax credit plus tax incremental financing (TIF) assistance	Possible historic landmark status for 25% rehabilitation tax credit. TIF less likely because increase in tax is smaller	None
Real Estate Tax Consequences to City	Modest increase in assessed value	Loss of $194,300 tax base with tax-exempt agency as owner	Real estate tax base would be multiplied approximately 3 times the present assessment	Real estate tax base would be multiplied approximately 3 1/2 times the present assessment	Real estate tax base would be multiplied approximately 2 1/2 times the present assessment	Loss of approximately $140,000 of tax base

EXHIBIT 7

F. Highest and best use is directly related to careful definition of the bundle of rights defined as real estate

1. A hotel or shopping center or warehouse is a combination of real estate, tangible personalty, intangible personalty, and positioning to control a market environment.

2. Consider valuation of a shopping center created by a joint venture of two department stores who choose a developer to develop and manage a center.

    a. Land and zoning are clearly real estate
    b. Cost of building shell clearly real estate
    c. Monopolies created by operating agreement - probably a franchise and intangible personalty
    d. Property management fees - personalty
    e. Utility sales - service and collection fees - only transformer room is real estate
    f. Tenant improvements - realty or personalty
    g. Parking ramp revenues - rents or service income
    h. Franchise logo and reservation service
    i. Bookings assuming hotel remains in operation

3. Suggested rules for allocation

    a. Entitlements which are point specific rather than portable
    b. Wholesale control of space vs. retailing of short term fractions of space (to exclude contributions of marketing and management).
    c. Services customarily inherent in project or available from alternative off-site suppliers
    d. Income tax category indicating intent of parties
    e. Fees for arbitrating conversion of asset to other markets such as condo conversion, syndication or captive buyer

4. Fee title is much less important than land use entitlement. Assignable permits to build X units, or a dam, or freeway ramp, or a franchise to be the only out-patient surgical center in a medical region.

5. To define best use it is first necessary to define the public entitlements and the tangible and intangible property to be included in the valuation.

G. Definition of market value required economic rents and asset value.

1. Asset value in terms of economic surplus

2. Financial value in sum of claims

3. Captive consumer value in terms of present value of service income

4. Commodity value in terms of a risk management straddle

H. Economic rent rather than contract rent is value of fee simple title without recognizing encumbrance of a lease.

1. Appraiser must report fee simple value and allocate value between leasehold position of tenant and owner.

2. Contract rents higher than economic rent, such as Section 8 FMR's in many communities, must be ignored.

3. Many leasehold interests can be bought out at a fraction of their apparent value so that the appraisal allocation must evaluate alternative scenarios from the standpoint of the tenant before making allocation. (K-Mart, Sear's Warehouse, dying long term tenant unlikely to exercise non-assignable option.)

I. Economic rent must be adjusted to those elements which pay for space rather than services that are not customarily provided.

1. Rent is the wholesale cost for the parking ramp or the floor in the John Hancock Building used as an observation deck business.

2. Percentage rents can be argued to be a return for good marketing management rather than real estate if the base rent is appropriate.

3. Expense pass throughs mean additional revenue in future periods, but must be reduced by history of non-collection.

4. The use of inflation indexed or non-use must be reflected in valuation assumptions about tenant turnover, bad debt losses, and lease rollover rents in defining economic or market rents, and discount rates utilized in the valuation. Consistency is the hobgobblins of small minds and appraisers.

J. Market value and economic rent presume cash equivalency, that is, cash to the seller and conventional financing for the buyer. If price reflects non-market financing by the seller, the appraiser must first report the cash equivalent price and then the price increase or value increment attributable to financing or other features of the deal.

1. Computation of cash equivalency is a highly debatable process since it requires establishing a benchmark for conventional terms and the length of time the presumed financial advantage will actually benefit the buyer.

2. Many assessors, syndicators, and mortgage bankers use nominal prices as market comparison data. They argue that creative financing is the norm and therefore it meets the test of conventional financing. This is incorrect. The test is cash to the seller or the exit discount value of paper received.

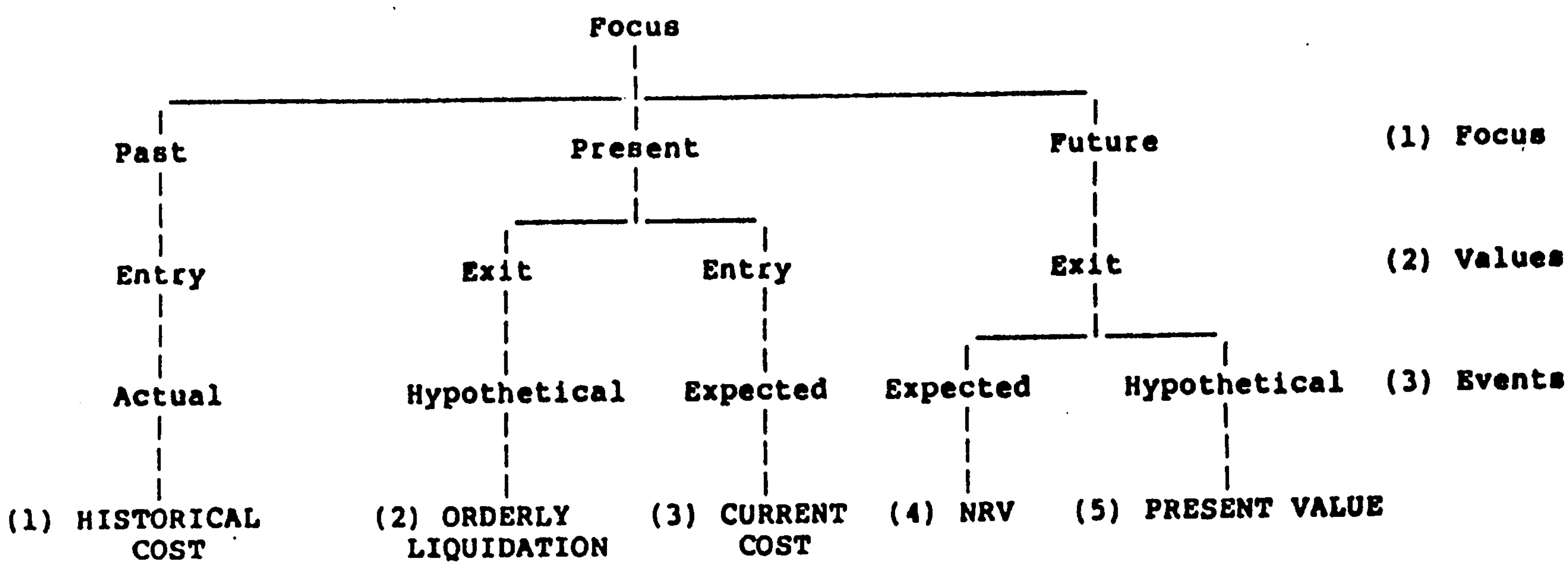
3. Many observers of the market argue that seller financing is a compromise between buyer and seller and that evidence suggests each party perceives himself absorbing 50 percent of the cost in the process of closing a deal. Each comparable sale must be investigated as to its own merits as to the objectives of the buyer and seller.

K. Fair market value presumes non-speculative, completion of current business cycle. Potential risk is presumably discounted by the marketplace relative to foreseeable upset. Objectives of appraisal may require different assumptions in terms of focus, values, and events. (See Exhibit 8.)

1. Consider European appraisals distinguished between forced sale and orderly sale, and between existing use and reuse.

2. Should a construction lender use exit value or completion value.

HIERARCHY OF ACCOUNTING PERSPECTIVES TO DEFINE
METHODOLOGY AND ACCEPTABLE ASSUMPTIONS FOR FINANCIAL INFORMATION MODEL



3. Should pension funds use exit value or expected future value, portfolio value or sum of individual property values.

4. Should the purpose or event requiring appraisal shift the definition of value?

IV. TPENDS IN THE THREE APPROACHES TO VALUE

A. Market comparison approach to value using actual sales data adjusted for time, terms of sale, and location, as well as physical differences has always been preferred as an indicator of value. There are two major trends occurring in the use of the market approach:

1. There are improved quantitative methods for screening for similarity of comparables and adjusting for differences.

2. There is less reliability in terms of reported nominal sales prices than ever before because of creative financing, creative tax accounting, and creative marketing.

B. Improved quantitative methods which will sometimes appear include:

1. Better definition of units of comparison as a result of linear regression

2. Hybrid units of comparison such as price per point per square foot or price per foot per operating ratio (See Exhibit 9.)

3. Ranking of comparables for weighted average price per unit using Euclidian distance.

4. Selection of features of comparison and adjustment factors by multiple regression.

5. The objective is to reduce variance among adjusted prices per unit; appraisers should not be allowed to "blackbox" net adjustments for differences.

C. Failures of multiple regression in court:

1. Violation of premises of multiple regression as to independent variables, normally distributed residuals, linear relationships, and hidden weighting of heterogeneous quantities.

EXHIBIT 9

SCALE FOR SCORING COMPARABLES ON IMPORTANT INVESTOR CONSIDERATIONS FOR OFFICE/RETAIL SPACE IN MADISON C-4 ZONE

Parking 25%	5 = Ample private parking on site or available on contract within the same block. 3 = Limited parking on premises 0 = Little or no surface parking on premises.
Location 20%	5 = In the blocks of East and West Mifflin St. or North and South Carroll St., across from the Capitol Square 3 = In the blocks of North and South Pinckney St., across from the Capitol Square, or in the 100 block of West Washington, or adjacent to General Executive Facilities. 1 = Off of the Capitol Square
First Floor Retail Lease in Place at Time of PUrchase 15%	5 = Strong lease in place. 3 = Strong lease in place for part of first floor. 0 = Lease expires in less than 6 months or vacant.
Need for Renovation of Office Space at Time of Purchase 15%	5 = No renovation required. 3 = Modest renovation required. 1 = Intensive renovation required.
Visual Quality of Office Entrance 10%	5 = Excellent design and location. 3 = Indifferent design and/or location. 1 = Poorly defined and/or adjacent to incompatible uses.
Vacancies in Existing Office Space at Time of Purchase 15%	5 = Less than 10% of net rentable area (NRA). 3 = More than 10% of NRA. 0 = Vacant

WEIGHTED MATRIX FOR COMPARABLE PROPERTIES

FEATURE/ WEIGHT	Rating/Weighted Rating #1 30 W. Mifflin	#2 50 E. Mifflin	#3 16 N. Carroll	#4 123 W. Washington	#5 102 N. Hamilton	#6 212 E. Washington	Subject
Parking 25%	5/1.25	3/.75	0/0	0/0	3/.75	3/.75	3/.75
Location 20%	5/1.00	5/1.00	5/1.00	3/.60	1/.20	3/.60	3/.60
First Floor Retail Lease in Place 15%	5/.75	5/.75	0/0	3/.45	3/.45	0/0	1/.15
Need for Renovation 15%	5/.75	1/.15	3/.45	5/.75	1/.15	1/.15	3/.45
Visual Quality of Office Entrance 10%	5/.50	3/.30	3/.30	5/.50	3/.30	3/.30	1/.10
Vacancies in Existing Office Space 15%	5/.75	0/0	5/.75	5/.75	0/0	0/0	1/.15
Total Weighted Score	5.00	2.95	2.50	3.05	1.85	1.80	2.20
Selling Price	$2,555,500	$850,000	$615,270	$2,896,000	$330,000	$472,000	X
Total Net Rentable Area (NRA)	65,000 sq. ft.	38,500 sq. ft.	35,725 sq. ft.	138,000 sq. ft.	28,000 sq. ft.	38,000 sq. ft.	74,000 sq. ft.
Price Per Square Foot (NRA)	$39.30	$22.10	$17.20	$21.00	$11.80	$12.40	
Price Per Square Foot of NRA / Total Weighted Score	7.86	7.49	6.88	6.89	6.38	6.89	

EXHIBIT 9 (Continued)

EXHIBIT 9 (Continued)

CALCULATION OF MOST PROBABLE PRICE USING
MEAN PRICE PER POINT EQUATION METHOD
(With Standardized Weighted Point Scores)

Comparable Property	Selling Price per NRA	Weighted Point Score	Price per NRA / Weighted Point Score (x)
1	$39.30	5.00	7.86
2	22.10	3.45	7.49
3	17.20	2.50	6.88
4	21.00	3.05	6.89
5	11.80	1.85	6.38
6	12.40	1.80	6.89
		TOTAL	42.39

Central Tendency (Mean = $\bar{x}$) $= \frac{\Sigma x}{n} = \frac{42.39}{6} = 7.07$

Dispersion (Standard deviation = s) $= \sqrt{\frac{\Sigma(x-\bar{x})^2}{n-1}} = \sqrt{\frac{1.38}{5}} = .525$

where:

x		$\bar{x}$		$/(x-\bar{x})/$	$\Sigma(x-\bar{x})^2$	n	$n-1$
7.86	-	7.07	=	.79	.62	6	5
7.49	-	7.07	=	.42	.18		
6.88	-	7.07	=	.19	.04		
6.89	-	7.07	=	.18	.03		
6.38	-	7.07	=	.69	.48		
6.89	-	7.07	=	.18	.03		
					1.38		

Value Range: $\bar{x} \pm s = 7.07 \pm .53$

Estimate of Value of Subject Property =

NRA of subject * Weighted point score of subject *
(74,000 S.F.) (2.2)

[Sample mean of price per NRA per total weighted score ± (Dispersion * t value)]
[7.07 ± (.53 * t value)]

	Confidence Level	
		@ n-1 = 5;
	68% (t = 1.000)	90% (t = 2.015)
High Estimate:[1]	$1,240,000	$1,320,000
Central Tendency:	1,150,000	1,150,000
Low Estimate:	1,060,000	980,000

[1]All value estimates are rounded.

2. Subtle shift from appraisal standards of:

    a. Responsibility for personal knowledge and inspection.
    b. Direct comparison of subject to comparables rather than to mean of set.
    c. Appraiser responsibility for dollar value on adjustment factors.
    d. Shift from market comparison as set theory to market price as probability theory.

D. Appraisers fail to research comps, so the best defense is knowing the comparable sales better than the opposition, and never assume the public records are correct.

1. Deliberate shifting of values to or from the real estate for income tax purposes, divorce settlements, marketing tactics, or financial disinformation.

2. Greater paranoia of grantor/grantee as a result of No. 1, relative to sharing of information.

3. Genuine misunderstanding as to what is realty, tangible personalty, and intangible personalty.

4. Understanding of buyer and seller motivation, profit centers, and ranking of bargaining objectives.

E. The income approach to value must counterbalance three schools of thought as a check and balance of reasonableness of the conclusion. Once thought very speculative, the investment pattern is being recognized as the key set of assumptions in the income valuation of investment properties.

1. The traditional overall capitalization rate requires confirmation of cash equivalent price and net income as perceived by the buyer.

2. The "back-door" approach indicating how the cash income is converted to capital pricing by the lender is the first check on value representations by your side or theirs. (See Exhibit 10).

3. The basic discounted cash flow test will suggest reasonableness of value conclusion and sensitivity of investment return to changes in critical assumption. (See Exhibits 11 and 12.)

EXHIBIT 10

REVENUE JUSTIFIED CAPITAL BUDGET DEBT COVER RATIO APPROACH

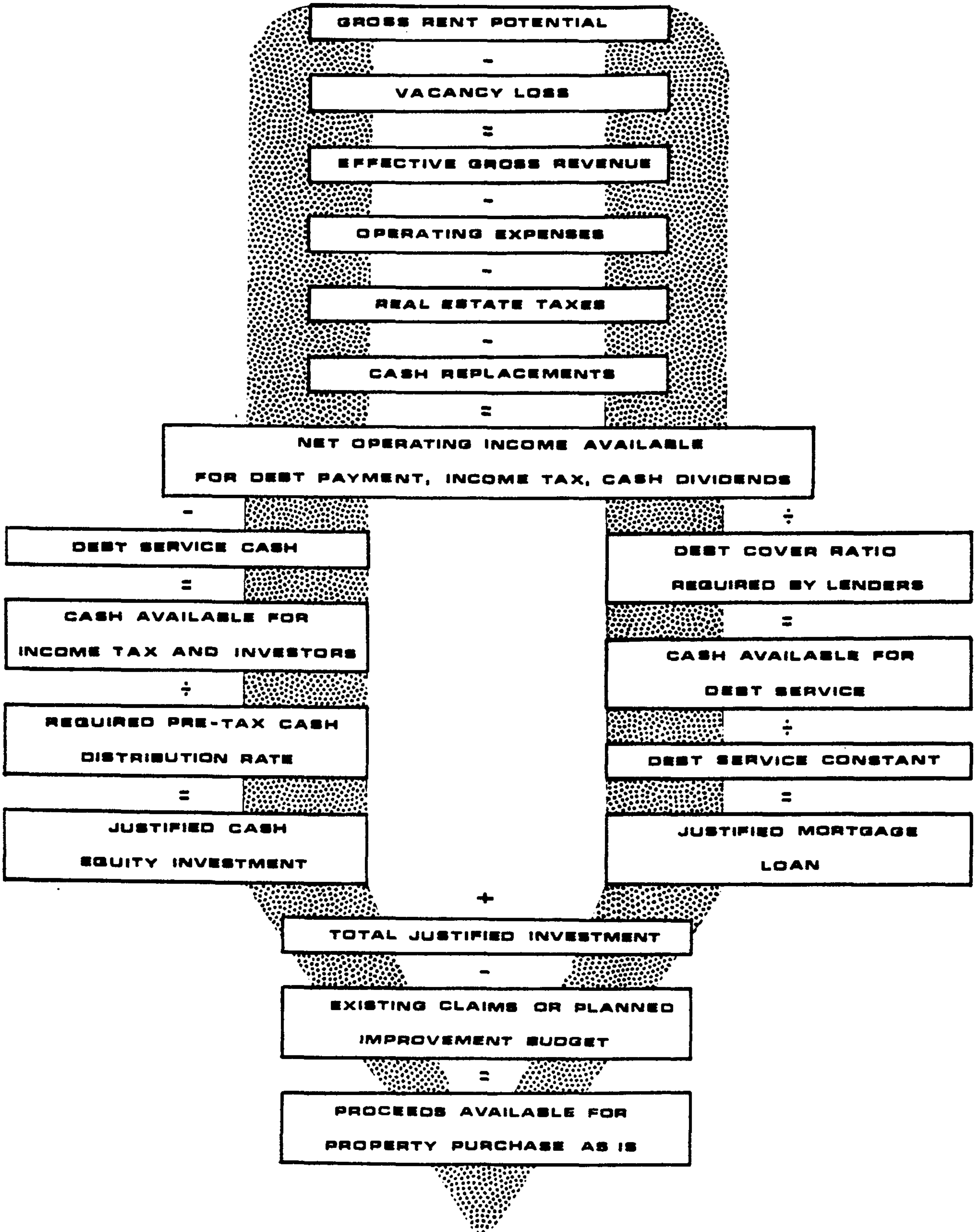


EXHIBIT 10 (Continued)

INCOME APPROACH TO VALUE

Assumptions as of 1/1/83:

Debt Cover Ratio	=	1.30
Interest Rate	=	.13
Mortgage Term	=	25 years
Mortgage Constant	=	.13534
Cash Dividend Rate	=	.06
Net Operating Income in First Year	=	$449,930

CALCULATIONS

Mortgage Value

STEP 1 $\frac{\$449,930}{1.30} = \frac{\text{NOI}}{\text{DCR}} = \$346,100$ Available for Debt Service

STEP 2 $\frac{\$346,100}{.13534} = \$2,557,263$ Maximum allowable mortgage

Equity Value

STEP 1	$449,930	=	NOI
	346,100		Debt Service
	$103,830		Cash Throw-Off

STEP 2 $\frac{\$103,830}{.06} = \$1,730,500$ Maximum Allowable Equity Contribution

Property Value

Mortgage	=	$2,557,263
Equity	=	1,730,500
		$4,287,763
Rounded		$4,300,000

EXHIBIT 11

TEST OF ECONOMIC REASONABLENESS OF
PROPOSED 1983 ASSESSMENT

INPUT ASSUMPTIONS
****

```
1. ENTER PROJECT NAME ?  BUILDING XXX
2. ENTER PROJECTION PERIOD ?  6
3. DO YOU WANT TO ENTER EFFECTIVE GROSS REVENUE INSTEAD OF NOI? N
   N.O.I. YEAR  1? 449930
   N.O.I. YEAR  2? 421848
   N.O.I. YEAR  3? 417517
   N.O.I. YEAR  4? 485968
   N.O.I. YEAR  5? 485802
   N.O.I. YEAR  6? 482014
4. ACQUISITION COST: ? 5271282  1983 PROPOSED ASSESSMENT
5. DO YOU WANT TO USE STANDARD FINANCING? Y OR N?Y
   MTG. RATIO OR AMOUNT, INT., TERM, NO PAY/YR ? 2557263, .13, 25, 12
6. ENTER RATIO OF IMP #1/TOTAL VALUE, LIFE OF IMP #1? .87, 15
   IS THERE A SECOND IMPROVEMENT? Y OR N? N
7. DEPRECIATION METHOD, IMPROVEMENT #1 ? 1
   IS PROPERTY SUBSIDIZED HOUSING ? Y OR N ?N
   IS PROPERTY RESIDENTIAL? Y OR N? N
8. IS OWNER A TAXABLE CORPORATION? Y OR N ?N
   THE MAXIMUM FEDERAL INDIVIDUAL ORDINARY RATE COULD BE:
           70% (PRE-1981 LAW)
           50% (1981 LAW, EFFECTIVE 1982)

           (PLUS STATE RATE)

    ENTER:
   1) EFFECTIVE ORDINARY RATE  2) EFFECTIVE ORDINARY RATE (YEAR OF SALE)
?  .5, .5
9. RESALE PRICE (NET OF SALE COSTS) ? 5150000
10. IS THERE LENDER PARTICIPATION ?N
11. ENTER OWNER'S AFTER TAX REINVESTMENT RATE (%)?  8
12. ENTER OWNER'S AFTER TAX OPPORTUNITY COST OF EQUITY FUNDS (%)?  8
```

EXHIBIT 11 (Continued)

AFTER TAX CASH FLOW PROJECTION
BUILDING XXX
DATE 1/1/83

DATA SUMMARY
****

ACQUISTN COST:	$5,271,282.	MTG. AMT.:	$2,557,263.		
NOI 1ST YR:	$449,930.	MTG. INT.:	13%		
ORG. EQUITY:	$2,714,019.	MTG. TERM:	25. YRS		
CTO 1ST YEAR:	$103,829.	DEBT SERVICE 1ST YEAR:			$346,101.
		MTG. CONST.:	.1353403		
IMP. #1 VALUE:	$4,586,015.	IMP. #1 LIFE:	15.		
INC. TX RATE:	50%				
SALE YR RATE:	50%	OWNER: INDIVIDUAL			

DEPRECIATION IMPROVEMENT #1 : STRAIGHT LINE
NON-RESIDENTIAL PROPERTY
LENDER PARTICIPATION: CASH THROW-OFF: NONE REVERSION: NONE

NO REPRESENTATION IS MADE THAT THE ASSUMPTIONS BY JAMES A GRAASKAMP ARE PROPER OR THAT THE CURRENT TAX ESTIMATES USED IN THIS PROJECTION WILL BE ACCEPTABLE TO TAXING AUTHORITIES. NO ESTIMATE HAS BEEN MADE OF MINIMUM PREFERENCE TAX. CAPITAL LOSSES IN THE YEAR OF SALE ARE TREATED AS ORDINARY LOSSES (SECTION 1231 PROPERTY) AND ARE CREDITED AGAINST TAXES PAID AT THE ORDINARY RATE AT THE TIME OF SALE.
FOR THE PURPOSE OF THE MODIFIED INTERNAL RATE OF RETURN (M.I.R.R.) CALCULATION, NEGATIVE CASH IN ANY ONE PERIOD IS TREATED AS A CONTRIBUTION FROM EQUITY IN THAT PERIOD.

YEAR	NOI	MTG INT & LENDERS %	TAX DEP	TAXABLE INCOME	INCOME TAX	AFTER TAX CASH FLOW
1.	449930.	331600.	305734.	-187406.	-93704.	197533.
2.	421848.	329599.	305734.	-213486.	-106744.	182491.
3.	417517.	327321.	305734.	-215539.	-107770.	179186.
4.	485968.	324729.	305734.	-144496.	-72249.	212116.
5.	485802.	321779.	305734.	-141712.	-70857.	210558.
6.	482014.	318422.	305734.	-142143.	-71072.	206985.
	--------	--------	-------	---------	---------	---------
	$2743079.	$1953450.	$1834406.	$-1044782.	$-522396.	$1188871.

EXHIBIT 11 (Continued)

RESALE PRICE:	$5,150,000.	1ST YR B4 TAX EQ DIV:	3.8257%
LESS MORTGAGE BALANCE:	$2,434,109.	AVG DEBT COVER RATIO:	1.3209
PROCEEDS BEFORE TAXES:	$2,715,891.		
LESS LENDER'S %:	$0.		
NET SALES PROCEEDS BEFORE TAXES:	$2,715,891.		

RESALE PRICE:	$5,150,000.
LESS LENDER'S %:	$0.
NET RESALE PRICE:	$5,150,000.
LESS BASIS:	$3,436,876.
TOTAL GAIN:	$1,713,124.
EXCESS DEPRECIATION:	$0.
EXCESS DEP. FORGIVEN:	$0.
CAPITAL GAIN:	$1,713,124.
ORDINARY GAIN:	$0.

TAX ON ORDINARY GAIN:	$0.
TAX ON CAPITAL GAIN:	$342,625.
PLUS MORTGAGE BAL:	$2,434,109.
TOTAL DEDUCTIONS FROM NET RESALE PRICE:	$2,776,733.

NET SALES PROCEEDS AFTER TAX:	$2,373,267.

IF PURCHASED AS ABOVE, HELD 6 YEARS & SOLD FOR $5,150,000.
THE MODIFIED I.R.R. BEFORE TAXES IS 4.3866% AND AFTER TAXES IS 5.8592%
ASSUMING AN AFTER TAX REINVESTMENT RATE OF 8%, AND OPPORTUNITY COST OF 8%

EXHIBIT 12

TEST OF ECONOMIC REASONABLENESS
OF APPRAISED VALUE

INPUT ASSUMPTIONS
****

```
1. ENTER PROJECT NAME ? BUILDING XXX
2. ENTER PROJECTION PERIOD ?  6
3. DO YOU WANT TO ENTER EFFECTIVE GROSS REVENUE INSTEAD OF NOI? N
   N.O.I. YEAR  1? 449930
   N.O.I. YEAR  2? 421848
   N.O.I. YEAR  3? 417517
   N.O.I. YEAR  4? 485968
   N.O.I. YEAR  5? 485802
   N.O.I. YEAR  6? 482014
4. ACQUISITION COST: ? 4300000  APPRAISED FAIR MARKET VALUE
5. DO YOU WANT TO USE STANDARD FINANCING? Y OR N?Y
   MTG. RATIO OR AMOUNT, INT., TERM, NO PAY/YR ? 2557263, .13, 25, 12
6. ENTER RATIO OF IMP #1/TOTAL VALUE, LIFE OF IMP #1? .84, 15
   IS THERE A SECOND IMPROVEMENT? Y OR N? N
7. DEPRECIATION METHOD, IMPROVEMENT #1 ? 1
   IS PROPERTY SUBSIDIZED HOUSING ? Y OR N ?N
   IS PROPERTY RESIDENTIAL? Y OR N? N
8. IS OWNER A TAXABLE CORPORATION? Y OR N ?N
   THE MAXIMUM FEDERAL INDIVIDUAL ORDINARY RATE COULD BE:
           70% (PRE-1981 LAW)
           50% (1981 LAW, EFFECTIVE 1982)

           (PLUS STATE RATE)

    ENTER:
   1) EFFECTIVE ORDINARY RATE  2) EFFECTIVE ORDINARY RATE (YEAR OF SALE)
?  .5, .5
9. RESALE PRICE (NET OF SALE COSTS) ? 5150000
10. IS THERE LENDER PARTICIPATION ?N
11. ENTER OWNER'S AFTER TAX REINVESTMENT RATE (%)?  8
12. ENTER OWNER'S AFTER TAX OPPORTUNITY COST OF EQUITY FUNDS (%)?  8
```

EXHIBIT 12 (Continued)

AFTER TAX CASH FLOW PROJECTION
BUILDING XXX
DATE 1/1/83

DATA SUMMARY
****

ACQUISTN COST:	$4,300,000.	MTG. AMT.:	$2,557,263.		
NOI 1ST YR:	$449,930.	MTG. INT.:	13%		
ORG. EQUITY:	$1,742,737.	MTG. TERM:	25. YRS		
CTO 1ST YEAR:	$103,829.	DEBT SERVICE 1ST YEAR:		$346,101.	
		MTG. CONST.:	.1353403		
IMP. #1 VALUE:	$3,612,000.	IMP. #1 LIFE:	15.		
INC. TX RATE:	50%				
SALE YR RATE:	50%	OWNER: INDIVIDUAL			

DEPRECIATION IMPROVEMENT #1 : STRAIGHT LINE
NON-RESIDENTIAL PROPERTY
LENDER PARTICIPATION: CASH THROW-OFF: NONE REVERSION: NONE

NO REPRESENTATION IS MADE THAT THE ASSUMPTIONS BY JAMES A GRAASKAMP ARE PROPER OR THAT THE CURRENT TAX ESTIMATES USED IN THIS PROJECTION WILL BE ACCEPTABLE TO TAXING AUTHORITIES. NO ESTIMATE HAS BEEN MADE OF MINIMUM PREFERENCE TAX. CAPITAL LOSSES IN THE YEAR OF SALE ARE TREATED AS ORDINARY LOSSES (SECTION 1231 PROPERTY) AND ARE CREDITED AGAINST TAXES PAID AT THE ORDINARY RATE AT THE TIME OF SALE.
FOR THE PURPOSE OF THE MODIFIED INTERNAL RATE OF RETURN (M.I.R.R.) CALCULATION, NEGATIVE CASH IN ANY ONE PERIOD IS TREATED AS A CONTRIBUTION FROM EQUITY IN THAT PERIOD.

YEAR	NOI	MTG INT & LENDERS %	TAX DEP	TAXABLE INCOME	INCOME TAX	AFTER TAX CASH FLOW
1.	449930.	331600.	240800.	-122471.	-61236.	165065.
2.	421848.	329599.	240800.	-148552.	-74277.	150024.
3.	417517.	327321.	240800.	-150605.	-75303.	146719.
4.	485968.	324729.	240800.	-79562.	-39782.	179649.
5.	485802.	321779.	240800.	-76778.	-38390.	178091.
6.	482014.	318422.	240800.	-77209.	-38605.	174518.
	$2743079.	$1953450.	$1444800.	$-655177.	$-327593.	$994068.

EXHIBIT 12 (Continued)

RESALE PRICE:	$5,150,000.	1ST YR B4 TAX EQ DIV:	5.9578%
LESS MORTGAGE BALANCE:	$2,434,109.	AVG DEBT COVER RATIO:	1.3209
PROCEEDS BEFORE TAXES:	$2,715,891.		
LESS LENDER'S %:	$0.		
NET SALES PROCEEDS BEFORE TAXES:	$2,715,891.		

RESALE PRICE:	$5,150,000.
LESS LENDER'S %:	$0.
NET RESALE PRICE:	$5,150,000.
LESS BASIS:	$2,855,200.
TOTAL GAIN:	$2,294,800.
EXCESS DEPRECIATION:	$0.
EXCESS DEP. FORGIVEN:	$0.
CAPITAL GAIN:	$2,294,800.
ORDINARY GAIN:	$0.

TAX ON ORDINARY GAIN:	$0.
TAX ON CAPITAL GAIN:	$458,960.
PLUS MORTGAGE BAL:	$2,434,109.
TOTAL DEDUCTIONS FROM NET RESALE PRICE:	$2,893,069.

NET SALES PROCEEDS AFTER TAX:	$2,256,931.

IF PURCHASED AS ABOVE, HELD 6 YEARS & SOLD FOR $5,150,000.
THE MODIFIED I.R.R. BEFORE TAXES IS 12.3849% AND AFTER TAXES IS 12.1350%
ASSUMING AN AFTER TAX REINVESTMENT RATE OF 8%, AND OPPORTUNITY COST OF 8%

4. Major income properties are priced by sophisticated cash flow models which generate lease roles, expenses, and vacancy losses lease by lease. Net income is converted to capital value by specification of financing terms which characterize financial structure determined by most probable buyer.

F. Investment value from existing leases and operating expense data presumes:

1. Objective is most probable price rather than fair market value.

2. Appraiser has read the leases and represented them correctly.

3. Appraiser has audited the success of prudent property managers in collecting pass-throughs and time indexes in light of existing market condition, and represented that appropriately. Presuming lease abstracts to be sufficient reduces appraisal time and underlies terrible losses to clients.

4. Appraiser justifies roll-over rents in light of purpose of appraisal, American vs. European patterns, and the selection of the present value discount rate used to determine value.

5. Appraiser must audit general ledger of operating expenses to detect non-market services, capital costs expensed, or operating inefficiencies as a result of management procedure which would not characterize average management ability presumed of the next buyer.

6. Appraiser should indicate energy budget in BTU's and kilowatt hours, and degree of obsolescence implied.

7. Appraiser should indicate availability of engineering inspection and thermal photography of property at the time of valuation, and indicate limited liability for latent defects.

G. The cost approach has a pseudo-science which makes it appear objective and is favored because its monotonous detail implies thoroughness. To the contrary, it is the mostsubjective, it has been denigrated in appraisal literature, and it was once regarded as unethical.

1. The cost approach is the sum of a series of fictional numbers:

   a. The value of the land as though clear and vacant.
   b. The cost to replace or to reproduce, depending on whether the subject property represents a need for the current state of building technology or a visual image of some historical dimension.
   c. Cost, new, must then be reduced by a complex, subjective set of depreciation factors:

      i. Cost to cure deferred maintenance from wear and tear.
      ii. Cost to cure functional design features which can be corrected.
      iii. Loss in value attributable to either incurable functional features in the subject property or features in the cost base not found in the subject property.
      iv. Loss in value because market will not pay for superadequacy of features included in replacement or reproduction cost of subject property.
      v. Locational obsolescence of the right structure in the wrong market area.
      vi. Economic obsolescence of a specialized structure for which there is no further economic need.

   d. The premise of the cost approach is that the structure represents the most appropriate building technology for the use intended and the optimal use of the site on which it is located. That premise is very difficult to find or defend.

2. Cost is never value, and in the 1920s, the cost approach was regarded as unethical. In the 1930s, the insurance companies brought it back to increase the probability that a borrower would have cash invested ahead of the mortgage.

V. APPRAISAL/LEGAL PROTOCOLS

A. Supervision of appraisers by professional organizations is in a great state of flux.

1. Designated appraisers on opposing sides are no longer required to submit their appraisals to review by their peers.

2. There is a process for review of ethical issues, including incompetence, but it is dependent on willingness of the client to pursue such a review, and lenders and lawyers are reluctant to do so. It is not cost effective, and might trigger nuisance actons by the appraiser.

3. The cost to the professional organization of canceling the designation averages $25,000, and the recertification process every five years is still a relatively weak threshhold.

B. Appraisal within and SEC prospectus exposes the appraiser to equal liability for sins of omission or commission with the attorney and accountant.

1. Prospecti are excellent sources of inside-the-deal data and public information.

2. Attorneys for FDIC or FSLIC may be able and willing to provide subtle evaluations of appraiser performance on buildings with some adverse banking history.

C. Appraisal organizations are maneuvering to merge to establish a single standard, but appraisal practice is so diversified, single designations are irrelevant.

1. Pension investors estimate there may be no more than 100 appraisers qualified to do large income properties.

2. Many of the best appraisal witnesses may be those from firms which both appraise, counsel, and transact investment and development.

3. Some firms prosper because they are not limited by professional designations in terms of assisting in developing cross-examination questions, forming legal strategies, and critiqueing reports by the litigants.

D. There are elite appraisal firms scattered around the country who are individually innovative, sophisticated, and communicating with one another, more often than not through informal networks rather than professional appraisal organizations. They are generally Renaissance type people with multiple skills, but their work is regarded as proprietary or too esoteric for the journals. They generally scorn traditional appraisal formats such as the three approaches to value, and are often regarded as a threat by professional associates who do not see it cost effective to update their skills until appraisal customers are clamoring for better technique.

E. Independent appraisers are being supplanted by other professional teams:

1. Accounting firms with real estate specialists or subsidiary appraisal companies.

2. Engineering forms with economic analysts.

3. Investment banking firms with subsidiary real estate brokerage divisions.

4. Real estate market research and economic planning firms.

F. New standards on the appraisal process will be imposed by engagement letters and by new regulations imposed by government agencies, many of which are suffering serious financial losses because of the silent conspiracy between lending institutions and appraisals sought to justify lending decisions. These government agencies have the real motivation for modification of contemporary appraisal methods and standards:

1. FDIC and FSLDIC.

2. ERISA.

3. HUD.

4. FMHA and SBA.

G. New standards are going to be imported from overseas as a result of standards developed for doing business in the European economic community. These detailed standards can be acquired from:

1. The Secretary, The International Assets Valuation Standards Committee (TIAVSC), 103 Mount Street, London W1Y 6AS, United Kingdom.

2. Guidance Notes on Valuation of Assets, The Assets Valuation Standards Committee, 12 Great George Street, Parliament Square, London, SW1P 3AD, United Kingdom.

3. It is important to note that RICS and TIAVSC Standards apply directly to valuations for financial and reporting purposes. They do not attempt to speak of valuations assignments (such as Eminent Domain), except to provide that member nations may have specific reasons to avoid or to vary the International Standards. Thus, the importance of the International Standards is in creating common understandings and, to the extent possible, common practices, without being directive in nature.

4. The American Institute of Real Estate Appraisers is presently participating in TIAVSC and evaluating the International Standards for adoption in the United States. They have established direct liason with the Financial Accounting Standards Board and the American Institute of Certified Public Accountants, and are beginning to expand explanations of these standards within the Institute's continuing educations programs. Anticipate that late 1984 and 1985 will see major strides in the establishment of these and other standards for appraisers.

American Bar Association

780 North Water Street
Milwaukee, Wisconsin 53202

October 11, 1984

Professor James Graaskamp
University of Wisconsin
Room 118
Commerce Building
Madison WI 53706

Dear Professor:

Thank you for chatting with me about your allowing your presentation on real estate appraisal at the annual meeting to be incorporated into the American Bar Association Real Property, Probate and Trust Section cassette series. I am enclosing for you copies of the tapes, together with a transcript which was made by my secretary of the tapes. Assuming that the tapes are acceptable to you, I would like to obtain from you a written confirmation allowing our use. We were all very happy with your presentation.

Very truly yours,

John W. Daniels, Jr.

JWD:ng
Enclosures

cc: William A. Chatterton, Esq.

P.S. I would appreciate clean copies of pages 19-22 of the printed material.

WHAT EVERY LAWYER SHOULD KNOW ABOUT THE BASICS
OF REAL ESTATE APPRAISALS

AN ECONOMIC & LITIGATION ANALYSIS

James A. Grasskamp, Ph.D.

A.B.A. Section of Real Property, Probate & Trust Law

August 1984

...Member of the Council of Real Property, Probate & Trust Law Section will act as moderator this morning of our program. I have been asked to announce that there are some yellow sheets at the back of the room. Anybody who wants to get CLE credit for this today, I guess, can pick those up at the back of the room and complete them and process them accordingly. Start here We're honored this morning to have as our speaker Professor James A. Grasskamp, who is chairman of the Department of Real Estate and Urban Land Economics, School of Business, University of Wisconsin-Madison. Jim is a senior real estate analyst, Society of Real Estate Appraisers, counselor of real estate, American Society of Real Estate Counselors. He has his Ph.D. in Urban Land Economics and Risk Management from the University of Wisconsin in Madison. He is an Urban Land Institute trustee, but lest you think he's strictly academic, he's not. He's the president and founder of Landmark Research, Inc., which is a very successful organization involved in real estate appraisal. He's formerly a member of the Board of Directors and treasurer of the Wisconsin Housing Finance Agency, and he is currently a member of the Board and executive committee of First Asset Realty Advisers, a subsidiary of First Bank-Minneapolis. Jim, you can take it over from there:

JAG: Thanks very much, Bill, and good morning. One of the things that our firm does is the assessors of the Village of Maple Bluff in which

Mr. Chatterton resides, and therefore, I think I arrived here under his duress....work out an accommodation on his assessment at the end of the day. Landmark Research is a firm which specializes, at least better than 50% of its work, in litigation where valuation is the critical issue, and we have four project officers working with me that prepare research papers where I do most of the testimonial and presentation work, and we work from coast to coast on major issues which we'll use as a basis for much of our comment today. At the same time, the University of Wisconsin has a long history of urban land economics. It began there as a specialty within the Institutional Economics framework, and my mentor was Professor Richard Radcliff, who is regarded as the premier logician and, shall we say, father of contemporary appraisal thought and structure. Most of the work that I have done in the academic area has been to operationalize contemporary appraisal theory, and that is why we have our firm on the side. The only way you can make an impact on the appraisal profession is beat them in the courtroom and demonstrate that contemporary techniques are relevant and appropriate and that innovation and change are in the offing. Appraisal has been a much maligned stepchild of the legal process, and unfortunately, it probably arrived that way as a result really of almost a implicit conspiracy between those who are customers of the appraisal process and the appraiser, and the lawyers, I think, deserve as much credit for that conspiracy as the mortgage bankers and the tax specialists and so on; but nevertheless, appraisal is pivotal to a whole series of social issues, as well as equity issues in the court, and appraisal becomes the benchmark really for a broad variety of decisions within the legal process. One, of course, is the whole area of fiscal equity, beginning with the real estate tax, certainly in the administration of the federal income tax, to some degree the state income tax, and to a degree, of course, in eminent domain; and to the degree that it is practiced in a slovenly fashion or manipulated as part of the advocacy process, you're subverting the ultimate objective of equity. At the same time, appraisal is a major factor in the validation of assets which underly, of course, millions of vested interests in property. Whether we're talking about the solvency of our savings and loans or banks or our pension funds, the role of the appraisal process in determining collateral values and determining the existence of economic power to repay the loans and so on, the entire financial institutional system of the U.S., where real estate is the single largest category of investment, really depends on the appropriate practice of the appraisal process; and more recently, we are beginning to see appraisal becoming a very significant part of benchmarking the performance of our asset managers. Whether we're talking about corporate assets and the analysis of the efficiency with which capital is being used in the corporate process and the SEC's concern for current value indications as alternate values on balance sheets, or whether we're talking about measuring the performance of asset managers for pension funds in order to determine the adequacy of funding and the need for additional funding, or whether we're talking about simply the performance of even public real estate capital, the appraisal becomes the fulcrum for determining the efficiency of those who are managing those resources; and finally, of course, appraisal is the underlying discipline in the process of counseling in recommending courses of action for those that are involved in real estate, and that process of counseling, of course, cuts across not only the legal profession and the investment banking profession, but today, of course, is becoming a more significant part in the public planning and land use determination process as well. I think it's significant, for example, that Seattle, in looking at a modification of their density zonings for the downtown area, are working with appraisal models which begin to measure the consequences of alternative courses of action relative to the zoning and planning concept, so that the burden of land use administration in financial terms is considered a part of the zoning process. We're certainly not as far as the English and certain other countries where the appraisal process is the critical element in the public determination as to the land use, but nevertheless, appraisal is probably the fundamental benchmark around which a whole variety of other social decisions and equity decisions, which are, of course, the essence of the real estate court process, are concerned; and the failure to understand when it is you are dealing in the fiscal area or when it is you're dealing in the ~~elevation~~ valadation area or when it is you are dealing in the benchmarking area, results in the misapplication of the appraisal process and a misdefinition of the task to the appraiser. Different functions require a whole variety of different definitions, and the historical evolution of appraisal has led, I think, to a slovenly way of dealing with the terminology in the appraisal process. Fair market value is regarded as a generic, all-purpose term, which it is not; and therefore, before you can request the appraiser to do a fair market appraisal, you'd better have a pretty good definition of what purpose is to be served, what rights are involved, and what definition of fair market value is applicable in that particular situation, and what conditions and assumptions may be appropriate. Appraisal is a game in logic, and the logical premises become the critical element in arriving at a definition of task between the lawyer and the appraiser. They tell the story, of course, about the appraiser and the engineer and the physicist stranded on the desert island with nothing surviving the shipwreck other than a case of canned beans and the only problem is how to gain access to the beans, and the physicist is suggesting, of course, that the use his eyeglasses to focus the sun on the can and cause it to heat and explode, and then they can run about their little island picking up the beans, and this doesn't sound particularly attractive to the engineer, who suggests instead that they use a coconut log as a lever and mash the can on a rock and then scrape the beans off the rock. The appraiser is looking at both of them a little astounded, and he says I really don't see the problem. He says all we need to do is assume a can opener. And much of the appraisal process is the selection of the proper set of assumptions. There is a tendency for those who practice advocacy to want to help the appraiser select those assumptions that are most favorable to his case, and this is where the fundamental friction between the appraiser and the lawyer begins. The appraiser is supposed to be an independent advocate of his own opinion as to value, determined from his independent evaluation of the facts. Unfortunately, of course, those who pay the fee and those who choose which appraiser is to be hired introduce an implicit bias into the process, and those who are the most zealous advocates of their client's position tend to feel that, having paid that fee, they are entitled to help set the assumptions, and we begin initially then with a fundamental dichotomy in terms of the attitude of the lawyer who is an advocate of his client's position and the position of the appraiser who is to be an advocate only of the truth as he sees it, and that is a difficult relationship to carry off in the American cultural scene, where we're all members of the team and the idea is to win and the implicit insensible bias of that competitive position tends to be infectious and lead to certain incentives toward destruction of the independence of the appraiser. In the process of beginning to look at the appraisal process, there are really three, what shall we say, disciplines in the appraisal process. One is where appraisal deals with conditions as a matter of certainty. The second is where he is permitted to deal with conditions as a matter probability, and the third is where he's even allowed to consider possibility. Certainly, the tax assessor deals with questions of certainty. The eminent domain attorney, on the other hand, is allowed to deal with conditions of probability. He can deal with the probability that zoning would be changed and that best use would be something other than existing use, and by the same token, you may be able to move into investment prospecti in which possibilities of a certain rate of inflation or a certain resale element are allowable assumptions on which to make a forecast and a determination of value. Surely the decision process has become much more sophisticated than the old days. I always liked Tony Downs' great comment that in the days of Caesar the the high priest would kill a chicken and look at the entrails and decide what decision to make, but you can't do that anymore. It takes a lot more guts to be an appraiser. The proper definition of the task is one of the things we're going to stress today, because growing out of the legal canons and I believe it's, what, 346 and 6700 of your rules growing out of the new tax law and coming down the pipe from the European community an international law, a new set of standards on appraisal and soon to arrive from ERISA and the FDSLIC an additional set of standards relative to appraisal. The result is going to be that the first step in the appraisal process is going to be a fair elaborate negotiation establishing the letter of engagement with the appraiser defining his task. In fact, this may be a whole new area of contract law because the letter of engagement is going to become the new area of contest between the appraisal profession and those who employ the appraiser. The American Institute of Architests, of course, has designed a marvelous contract relative to an intangible service, which has nothing to define the product, and everything defined the responsibilities of the client, which you virtually have to rewrite before you can use it as an instrument of building the building. I foresee that they will have the same problem in the appraisal process. The appraisal organizations will have designed a standard letter of engagement, which promises nothing but obliges you to everything, and by the same token, those who are consumers of the appraisal process will have some fairly explicit letters of engagement which define the task and services and liabilities that are a part of that in the appraisal process. The day when you could call up on the telephone and say Charlie, will you do a fair market value appraisal of the building at such-and-such an address is over, and the task needs to be much more elaborately defined because of this much too important--like a building is much too important to be left to architects, the appraisal process is much to important to be left either to the appraiser or the lawyer. Now, the three approaches to value are evolving relatively quickly, and I think it is important to understand where they came from for a moment in order to understand how we reached the point where we are today, where people are beginning to tell the lawyer that he is responsible for understanding the appraisal process, rather than just ordering the one out and where ERISA is beginning to say to the trustees that they are personally accountable for the failure to secure adequate appraisal and so forth. The historical three approaches to value is one of the great mystiques of the appraisal process. All of you, I'm sure, have recanted innumerable times the fact that we have a market comparison approach, an income approach, and a cost approach to value. The origins of that premise that you had to do three approaches to value and then synthesize those into a final conclusion really had to do with the collapsible real estate field in the 1930's and the effort to re-establish credibility in our financial institutions by re-establishing credibility in the appraisal process, and as has ever been the case, the consumers of appraisal services are those who really define what the appraisal process will be. The insurance companies---the life insurance companies---have been badly burned in situations where the borrower had inflated his appraisal value. They had made a 50% loan on it and it still turned out to be a 110% of what it cost them to build, and therefore, the life insurance people felt that a cost to replace or to build should be the upper limit of value and that they should lend on some percentage of that to be assured that the borrower had his own money in ahead of the life insurance company's money as a cushion against a possible decline in value, and therefore, the life insurance industry is one of the major customers for appraisals, were insisting that the appraisal process be a cost approach, having witnessed, of course, from the late 20's and early 30's, you know, tremendous variance in income or loss of income and loss of market values. They felt the cost approach was the only objective way. They felt this was a great irony, because in the 1920's the National Association of Realtors had made the cost approach an unethical methodology, because it had a specious appearance of precision and accurancy, when in fact it was highly subjective, because it dealt with the land as though vacant, which was nonsense, because there was obviously a building on it, and it dealt with three types of depreciation,which could only be measured subjectively. One, of course, was wear and tear. The second, of course, was a functional obsolence, presuming that the building layout and so forth wasn't quite as appropriate to its functions and purposes and that there was an economic or locational obsolence because it was in the wrong place at the wrong time, and all of those elements have to be judged very, very subjectively. It's certainly difficult to break them out and distinguish one from the other, and so during the 20's the cost approach was considered unethical, so the life insurance companies brought it back as a way of avoiding the sophistry of the income approach, which tended to lead them down the primrose path and make loans in excess of cost, and this is where the mystery which appears actually in your own, where is that statement of your tax counsel's responsibility on the report of the Special Task Force on Appraisals of the Bar and the Committee on Real Estate Tax Problems in their draft of May '84, they continue to keep alive the myth that the cost approach is the upper limit of value and that it is controlling on anything, and it is not, and many states have already court decisions which state the cost approach is an approach to value, but by no means either the upper or the lower limit, but there continues to be this mythology that grew out of the life insurance companies' experience of the '30's, and so they were insisting on the cost approach. At the same time, there was a professor--Lord forbid--by the name of Babcock from the University of Michigan, who had integrated real estate with Fisher's capital theory that real estate was a capital asset, and you took the present value of the future benefits to determine what its true value was as a producing asset, and economics of ________ in the '30's and the present value discount theory of Fisher before that essentially said you were measuring asset values which represented the economic surplus produced by the real estate, and you took the present value of that economic surplus and represented that as the "economic value" of the real estate. Babcock nobody would have listened to, although he had written a very brilliant book on appraisal, which is still some of the best contemporary thought we have in the '30's. Nobody would have listened to him if he was a professor, but unfortunately or fortunately, as the case may be, he was placed in charge of the FHA appraisal department when it was created, along with Miles Folèen and Richard Radcliffe, and as a result, was in a position to control most of the residential appraisal in the 30's and 40's, and therefore, was in a position to say we shall use the income approach, and it is the preferred approach on all properties, and to this day, federal residential forms have a rental value factor in them representing the income power of the single family home. The third group were the real estate brokers. One, they didn't have anything to do because nobody was buying and selling houses, and two, they controlled what they presumed to be the best market data by the nature of their position as brokers, and so they believed that the price of the thing, or the value of the thing is the price it will bring and that, therefore, the market comparison approach was really the only way to go and that furthermore brokers were the ones that best understood what the market was all about. Now, the National Association of Realtors wanted to create an institute of valuation, which presumably would speak with a single voice, and in order to get a constituency of these major consumers and influences in the appraisal process together. Somebody, in the time-honored American tradition, said I got a great idea fellows; we'll use all three methods, and we'll synthesize them as a political accommodation in order to gain your support. Up until that time, there was no hint in any of the theoretical appraisal literature, or the metaphysics of appraisal, if you will, that you had to use three approaches; you were supposed to use the one best approach that was most relevant to the problem at hand. Then all of a sudden we now have the three approaches to value, and we have to synthesize those and that if you don't do that, you're not doing an appraisal for some reason or another. Well, that whole process is falling apart, except where form is more important that substance, and we'll come back to that in a moment. The really legitimate appraisers no longer pay much attention to three approaches to value, other than perhaps to give one line to explain why they didn't use it, and still feel obliged by their own professional canons to suggest that they didn't use the cost approach because it wasn't relevant or they didn't use the market comparison approach because the sales prices available obscured the actual transaction to a point where they weren't reliable and so on. But in any event, the traditional form was a political accommodation which allowed them to re-establish some kind of standard of performance of the appraisal process at a time when it had lost all public credibility whatsoever, and to do that within the umbrella of NAR led to that historical format. Now, once you move beyond this, we have two other ways of looking at the process. The contemporary method still has three approaches, but they're significantly different, and I believe, significantly much more accommodating to what the intent of the law is. The preferred method in contemporary appraisal is inference from market transactions. It recognizes that the real estate market is as much an art form in behavior as it is a science form in terms of the economic characteristics of the property and that you have to meld those, and therefore, the first and preferred method of predicting what the price of the property will be in a transaction is to infer from past transaction of properties which are regarded as comparable. However, comparability ha two dimensions--a minimum of two dimensions. One is that the property be similar in terms of opportunity, and two, that the buyers be similar in terms of motivation. So, if we're looking at, let's say under the old 1976 tax law, an apartment building that was built new would have the one market, and the apartment building that was bought as an existing property would have been a separate market, because the income tax characteristics, for example, will have shifted, the risk characteristics will have shifted, etc., etc., etc. The profit centers would be different Now, as a result, the real estate market becomes much more highly segmente as it really is in fact when we begin to look at comparability as a matter of both motivation and opportunity in terms of the building. So if we're looking at a building, let's say that has reached the end of its original purpose and we're now saying gee, the best use of that building would be conversion from, let's say a department store to office, then those properties which are legitimate comparables are properties which were bought for conversion purposes--not necessarily department stores that were bought for conversion purposes, but neverthess commercial buildings in that particular community that were acquired and then converted or upgraded by significant renovation and so on, and it may involve always professional operators that bought for their own purpose, and you can begin to identify statistically very significant differences, for example, in Madison, Wisconsin, where we traveled much as Mr. Thorosa(?). The 33 foot wide properties downtown invariably are bought by retailers for their own use, and the fundamental unit of comparison is first floor area; whereas, buildings larger than that are almost always bought...are always bought by professional redevelopers, who pay for the entire square footage in the building. So if you use a 33 footer as a comp to a larger 44 or 66 foot wide, say, you know, turn-of-the-century commercial building you will invariably inflate the answer, and you will always have the wrong unit of comparison. So in matching for the market inference system, and we'll look at some this afternoon in terms of demonstration, you need to do very careful analysis of what you're using for comps and profile the investor who's buying those buildings. Now, quite often, you will be unable to do that successfully or there will be an inadequate number of sales, and therefore, you would then fall back to the second level, which would be market simulation. In that case, you go back and you say alright, how do you do that? For example, recently we, in our firm, we were involved in some major Chapter 11 cases in terms of agricultural land and the agricultural lands involved irrigation and cranberry bogs. But we got into the cranberry bogs and we found the other appraisers were using, well, the price per acre was so much for this bog and so much for that bog and so forth. Well, they were all over the map, so they were making beautifully imaginative adjustments for location, time, 15% for this, 5% for that, pulled out of the air somewhere. But you go back and you dig and you find out what people are buying, they're buying barrels of production of cranberries. Cranberries are measured in barrels. When we shifted the price back to a unit of comparison that was barrels, we got almost perfect correlation, and the only difference in price per barrel was the species of the cranberry, because there were two essentially different categories of cranberries. When we did that, it didn't matter if the guy bought 500 acres of land or 50 acres of land if they had the same amount of production in terms of barrels of cranberries, the price was identical for a barrel You got to get the motivation and what's the economic unit in order to arrive at the market inference. And most appraisers traditionally have not been willing to do that kind of research on the subject. Fraternity houses may buy and sell based on the number of beds for which they're licensed. Cranberry bogs are likely to sell by the barrel. We may be selling cubic feet in the case of buildings for redevelopment and so forth. Market simulation means you go out and interview the folks that are making the market; find out what it is they buy; how it is they price their properties. And if they're pricing their properties illogically, then you price your property illogically in appraisal. The object of appraisal is to simulate behavior, not the elegance of the logic of the appraiser. Too much of what has passed for appraisal has been what we would call normative methodology, which is the third category, which is, what would a buyer do if he was as smart as me, the appraiser? That's no way to predict the price at which a property would sell, but nine times out of ten, your appraisal assignment is to predict the price at which a property would sell under a specified conditions in the law. It is a behavioral science. Normative methods that are not used by those who are actually in the market place therefore can't possibly predict the appropriate price, unless you're just lucky as hell, or somebody has manipulated something somewhere. For example, recently a major national appraisal company on the other side of the case on which we were on were appraising a privately owned dam. They used the three approaches to value and got the identical number on the three approaches to value. It was a classic case of form over substance. In fact, hydroelectric dams have to be valued based on the marginal cost of kilowatt production of the local electric company because under the 1978 Energy Act, if that dam is owned by a private individual, he can compel the local utility to buy that electricity at whatever the marginal cost of production is, and that utility is compelled to file quarterly with the local state public utility commission what their highest cost of production is. Unless you understand the motivations of those that are buying dams these days, there's a damn good chance you're going to be wrong on the value of the dam. That bad, yes. I apologize for that. Therefore, the contemporary approach is, one, I would prefer to use market transactions if I can learn how to understand them and have a sufficient number of them. Second of all, failing that, I want to find out how buyers think about these kinds of properties and simulate their method. There's an ethnic area here in Chicago, which is a very closely knit organization in which grandparents and great-grandparents are there and their parents and now the grandchildren are still there, and everybody buys at six times gross, and most of the neighborhood are two and three unit rental properties. Everybody knows you pay six times gross; then the prices continue year after year to be at six times gross, even though they're relatively old buildings and there's no net; there's no net income; there's no economic product, other than the fact that they continue to live within their ethnic group, and the conventional wisdon is sim times gross. If that's the way buyers price it, then the best way to predict what the next one's going to sell for is in fact using the buyer's method. It has nothing to do with the intellèctual elegance of the method, and you could go and explain to them that they don't have any net and that, therefore, they should pay something less for the property and so forth, but that isn't going to change the marketplace. So the contemporary approach, I think, is sensitive to the realities of how it works, where the normative methods typically are those which you use in desperation. The cost approach is a normative method. Investment band theory, or at least the Elwood(?) approach, which was highly trumpeted for years by the appraisers, is normative. I couldn't find anybody out in the market who actually bought buildings that ever used the Elwood approach to set a capitalization rate and multiply that times net income. You would get a blank look at the use of the term Elwood. Alternatively, the philosophical, metaphysical base for appraisal has been said, I think, most beautifully by Gene Dilmore down at Birmingham who is one of the best head men in appraisal today. And he said really there's only three methods to appraisal. One is order, second is beauty, and the other is probability. Order means normative, logical systems that are eleganty symmetrical and consistent internally, although perhaps not relevant externally to the marketplace. Beauty has to do with intuition, and quite often in appraisal you get paid for your intuition. There is nothing wrong with an educated intuitive guess as to what the property is worth if that's in fact what you're going to have to rely on. More and more today, however, we're able to move into the areas of probability. More and more data and methodology begins to revolve around the fact that we can identify a central tendency for price and as well as the degree of error in that instance, and this is where I think much of the best work in appraisal is being done. Recognition that a sales price is really a central tendency within a range of possible alternative outcomes, and it doesn't really matter whether we're talking football or whether we're talking appraisal or we're talking finance. Variance and mean variance are becoming a dominant concept in our ways of looking about to future transactions. Even football coaches talk that way. If you ask why they don't pass the football more often than not, even the folks from Ohio State will say two of the three alternative outcomes is bad. Well, there's actually more than three alternative outcomes to a forward pass, but there's really no sense helping Ohio State understand the game. But nevertheless you can begin with that in the courtroom, and we have successfully in the courtroom in a case in which the federal home loan bank was being sued by a mortgage guaranty company that did not have $5,000,000 in capital necessary to be eligible to be in the secondary market, and they were arguing that $5,000,000 was arbitrary, whimsical, capricious, and downright mean to a little company, and the company happened to be in Maryland, where they were alleging that there was a guaranty fund that would take the place of the $5,000,000 worth of capital. Our presentation in the courtroom was simply what is called the density model that says here are the alternative outcomes for ruin, given a mortgage guaranty company that would operate in the following way, and we set up a computer model, and the computer model iterated through 100 alternative outcomes of that operation in which the key variables were random number of variables within controlled ranges, and we said, o.k., here's the probability with which it would go broke in the first year, second year, fourth year, fifth year, with $1,000,000, $2,000,000, $5,000,000, and $10,000,000 in capital and were able to demonstrate that until you got the minimum of $10,000,000 in capital, the probability of ruin was higher than that which would be permissible under European insurance rules of financial mass, and we were able to carry the day on that basis. We're beginning to see more and more appraisal models being run on the same basis. We're talking about a series of future events which obviously are not possible to predict with a high degree of precision, and we are being able to begin to demonstrate in the courtroom probability alternative outcomes and say alright, here's the central tendency on value and giving your range of opinions on alternative outcomes in terms of rate of absorption at the sale of this land or the prices that you may obtain for the lot or the roll over on the leases that may control the future resale value, this is where you would be prudent to place your investment. We've used the density model on a variety of land development issues and we're beginning to see that that is economically feasible to do with the advent of the computer and data processing techniques and the statistical techniques that are available today. So, we're moving from a system of order and presumption of certainty, which seems to be childish and not very sophisticated, toward probability and where we have, of course, issues in the probability, we're moving toward intuition or beauty in terms of the philosophical approach of sophisticated appraisals. Now, to provide a standard of performance, as we said, initially the appraisal organizations espoused the three approaches to value, and it was necessary, therefore, to stylize the content of an appraisal into a fairly deductive format in which you began with the national economic picture and then talking about the region and then you talked about the neighborhood, and finally, on page 17, after going through a whole series of time series data that was boilerplated, you got to identification of the lot and finally a description of the building and so on. And the appraisal organizations were so successful in selling that stylized format that the form of the appraisal became more significant than the substance of it, and by the same token, once the form of the appraisal was thoroughly established in the consumer's mind, it became a vehicle for disinformation. Disinformation, as you know, is the military intelligence technique of transmitting information which is erroneous in a medium which gives it legitimacy, and the appraisal process became that medium. And if it had all of the right elements in the format, the presumption was that it arrived at the right conclusion, and the subtleties of distortion that were going on either were ignored or purposefully ignored, and I believe in again the report of your appraisal committee that the tax thing is a marvelous line, which I'm not sure who the author was, but I wish I'd done it myself. I believe it goes that purposeful naivete is constructive fraud, and the lawyer and the investment banker and the mortgage lender and the bank officer have all been guilty of purposeful naivete about the appraisal, because if it follows the proper form, presumably everybody was off the hook as far as culpability for malfeasance was concerned. And, of course, the American tradition besides has a wonderful ethic in which if the other individual will make an ass of himself on our behalf, we are still performing in an ethical way, and therefore, if we can get the appraiser to come up with a number which is lyrical at best, that's his problem, not ours, as long as it serves our advocacy purposes, and of course, that attitude is what the new directives of the Internal Revenue Service and the new canons of the Bar Association are driving at--the tendency to use the appraiser and his appraisal report as an element of disinformation to support an advocacy position has got to come to a halt, and it is coming to a halt. Now, because the form itself is suspect, the legitimate appraisaer today is not bound by the three approaches to value, nor is he bound by the traditional appraisal format in any way whatsoever. Now, the intellectual conditions which must be applied to the appraisal report were further corrupted. Obviously, the appraiser is not doing a survey of the building. He's not an engineer who can say whether it's structurally sound or not, but it's not clear whether in fact the appraiser doesn't have a responsibility to call for an engineering analysis where he has reasons to suspect the building is not structurally sound. He should be aware of what those opportunities are. In any event the intellectual conditions became so subverted that there are still appraisal companies in the U.S. which say to the client essentially you get to name the price, I get to name the conditions. If you want the price set here, that's fine, but then I'm going to set up a series of conditions which in effect are an exculpatory clause relative to myself as the appraiser. If you want a totally fictitious set of financing terms under which this price is true or you want a totally fictitious set of presumptions about how the public is going to regulate this piece of land relative to my value and so forth, that's fine; just send me a note as to what my instructions are, and then I will value it under that set of fictional conditions, and the result has been, of course, to further erode the credibility of the appraisal process. Today, that's one of the first areas that you can begin to attack, and much of our role in Landmark Research quite often is doing the cross-examination questions on appraisals. The appraisers, like the doctors and the lawyers and so forth, generally eschew the practice of having one of your own kind develop the cross-exam questions, which is one of the reasons we don't belong to one of the major appraisal organizations, simply because we feel that the best way to teach appraisal is to destroy the appraisers who are incompetent on the stand, and therefore, we have no compunction at all about representing our client by preparing the cross-examination questions relative to the opposition. In fact, a week and a half ago on the East Coast I became so incensed with the attorney that was representing our client that at lunch I just simply told him that he was going to ask the questions as written by my assistant and that since I was there to do the rebuttal testimony in any event, he would simply follow the cross-exam set that we had set up for him and that's the way we operated. The attorney obviously knew nothing about appraisal. He had allowed a totally incompetent witness for the opposition to slip away and actually represent himself as knowledgeable. I'm not sure the judge knew the difference between the 1976 tax law and the 1981 tax law that was relevant, and the witness for the opposition proceeded to give a brilliant demonstration of the '76 tax law, which was totally irrelevant to the issue, and yet the attorney representing our client missed that altogether, and so I simply took over the cross-examination by feeding questions through my associate to the attorney and proceeded from there. So, I really believe that contemporary appraisal is at a new threshold really of service in which the truly professional appraiser is equal to the attorney in the preparation of the case--in the presentation of the case and in the evaluation of the opposition's case. We feel that in working with our clients, we'll not only tell you what your case is, we're going to tell you what his position is going to be, and we'll prepare both sides, so that we're in a position to appropriately dissect that which we feel fallacious on the presentation. Now, the decline in the status of the appraisal profession or process is directly attributed to three ethical problems in American society, which are certainly not unique to appraisal. Our first problem is that accounting systems fail to measure the damage of faulty appraisal work and assess it on the individuals involved. Certainly the IRS' new tax law, the Accountants and Attorneys Relief Act of '84, attempts to say, hey, if you are "aggressive," I believe is the term the IRS uses in their legislation, to appoint where your values are 150% more than they should have been, that we can assess, I believe it's 30%, of the tax loss that would have resulted from that to the federal government to the appraiser and that furthermore the appraiser can be banned from further presentation and involvement in a tax matter, and so on. They're certainly attempting to get at the fact that the financial accountability of malfeasance has always missed both the appraiser and the client who has encouraged that malfeasance. I believe the Senate version, which was ironed out in ____________________ said that a taxpayer could not benefit from a "aggressive appraisal," and therefore would be forced to cough up the taxes and penalties that would be involved in a setback on the appraisal. That's been modified, I think, to some degree, and I think it's the appraiser who takes the hit presently, rather than the taxpayer. But nevertheless it represents a very narrow initial effort to put accounting and cost accountability on the appraisal. But the larger damage is always concealed, first of all by the nature of the time lag in workouts. You make an appraisal today for a loan that will be closed a year from now, the project goes sour two years after that, the workout doesn't occur for another two years, and therefore, you really don't understand what went wrong relative to the appraisal in the first place until six or seven or eight years later, and there are so many intervening circumstances that the opportunity to hang the appraiser with his misleading report in the first place is simply not there. Now, the second element, of course, is that ~~more~~ many the losses accumulate and eventually end up at the FSLDIC or the FDIC, who are holding billions of dollars of real estate today that was provided as collateral. Question, Bill?

Bill: Is a James D. Lawler here?

JAG: And again, the cost of that malfeasance in terms of the execution of that original appraisal can never be recovered. There is not constituency to go for it. But the subtle miscarriages in the courtroom of justice as a result of the credibility versus reliability of appraisal in the advocacy process again can never be accounted for appropriately. The second element in American ethics, as we suggested, is the silent conspiracy because of the American competitive team approach, where a side is represented concurrently by lawyers, engineers, architects, appraisers, and so on, and the object, of course, is to achieve some particular goal, and they tend to rationalize each other into a position which is supportive of an advocacy position, even though perhaps they still, at least superficially believe they have maintained their independence. That's simply a social phenomenon in the American way. And the appraiser typically doesn't have the stature to be an S.O.B. about it. If he does, he doesn't get the next job. That's why I'm a professor. I always have an alternative income and can be independent as hell. In fact, many lawyers refer to me as Spooky, which means they're not sure they really want to hear an objective value because it may not be supportive of their case. Finally, the user of the appraisal service himself is often well-intentioned but ignorant of the appraisal process.

He assumes that an appraiser with a designation is technically competent, just as we assume somebody that's called a doctor or lawyer is technically competent. We are more nervous, of course, about the doctor's credentials because if they are not good, we stand to suffer. The difference, of course, in real estate appraisal is that malpractice is generally favorable to the purposes of the client. The opposition may die, but we probably will prevail, and this is accentuated by the fact that third parties do not have right of suit, unless they have purvity(?) of contract with the appraisal. Malpractice in the appraisal area, with the exception of the securities law and now with the exception of the certain specified areas of the tax law, the third parties who are adversely affected have no recourse against the appraiser if they didn't pay his fee and contract for him in the first place, and so we're back in terms of malfeasance where the accountants were in the 1930's again, where the courts felt that to protect an infant profession against the crushing blow of liability from the consequences of negligence, it was desirable to put in that purvity(?) of contract constraint on liability. That's where appraisers are presently, with the exception of security. Now, appraisals and accounting are very much interrelated, both in terms of their historical functions and in terms of their historical evolutiona development, and both of them are undergoing a whole new review of standards, interestingly enough being brought over from the European community. The European economic community, in order to operate and with the vocabulary, commercial vocabulary that everybody unerstood found it necessary to overhaul both their appraisal and their accounting practices so that they were talking about the same thing across the international line, and as a result, the accountants and the appraisers in Europe have defined a set of standards which are now being introduced in the U.S. The FASB is currently studying the European standards of accounting and appraisal for adaptation here in the U.S., and the American Institute is in fact operating with them, and we'll look in just a few moments at some of the contents of that, as I have xeroxed several pages out of the Chartered Surveyors Standards book to suggest where it is we're going to be going very soon in the U.S. In talking with the people at the Institute in Boston two weeks ago, they estimated it would be 1985 when the new standards for both accounting reporting on financial statements and appraisal standards for financial statements would be introduced in the U.S. Now, an appraisal is a systematic analysis of economic potential of a specific property in order to estimate the probable sales price under specific conditions and limiting constraints. And fair market value is simply a base number with a number of very specific implicit and explicit conditions, which get modified, depending on the purpose for which the appraisal is sought, and we'll pick up on that in just a moment. I'll give you about ten minutes for coffee, which I believe is at the back of the room, and then we will proceed immediately into fair market value, because most cases can be made or broken on your understanding of fair market value and its implici conditions.

___: I have one announcement, too, that if you want to prepare written questio and hand them in, Professor Grasskamp and I will review them over the noon hour and answer them this afternoon.

JAG: We'll answer them directly after lunch, and then we'll open up again to questions at the end of the afternoon about 4:00. Most of my talk today, of course, is in the white space between my outline, but nevertheless, I'm just about at the end of page 6, if you need something to redirect you ________________. We want to talk about fair market value highest and best use and a few other basic concepts in real estate appraisal because virtually every successful attack on cross-exam of an appraisal, and therefore the most critical element in determining the internal logic and consistency of the appraisal, depend on your thoroughly understanding those concepts, and yet they seem to be so self-evident that most people take them for granted. Nevertheless, your own appraisals canon says that you are not only responsible for the qualifications of the appraiser, but whether in fact his appraisal makes common sense, and common sense begins in understanding what is the internal logic of the appraisal as it relates to market value and the property to be appraised. The first implicit idea of fair market value is that there is a statistical marketplace in which buyers and sellers have acceptable alternatives. If you have an absolutely unique property or if in fact the sale involves someone with a unique need, that is not a statistical marketplace. For example, let's assume that we have an office building adjacent to a vacant piece of land, but that office building has no parking and that it's losing tenants to newer buildings which do. If you ask for the fair market value on that vacant piece of land, it will simply look at what vacant pieces of land are selling for that are not on the corner, that are internal to the block, and come up with a mean price under conventional fair market theory. Under contemporary apprais theory, the most probable price will say the most probable buyer is that building that needs parking in order to maintain its competitive position Therefore, what is the maximum price that building could afford to pay for parking in order to preserve the present value of the rents that it would otherwise lose for lack of that competitive amenity. It does not have to be a statistical marketplace. There is one buyer; it is the building next door and the question now between the buyer and the seller is how much can I extort from that building because it desperately needs convenient and adjacent parking. The most probable price and the highest price likely to be paid is to that individual buyer next door. But that is not fair market value. Fair market value assumes that all of the buyers had alternatives which were more or less equally suitable, and if they weren't quite equally suitable, you could make small adjustments for the differences in convenience and amenity and economic power. So the first thing you need is a statistical marketplace. Now, if you can't prove that, you've got real problems, but if you can prove it, you open up a whole new door. For example, one of our cliènts had 25,000 acres in the Eastern Cascades to be acquired as a federal wilderness area. The federal position was that of that, 7,000 acres had commercially viable timber, and the rest was rock and snow, and as far as they were concerned, they paid $50 an acre for rock and snow. Our position was no, you're buying scenic quality, everybody recognizing that this is the premier piece of scenic quality in the Northwest, called the Alpine Lakes area and was critical to the integrity of that natural bowl of the Alpine Lakes and Cascades wilderness park. The government's position came back and said yes, but scenic quality, there's no market for scenic quality, and therefore, the public good is not compensible under eminent domain. So we went back and we said hey, is there anybody buying scenic quality these days, and yes, there is--the Conservancy, the Sierra Club, the Land Trust, a good made state open space programs have assigned priorities to land based on their characteristic scenic quality. We had a marketplace in which buyers and sellers had alternative courses of action, and therefore, we could find sales that were not dependent on federal eminent domain acquisitions for scenic quality.

We had a marketplace for scenic quality. If we could then establish that scenic quality was paid per acre better than alternative uses, such as commercial timber or recreational development, you can then do an appraisal based on highest and best use is for scenic quality, which in fact we did in this case. The government offered $12,000,000. They settled for $28,000,000. Our appraisal was $34,000,000. The first critical issue, is there a marketplace where buyers and sellers have alternatives and can rank those alternatives in terms of their desirability? If so, you can do fair market value, and at the same time, you can begin to see the interrelationship between market value and best use. Best use may be unique, but it may not have fair market value, and this is a basic confusion in theory that haunts a good many appraisal demonstrations. Disney World is not fair market value for 100,000 acres outside of Orlando. There is only one of them, and they may not have perceived themselves as having alternatives. The second thing is that there's an informed marketplace that the property was available and that that was widely circulated and known before the offer was accepted, particularly appropriate in real estate tax appeal. The house sells at a very high price from the owner of the home to a friend, business associate, or somebody who had happened to stop by one day and said gee, if you ever sell your house, I'd love to have a chance to buy it. That is not a fair market value transaction. Why is that important? Now, for example, in Bill's little home town of Maple Bluff one of the major mansions on the lake sold for $400,000 and some thousand dollars. The owner of the house simply called the first name on the list of five people that said if they're ever interested in selling, they'd be interested in buying. Then the person that she called boss happens to live in the house next door. Now, the house at the time it sold was assessed for like $300,000, sold for $400,000. That has a really adverse impact on the equalized value of the village, and therefore on how much of the school tax it would pay the following year. By knocking out that sale, which was erroneously included in the state equalization board, you recaptured for the little village over $100,000 in taxes it would have paid to the school board if that sale were allowed to stand. And how do you knock it out? Because it was not advertised in the market, and the basic definition of fair market value says that it was on the market for a reasonable period of time and that, therefore, there was a statistical marketplace. There were alternative buyers out there who were aware of its availability and who would have had presumably an interest in making a proposal to purchase. If those conditions aren't there and they're not knowledgeable, you don't have a market transaction. That's also true in not only real estate, but in other things. I did a lot of the original work on the Mortgage Guaranty Insurance Company financial simulation models. I built the first computer models for Max ~~Carl~~ K (?) and initially did them on accounting paper. As a result, as a graduate student I was given stock, and in order to pay for my graduate degree, I sold that stock to the Robert Baird Company at the highest price ever then recorded for an MGIC share. It was the only transaction in stock at that time. Now the IRS attempted to hang another taxpayer on the grounds that that was the market value of the stock at the time that they received an option to purchase some. They lost. I was the only knowledgeable seller around because I was the only one that had done financial simulation models and I knew where the glitch was at that time. And the basic glitch was how California was going to set the ratio of potential liability to stockholder or policyholder surplus and if that was set too low, MGIC would have been in a continual round of dilution of equity in order to maintain its underwriting capacity. Well, that didn't come to pass ultimately, but at that point in time at which we sold the stock, that was a real possibility. This was years and years and years ago. Therefore, the entire IRS case depended on whether our single sale transaction was in fact a market transaction. It was not. I didn't advertise that it was available, I simply sold it to my friendly brokers at the Baird Company, who bought it for their own account, that they bought it as a speculation. I sold it because I knew what it was worth if the policyholder surplus ratio went into place. You do not have a knowledgeable buyer or knowledgeable seller, you do not have a market transaction, and therefore, that comparable, if you will, fails the test and is not relevant. Finally, you have to presume that both parties were aware of probable use and immediate trends affecting the location and the probable use of the property. Of then that is not the case. Often one party or the other really didn't know what they were doing. For example, they sell a two-story apartment building for X dollars, only to discover later that it was a prime candidate for condominium conversion. That is not the fair market price on that property. If that immediate conversion takes place shortly after the transaction, the syndication takes place shortly after the transaction, one party knew what they were going to do with it, but the seller may not have. Or if they demolish a two-story building and build a high rise on it, the chances are good the seller had poor advice in terms of what best use of that property was, and therefore, does not meet the knowledgability test. So, these implicit conditions become the basis for either dismissing the comparable or become the element. If your case depends on that transaction, that better be very carefully researched. For example, in the scenic quality case that we talked about, we had a number of transactions in which state governments had acquired the land. The question was whether they had acquired it under threat of eminent domain or not. In the federal district in which we were operating, they took the more liberal view that unless the funds had been appropriated, the latent power of eminent domain was not operational if they negotiated the acquisition, where other federal jurisdictions take the sterner view that if you have the latent power of eminent domain, then the acquisition was under threat of eminent domain. We had to research each transaction to be sure as to what the funding for that particular program was at the time of the acquisition, and we happily found a number of situations in which the acquiring agency had transferred funds from another account, expecting to get a future appropriation to cover their tailfeathers. As a result under that rule they don't have power of eminent domain at the time they negotiated the acquisition, and that becomes a legitimate comparable transaction. Now, the current definition of fair market value you may not be aware of because it was recently changed in the 8th edition to cover one of the major problems of enforcement of market value. I think it's useful to look at that in Exhibit 3, page 7, of your notes. The current definition of value is the most probable price in cash or terms equivalent to cash or otherwise precisely revealed terms for which the appraised property will sell in a competitive market. That means there are alternatives for buyers and sellers under all conditions requisite to a fair sale, the buyer and seller each acting prudentl knowledgeably and for self-interest and assuming that neither is under undue duress. The problem is that in some cases self-interest is for both parties to inflate the real estate value, in which case that is not a fair market value transaction. For example, let's assume that we were selling one of these one-day surgery centers. First of all, they typically are licensed by some regional medical board so that they are a franchise, and second of all, the medical practice therein can be extremely profitable. As you know, franchises are never eligible for capital gains treatment. The sale of a franchise is sale of ordinary income, prepayment of ordinary income, and therefore, it behooves those that are selling it to get as much value in the real estate and as little in the franchise as possible. As a result, the building price and the price paid for the internal appointments for surgery, shall we say, are generous, and the price paid for the "business" is diminished, and there may be other arrangements to spread that out over time in terms of participation of the sellers. As a result, both parties have an interest in exaggerating the real estate. The one because they get a capital gain, the seller; and two, the buyer gets a depreciable asset rather than good will. That is not a market transaction, even though both were proceeding for self-interest, and assuming that neither is under undue duress. Virtually anybody in a real estate transaction is under some kind of duress because inertia is always preferred to action, and there's got to be a burr under your saddle if you're selling or buying. You simply otherwise probably wouldn't get involved in the process. So what is undue duress gets to be a rather interesting problem, but nevertheless requires a little research. We'll come back to that later because it may also be the grounds for knocking out leasehold interests. Fundamental assumptions and conditions presume (1) buyer and seller, as we said, motivated by self-interest, but it's not a mutual self-interest. You have to be careful about that. A mutual self-interest of overstating the price is no longer an arm's length agreement. Buyer and seller are well informed, acting prudently. That's a little touchy as to who's well informed on a case. The property is exposed for a reasonable time on the open market, payment is made in cash. Specified financing, if any, may be the financing actually in place or on terms generally available for the property type in its locale, but not from the seller. It has to be third party financing, and the appraiser today is being instructed by his professional organization to always provide the cash to seller value first and then if there is financing that is going with the property, either as a result of assumption or a wrap back to the seller or something of that sort, that the increment in value attributable to that financing be identified as a separate number and then you would get a final number which is qualified very precisely by the terms of financing on which that is contingent. Now, it is to strike at the practice in the securities area of referring to a market value provided by the appraiser which presumes very elaborate financing back to the seller, wrap arounds, contingent participation and Lord knows what all, and to try to get back to a benchmark number, which is fair market value. Fair market value is assumed to be that, a benchmark. This is what it's worth as an asset, as an economic entity. Now, to the degree that we want to sell liabilities rather than assets, that becomes a different problem, and I think that's critical to see how we slipped in the evolution of appraisals. The concept of appraisal was to measure economic surplus. What's the net value of the economic product? So we would take the buildings' gross rents available in the marketplace--not necessarily what they did get, but what they should have gotten as of the date of appraisal--we subtract the operating expenses as they should have been--not necessarily what they were--on the property, and reserves for replacement of short-lived items, for example, and we got down to something called net economic income, and you were then to value that net economic income. That's asset valuation. What is the economic product worth in the marketplace? At some point, we slipped into liability valuation. When Elwood came along and said, hey, what we want to do is take the present value of the payments to the lender and the present value of the payments to the second mortgagee, and so forth, and then we'll add that to what the equity position is willing to pay for the cash dividend and the future reversion on the property. You converted valuation to the sum of the claims on the asset, which is really liability valuation. That's a whole different concept, particularly legitimate for making mortgage loans, but not fair market value. It is now the value is the sum of the claims on the assets. That's a very subtle difference, but produced obviously significantly higher values for the same property, because you began to get a blended capitalization rate rather than true economic capitalization rate. But we then went one step further. We recognized that the real estate no longer existed in a vacuum as a single unit; that the real estate was always part of a portfolio of investments or activities; that in fact by owning real estate we created a captive customer for our services and by owning the piece of land we could then get the contractors fee, we could get the leasing commission, the insurance commission, the property management fee, a whole variety of other service fees that were connected with the real estate operation, and therefore, if we looked at it from the equity standpoint, the real value of owning real estate was the present value of the change in our spendable cash plus the present value of the liquidating value of our net worth on an after-tax basis, and because the tax laws generally gave a short-term advantage which allowed us to shelter other income, the ownership of the real estate significantly changed our spendable cash over and beyond the cash produced by the real estate, and by the same token, the real estate significantly altered the liquidating value of our net worth because of its transfer opportunities and so on. Now, in addition to, of course, the change in made on our subsidiary corporations, we created a captive consumer for services that were buried on the expense side of the real estate, but were revenued to our property management firm and our insurance agency, and so forth, and going concern value on the equity side is an entirely different number than in fact the sum of the liability or the economic product. And we're not doing a very good job of delineating that at the moment, and this is what fair market value is trying to get back to. So the first control is the effect, if any, on financing, which has been traditionally distorted, the values and the syndicator, of course, has been doing that deliberately to overstate his depreciable base. Notice the Institute is striking at that by its definition of market value. The Internal Revenue Service is striking at that in the new tax law in which seller financing is no longer given an imputed interest of 9% or 10%, but in fact will be at 120% of the treasury rate on bonds that have a similar maturity to the paper taken back by the seller. There's an attempt to deflate real estate prices for the payment being made for financing as opposed to real estate. Now, that's the first element of definition. Now, the definition of control of the appraisal assignment is going to go considerably beyond that, and the basic appraisal process today differs dramatically from the day when you called up and asked for a fair market value appraisal, and you and the appraiser presumably knew what the hell you were talking about. The appraisal report, as I said, has always implied by its format that it's deducted, but in fact it should be inducted. The first step is to understand the issue as to why the appraisal is required as a benchmark, because that becomes critical. Let me give you some examples. A Chapter 11 case. Our client is the owner of the hotel. He's being pressed hard by a major life insurance company that wants to take over the hotel because at one point our client failed to pay a series of payments on the mortgage. In this particular case, which is a happy and unique situation, a number of facts are important. One, there was a hiatus of about nine months in which the client did not pay on the mortgage as a result of financial difficulties of initiating this new hotel. When he then tendered the next payment, the insurance company refused and initiated foreclosure because the hotel had turned around and is a very profitable and desirable property, and the insurance company preferred to have the property than the mortgage, which was at an unfavorable market rate of interest __________. Our client then started putting in an escrow account his monthly mortgage payments at a time when short-term interest rates were considerably higher than the mortgage rate, and therefore, the money was accumulating faster than he owed it. When they persisted on going forward with the foreclosure, he went into Chapter 11. The issue for the judge at that point became do we foreclose the property because the creditors have a better chance of being secured by sale of the property in auction, or do we permit the property to go forward in operations because that will in fact guarantee full reimbursement for the creditors. Therefore, the first assignment was, one, what is it likely to sell for if it's put on the block, and two, what's the probability of the financial reorganization plan working out if we go forward? Now, in definition of that particular case, we sat down with the lawyer, and we discovered the following. One, the only thing they're entitled to sell is the building because the lender, at the time he had made the loan, failed to perfect a subordination of the chattels. Therefore, we're not seeling the going concern hotel. We are selling a building stripped of all furnishings, including the window air conditioner, including the kitchen equipment, and including all of the furbishings of the dining room and so forth. Second of all, it is not entitled... the seller...or the buyer is not entitled to the book of business that comes with it. He is not entitled to the working capital as part of it. He is not entitled to the name on the hotel, which was an independent hotel. He is entitled to the building, baby; that is what is going to be sold, and that is the definition of the issue, and that is what the appraiser has to appraise; a shell. Once you understand the issue, the appraisal assignment was clear. The other side proceeded to appraise it as though it would sell as a going concern and said, see, your Honor, there's more than adequate resource there to cover the creditors. Therefore, if it's all the same to you, we'll take over the hotel, please. And the judge said, no; what you're selling is the shell. And the shell by itself to a buyer who will now have to restaff, rebuild the dance bookings for the conventions and so forth and so on, retrain and so forth, sets them back six months or so, and the present value of that in the marketplace is considerably less than the total obligation outstanding against the hotel. Therefore, you have to go forward. Now, what's the probability of success on the reorganization plan? At that point, we used a density model that said,

o.k., here's our cash break even point. Here are the statistics as to how accurate budgets for hotel operations are in terms of the mean variance of those estimates of budget before the fact and after the fact, our cash break even point is three standard errors out from a one standard error variation in our expense forecasting, and therefore, we have the following probability of success. The judge bought both of them. One, the probability model was appropriate in estimating the future success of the refinance plan. The certainty of selling a shell which was fair market value made that an unacceptable alternative for the settlement of the Chapter 11. But notice, unless you sat down with the attorney and explained the facts of life to him, he didn't see those as what his real appraisal assignments were. You have to understand the issue as to why the appraisal is required and define very carefully, therefore, what are the rights that are to be appraised, because in America today we have completely confused real estate rights with everything else. Let me give you another example, which is to be determined currently by one of the Supreme Courts on the East Coast. This is a major shopping center, a mega-center of about a million three hundred thousand square feet. Our client was the developer of that center, but the land was initially owned by the department store that forms one of the anchors...
The system with the development of that center. The two of them attracted four other department stores to the center. Four of those department stores owned their own building, which they built on pads which they owned. The fifth one built his own building on a pad which they leased from the developer, and the developer bought the sandwich, or land between the majors and put in another 140, plus or minus retail stores. It costed $32,000,000 to build the center. It

was assessed immediately at $70,000,000. The tenants currently are paying about $375 a square foot in real estate taxes, which is probably the highest tax assessment on a square foot of retail space out on the East Coast that I have found in terms of shopping centers in suburban areas. Now, why the discrepancy. Well, first of all, you have to go back and say, hey, what do we really got here? First of all, what we really have is a franchise. If you read the state law in that particular state what a franchise is, you'll find it's a joint marketing effort in which there is a basic agreement as to marketing methods, hours, etc., etc., etc., of cooperation, and that's essentially what we have here. We have a number of department stores that have franchised this developer to market the space between their department stores in a synergistic fashion which will enhance the advantage of both. He in turn has sub-franchised to the retailer. The retailer is paying a premium base rent in excess of what the brick and mortar is worth in order to be part of a unique business environment which is defined by the operating agreement which guarantees that the major department stores are going to be there for 30 years, operate under their brand names and maintain their stores open and fully stocked and abide by the hours of the Merchant Association, contribute to the funding of the joint marketing efforts of the Merchant Association, etc., etc., etc., that they're going to provide 6,000 units of parking for the next 30 years, the joint easements make that parking available to everybody. Where else could a merchant find that kind of business environment in which he is assured that the mix of tenants will be to the mutual benefit of all and that you will have that ongoing consistent environment in which to operate? Nowhere. Therefore, you're paying a premium over and above space. Real estate, however, is space time, and in fact the shopping center developer creates an industrial shell which is then finished by his tenants to create the retail environment. That was one of the second issues. To what degree is the decor and the finishing by the retail tenant real estate, and to what degree is it personalty? The third issue was the fact that the shopping center developer provided the electricity and utilities, electricity primarily, through transformers and so forth which he installed and meters which he metered and which he collected, and so he was retailing power to the tenants, permissible under that state law. That accounted for a $500,000 net income, which, when capitalized at 9% by the assessor, was creating a value close to what somewhere in the neighborhood of 5-1/2 million dollars. Now, if we go back and say, hey, wait a minute. the real estate tax is to fall on the fee simple title of the real estate, the operating agreement has nothing to do with fee simple title. The generation of electricity has to do with a service, not a real estate interest, and in fact, since the providing of electricity typically is done directly between the tenants and the power company, in fact there is an alternative marketplace for that tenant. He, under that state law, is perfectly free to go purchase it directly from the power company. Now, as a result, when you begin to sheer away from the total revenue from the enterprise, that which is attributable to the real estate, we're back to traditional accounting, which says, hey, if I were to buy that developer's position, and the developer's position, the sandwich, was the issue of the real estate tax suit. What am I buying? I'm buying a going concern in which the profit centers include sale of electricity, sale of property management services, sale of construction services, sale of leasing services, and so on, as well as a certain amount of real estate. But under my leases, the only real estate I own is the industrial shell and the demising walls. The decor the tenant is free to take with him when he goes, including the store front. While there's a presumption that once the improvements are attached to the property it becomes part of the real estate, the presumption can be rebutted by the intent of the parties in terms of how the leases are framed and how they have done their accounting on those particular elements. Now we can go back and argue and say, hey, the real estate tax falls only on that which is real estate. General accounting principles would require that when you buy a going concern you subtract the cost to replace of the tangible assets category by category. Then if you have a portion of the purchase price remaining, it can be assigned to intangible personalty, such as franchises, patents, copyrights, financing, and so on. And then to the degree that you still have a surplus, it falls into that mystical accounting category called good will. Now, the same is true in real estate taxes. In this case, in the real estate tax case, the cost to replace of the tangible asset becomes the cap on the real estate value of the buildings, and now the question, of course, is how much value is assigned to the land and they had assigned a fully improved price to the land based on comparable sales. The balance of the value, whether the value is $70,000,000 or not, is irrelevant as a going concern. The real estate tax falls on the real estate element of that going concern. There has been very little effort to make those distinctions because in the shopping center game again if you argue that the developer has been given a franchise by the department stores who have allowed him to participate in the development process, then the developer is not entitled to capital gain if he sells it, so the developer has been typically unwilling to pursue very far the argument that the operating agreement has created a franchise. But in this case, you have a very successful development, one that's excessively taxed and one which the developer has no idea that he's ever going to sell, he's willing to argue that. The Internal Revenue Service is already arguing that in the case of many properties which have sold, in that much of the value was going concern value or franchise value and was not inherent to the real estate and has then been reallocating, if you will, the transaction accordingly, and it's a very, very difficult element to rebut. So, the first thing you have to do is understand the issue. Second of all then, define the appraisal problem in terms of the legal interest that are to be appraised. What part is real estate, if that's the issue; what part is going concern value, and so forth; what part is leasehold value, if that's a significant element; then, what is the definition of value that's appropriate; what is the date of sale that we need; and what are the conditions of sale that are appropriate? Now, if we're talking about a tax assessment, it's got to be cash to the seller. Anything beyond fair market value cash to the seller is the sale of a financial interest, which is personalty and is not subject to the real estate tax, and I can't tell you how many times we get involved in that issue in terms of when are we talking about investment value or an increment in value which is attributable to the financing, which is not a real estate interest subject to real estate tax, and the other, and the differences can be significant. We just completed another case out on the East Coast in which our client has 7,000 units of subsidized housing in a single county, and the assessor is using the cost to replace on his FHA 2013 form for

Section 8. Totally inappropriate, and which, by the way, I noticed again, the Bar Association's tax committee says that the cost approach is appropriate for tax assessment of subsidized housing, which it is not. Cash equivalency says, hey, you go back and you assign market value to the subsidized unit, you have prescribed institutional financing at the current market rates and appraised the apartment project accordingly. You ignore the distortion in construction cost that's permitted by the subsidized financing, and you ignore the construction costs on the 2013, which are overstated for a whole variety of reasons relative to the HUD program. And you go back to basics. What would it sell for as a conventional project if it had this rent in the market at current market rents and financed in the current market at institutional rates in which the seller would receive cash. The other increments in value are due to the financing provided by FHA, which is a personally property interest intangible and due to the possessory interest in government which is not taxable. The date of sale, of course, also becomes a critical factor in definition. The date of sale and eminent domain, of course, may be the date at which you received your jurisdictional offer, but in some cases we had situations in which the date of sale itself was an issue. For example, in the Cascade Mountain case, we had to develop our system so that as the judge decided what the date of taking was, we could adjust all of our appraisal overnight to accommodate that ruling. He hadn't even decided what the unit of sale was. Our client had essentially 64 sections or partial sections in a checkerboard pattern left over from the Northern Railway land bonuses provided for construction of the Great Northern Railroad, and every other section was owned with the federal government owning the other pieces of the checkerboard. We had to wait for a ruling to decide whether in fact you had one property, because it has single ownership, whether you had 64 different properties, or whether you had to cluster them, and there's a federal rule that says just because a property touches at the surveying corner doesn't make it contiguous, because the survey point is an abstract point. So we had to build an appraisal system that could adjust to whatever the judge determined was the appraisal unit. So, you've got to sit down with your appraiser and give him some specific instructions as to each of those elements, and then the conditionsof sale that will be appropriate to the case. At that point, the appraiser has to begin to analyze the property to determine alternative uses before selecting the most probable use, and again, in that process, the rules change, depending on what game you're in. In tax assessment work you have to take the existing use. You cannot and do not have to presume what the change of use will lead to. If the public wants to assess it as though it were high density residential land, then it has to first zone it as high density residential land. You cannot have it both ways. Therefore, you don't look at probability in terms of changing uses. On the other hand, once we begin to look at market value in terms of eminent domain, it's perfectly legitimate to take a look at the current use versus what it might be used for if there were reasonable opportunities for a change in use and so forth, and so again, the issue for which the appraisal is sought determines the lattitude and the scope of the appraisal assignment in exploring alternative courses of action. Now, the English tradition, as you will see, makes that a very specific part of the appraisal assignment. The chartered surveyor requires that the client tell him are we going to go on existing use or possible redevelopment use? And the client, having made that decision, limits, obviously, the scope of the appraisal function. Now, the scenarios for alternative courses of action are required, as we'll see in a moment, under the definition of most probable use, which says that the appraiser has to examine the physical, legal, the effective demand and financial viability of alternative courses of action, not only from the standpoint of the investor, but in addition in terms of compatibility with the community. That compatibility with the community, its goals and plans, means that there is an obligation to do some political analysis of the realities, and the fact that you are permitted to have a building 100 stories high under the zoning doesn't necessarily give the appraiser carte blanche license to assume that density if he can show that the community and the neighborhood are effectively organized and will block that, and we've got cases in Madison, for example, which the individual is perfectly within his rights to put a taco parlor on a particular commercial site, and the community shut him down tight because they said they weren't ethnic tacos, and therefore, they didn't want that kind of commercialization. The land use law today is more in the arrogance of its administration than it is in the black letter law. The appraiser has to be at least reasonably knowledgeable in the politics of land use in his area, as well as the black letter law that presumed for it by the code or zoning which has been attached to the property. Now, once he has determined most probable use, now he can say something about the most probable buyer. Once he has determined the most probable use is for redevelopment by those who like to redevelop old buildings, then he has really said the scope of my search for comparables is going to be those bought by people who buy old buildings for conversion, or once he has said that this kind of building is bought by people for their own use, then he is limited to, in effect, those who buy for their own use. Having defined the most probable use, he then must profile the most probable buyer, and market comparison depends on in fact those two elements operating in parallel. Now, once he begins to search then for the most probable buyer for sales to apply comparable inference, he can begin to develop his pricing formulas, and it may be that he will initially begin with an estimate of price from comparable sales, he then probably is obliged to test it with one or the other methods and say is this sales price consistent with what the investment value would be if he spent X dollars to renovate it, etc., etc., or what he could do if he bought new or built new and so forth and so on. Now, once you have your preliminary price forecast, transaction price forecast, at that point you want to bring in the influence of externality that are appropriate to a particular situation. For example, in the eminent domain area, the first thing you have is a price of the property in fee simple. Now you may have a tenant who is on that property with a lease that is reasonably favorable to the tenant. We have a situation like that presently in which we are appraising a department store building to be taken by eminent domain for urban redevelopment. The current tenant in that department store is the third tenant on a lease assumption that has seven years to go on this current term and has two ten year renewals. If you look at that strictly in terms of real estate tax, you ignore the presence of the leasehold. The unity rule says fair market value is the value of the property, unencumbered; and the fact that part of the real estate value is to the benefit of the tenant and part of it's to the fee owner makes no difference in real estate taxes. Under eminent domain, however, in the absence of any provision to the contrary within the lease, the award has to be allocated between the tenant and the building owner and fair market value to the building owner is encumbered fee. The presumption is, of course, that the leasehold would prevail to the end of the term, and that then gets modified by each state. In Wisconsin, it favors the tenant and says the tenant can stay there as long as is presumed by the lease. In other states, however, the burden is now on the appraiser to find out the probability with which the tenant would in fact remain on the property or would prefer to rearrange his affairs to some alternative, and we've done it both ways. Now, in the case of the department store that we were talking about, when we got the Dun & Bradstreet on the tenant and when we did a little research in the community, we found out, one, that the tenant had been losing money steadily for five years and was in fact was beginning to finance it with notes from the officers, holding out for the day that it was going to be acquired by eminent domain because it had been under cloud of eminent domain and figuring that the relocation benefits and so forth was his ticket for retirement. Well, at that point, it changes the whole thing. We don't have to look at 27 years of leasehold value on the thing. We can come back and say, hey, at best he would be there for the next 7, and we don't think he's going to last that long, based on the sales trends and sales per square foot. In fact, what would happen in the scenario assuming fail to another buyer is that this property would have been, without the fact that there was urban renewal coming through or urban redevelopment, this would have been a prime candidate for resale to those who renovate buildings, and the first thing a buyer would have done would have been to buy off the tenant, and say here's your hat, what's your hurry, and the tenant would have been delighted to go elsewhere. The traditional American process of assuming the full leasehold interest of the tenant as a deduction against fair market value is not appropriate at all. In very few cases is it in fact appropriate. The English tradition, of course, is much more aggressive and much more dynamic. What's the chances of their being there and then what's the changes of a buy out, and indeed many English firms make good money buying firms, buying buildings in the U.S. subject to leaseholds that appear to be unfavorable, when in fact the tenant is as unhappy as the fee owner. I remember one of our clients being miserable about a K-Mart which they owned, and K-Mart had a tremendous edge on them and it was an early K-Mart lease in which much of the real estate tax and maintenance burden was on the landlord and those were rising and the rent wasn't going anywhere because they weren't anywhere near percentage rents and so forth, and his assumption was well, I'm going to sell the damn thing and take my beating now, and we're saying, hey, now wait a minute, you've got a prime piece of property there; you're problem is K-Mart has two other stores that are reasonably nearby and therefore diluting the trade area, and they've got to be miserable too, because look at their sales per square foot as reported under the lease. They can't be making any money. Why don't we just go to him and make him an offer and say for $100,000 how would you like to go away, and we did, and they did. It made a difference of over a million dollars in the value of the property. Many think K-Mart got bad advice. And another case, one of our estates in Madison had the worst collection of real estate I have ever seen bequeathed to two kids that didn't know anything about real estate in my life. And one of the properties was a Sears Roebuck warehouse, which had been leased many years ago on a semi-gross lease in which the landlord was responsible for the real estate taxes, insurance, and exterior maintenance. Sears really no longer needed it; their whole nature of their operations have changed. They had leased it out to subtenants at rents four times more than they were paying for it. So it was a real profit center for them, but the net realized by the two kids that inherited this mess was almost zero. The roof was 20 years old and we knew it was going to start leaking any minute, and they didn't have the cash to repair it, nor did they have the inclination to repair it, but that was their obligation under the lease. In this case, we estimated the building was worth $1,000,000 and that their equitable interest was worth $100,000 and that the leasehold interest that went on God knows how long, into the year 2000 and something, was worth about $900,000. Now, fair market value under some conditions would be $100,000, but it wasn't. We simply went to Sears and said, hey, you guys, you don't want to stay around there to the year 2035 or whatever it is to realize your leasehold at the advantage. You're not in that kind of business and we don't want to stay around in the building. Let's put it all back together again. Tell you what we're going to do. We'll sell you your $900,000 leasehold interest for $450,000. Now you've got fee and you can go away and do something, and that's what we did. Therefore, a leasehold interest is not necessarily what the appraiser says its worth in terms of the present value of the total stream. What you can do to negotiate your way out of it, if in fact the tenant wants out of it, and even if the tenant is pretending that he doesn't want out of it, if you do your research and show that economically he should be out of it, the leasehold thing doesn't apply. So you've got to do your research on the externalities that are beginning to affect the asset allocation. Now, you're not obviously expected to deal with the unforeseen. But many economic events are foreseeable, where one party or the other may be under duress or under special financing or pressured by the changes in the tax law or whatever. Therefore, you may have to correct your preliminary estimate of fair market value, given no externalities, and adjust it at that stage for the appropriate conditions in this case which are relevant to the body of law under which fair market value is sought. The premise is that fair market value is a single number; it is not. Fair market value is no more and no less than I choose it to mean, I believe as Alice said in Alice in Wonderland or someplace along the line. Fair market value is defined differently for virtually every aspect of the law, and those variables which are allowable in once case are irrelevant in the next. Having corrected your preliminary estimate then of fair market value for the externalities the last step is to test the reasonableness of your conclusion in terms of market patterns as you perceive them and demonstrate that it's reasonable. I can't tell you how many times you can make your case simply by testing the unreasonableness of the opposition's conclusion. We always begin our appraisal of a property in a tax appeal case by saying if the assessor is correct and if the income is, as we both agree it is on the current property, the after tax rate of return to our investor over a five year period is 2.2%. We humbly suggest we will trade the property for the tax exempt municipals of the assessing authority. There's got to be something wrong prima facia with his assessment if it doesn't meet the test of a reasonable investment return, and yet we never see that done. But that's where your case begins. And you can go that again and again, and with the computer it's so quick. In the case on the East Coast recently the assessor testified to a value which he had not shared with us previously, based on his presumption of 120% appreciation in a five year span, etc., etc., etc., based on a net income presumed by the FHA 2013 form, instead of reality, and of course, the 2013 really looks official--it's government, after all. So we simply called into our office and said run this on our computer for us, and we did. We took his income and his resale price and his financing terms, and they produced a return of about 4.4% after taxes, and yet he had been testifying all morning to the fact that Section 8s are money machines in producing after tax income. By simply testing the appraisal as to its reasonableness, which is what, of course, the canons of the Bar Association now require, you can destroy the entire legitimacy of the presentation. But by the same token, we applied the same test at the end of our appraisal to our conclusion. We'll show you those this afternoon...those kinds of tests. Once you have then applied the test to show the reasonableness of your conclusions, given the economic realities that you're dealing with, you set the final value opinion and indicate the specific conditions of financing and the specific legal interests which are encompassed by that value opinion. And notice that's an entirely different process than the one which you normally see with the three approaches. Define the issue and define the appraisal problem in terms of what are the interests we're appraising and why, relative to this situation, what's the definition of value that's relevant and who gave me that authority to use that definition of value, such as the attorney. What is the date of sale that I have selected for the appraisal and where did that come from, and what are the conditions of sale that are relevant to this legal issue? Those have to be spelled out in the appraisal assignment. As a result, an appraisal report is probably useful for only one purpose at a time, and it's one of the things that's really intriguing to us, as we work around the country, where the guy says, well, you do the appraisal for me on this issue; then I'm going to use it for mortgage finance; I'm going to use it for this; I'm going to use it for that. And I said no. Appraisals are not a generic, homogenous unit which can be applied to any situation for any purpose. Appraisers have probably destroyed themselves by becoming Little Johnny One Note and selling the idea that a fair market value appraisal is relevant to no matter which issue, but it's not. A fair market value appraisal has to be tailored to a specific issue, and it is not freely substitutable and plugged into something else, and therefore, it's very legitimate for an appraiser to state that it was prepared for a real estate tax issue as of January 1, 1984, because that's a different set of circumstances allowable for evidentiary purposes than would be true if you mere making application for a mortgage loan or making application or going to be using it in a prospectus for investment purposes and so forth. That is not to say that real estate appraisal is sophistry. It simply begins to suggest that the issues for which appraisals are sought are different, and therefore, the appraisal properly has to be tailored to those issues and constraints and conditions because it is an exercise in logic. Now, the relationship of the lawyer to the appraiser is one that's been quite complicated, both by protocal, by the arrogance of the various professions, by appraisal training, and the confusion of advocacy versus relevancy. First of all, the appraiser can take nothing for granted about the property. The lawyer should take nothing for granted about the appraiser, nor the assumptions that are inherent in the appraisal process. Today, there has to be a letter of engagement which defines the task at hand specifically for that task, and the lawyer, by the very nature of his own professional canons, has to be aware of whether the appraiser is qualified to do what it is you want him to do. Now, in the past, it's been the tendency that you hope he's not qualified so he tends to be a little myopic and optimistic or pessimistic, depending on, of course, the value conclusion that you wanted; but today, that's not so. Your own professional canons require that you understand something about his qualifications and past experience, and therefore his ability to take on the task at hand. In the past, the lawyer has always assumed that if he had a designated appraiser, he had all he need do about qualifications. That is not so, and that has not worked well. The appraisal designation is a generic designation, which is not very indicative of their experience in a particular kind of property. I am on the appraisal committees of both the Pension Real Estate Association and the National Council of Real Estate Fiduciaries, and we have been comparing notes with them now for a year, and as best I can ascertain, there are no more than 100 appraisers in the country that they have sufficient confidence in to do large income properties. That's an incredible statement when you think about it. There are no more than about 100 appraisers who are doing the vast bulk of large income properties in the country. That means the fees you're going to pay are going to be equal to the fees you get as attorneys, which is only fair because by and large, the appraisal is going to be the best part of your case. We had a client recently again, one with a Section 8--7,000 units of apartments, a difference of only $50 in his taxes, which would be a difference of $2,000 in his valuation at a 2-1/2% mill rate. Fifty bucks was going to, you know, save him $350,000 a year. So he asked our firm to do the appraisal, we gave him a quote as to what it would take to come out and do that on the East Coast. Oh, he says, that's much more expensive; I can get an appraiser locally. I says fine. But he says would you teach him how to do what it is you do. I said fine. I'll send one of my associates out to do that. We tried teaching that appraiser. I think we made three trips out there with one of our associates to teach that appraiser. It was a disaster. The guy can do arithmetic, but he can't do appraisal. And his presentation on the stand was a disaster. Now, for a small additional charge, he could have had it done right. There was $350,000 a year riding on it, but he had been conditioned to think that appraisers work cheap, and what's worth, the lawyer wanted to save most of the fee for himself, and yet the lawyer's attitude, which I also found unbelievable, was that, hey, we're at $5,000,000, the assessor's at $8,000,000. If we can settle for the middle of 6-1/2, it's a win. That's not my idea of a win. $5,000,000 was the correct appraisal value of the property, which would be the precedent for the others. That's not a win to split the difference in Solomon's wisdom, as so often happens in court relative to appraisals. If you fail to get as close to what is the appropriate fair market value as possible, you lost. You didn't communicate to the judge, you didn't communicate to the jury, and all you're doing is contributing to the belief that if I get an assessor who is exceptionally low and because they've got a bastard who's exceptionally high, we'll settle in the middle, and that ought to be about right. This is an extremely small view of your function in the courtroom relative to appraisal. Now, the attorney, of course, is an advocate of his client's position, while the appraiser is to be an advocate only of his professional skills and opinion that result. The lawyer can deal in disinformation, but the appraiser is supposed to deal in a combination of facts and assumptions to hypothesize future events. But the appraiser is not dealing in questions of fact. He is dealing in questions of opinion, and therefore, he is dealing in areas that are legal rather than factual. He has to be careful...the appraiser has to be careful. He is not placed in a position of rationalizing his numbers with assumptions generated from the bias of the attorney who is legitimately an advocate, and that is what creates so much difficulty and misunderstanding between the appraiser and the lawyer, and it takes a very strong, self-confident appraiser to know exactly what he can do relative to the position of his client and what he cannot do, what he cannot rationalize without losing his independence. Nevertheless, the appraiser today is taught by many of his own publications that he should not interact with the lawyer any more than is necessary lest he bo coopted into becoming an advocate, and that's wrong. The appraiser and the attorney should have some long dialogues in beginning for each of them to understand each other's problem and limitations and directions in which they can go logically, because I can save my client more money by teaching the lawyer what is possible within the appraisal process, and where the pitfalls of the appraisal process are, both in his case and in the opposition's case. If we have a dialogue, then if we assume that the only way I can maintain my independence is not associating with you, the lawyer, any more than I have to. Now, if that becomes necessary, I think we are also moving into an area in which we are going to have experts on experts relative to appraisal, where there are people who help choose the appraiser for the assignment for the attorney and serve as advisor to the attorney on the appraisal process, rather than directly being involved in the appraisal process themselves. And we've come in on a number of cases on either side in which associates who are well versed appraisers themselves have chosen to take the role counselor to the attorney in the selection and execution of the appraisal process, rather than being the appraiser of record, and then bringing in someone that they feel has particularly specialized in the hotel valuation or in vacant land, mountain wilderness valuation, or whatever. Moreover, the second element that I think is important is that appraisal is no longer a one man show. There's just no way one person can know all there is to know about office buildings, shopping centers, or something of that sort. When we're talking about major properties, appraisal is going to be a team function, and much of the appraisal work that we did almost always has an allowance in it in which we can bring in a mechanical engineer of our choice or a civil engineer of our choice, we do a lot of wilderness valuations in which we're using air photo, digitized aerial photo work, and so forth, in which we'll bring in an environmental monitoring specialist of our choice, and so on. The appraisal process becomes a team approach in which the first problem is data simulation and validation. The second problem may be in the techniques of data processing which are legitimate, and then the third element, of course, may have to do with financing. For example, we had to build an appraisal model for evaluation of all the class 2 properties in the Penn Central Railway Case for the U.S. Railway Association. In that case we built a probability model as to how they would go about liquidating these 26,000 oddball properties that ranged everywhere from railway trestles to industrial development sites, and many of which had title problems that were obscure, to say the least, and we built a density model, which would arrive at the cash flow that the trustee in bankruptcy might expect as he liquidated those properties over a 20 year span. And now we have the interesting problem of what it is, how it is we capitalize that. We have the income flow, but what is the appropriate discount rate to a bankruptcy trustee, since that's not the market rate. Bankruptcy trustees, by the very nature of their fiduciary interests, are expected to invest their cash in much safer positions than would be true, let's say, of a market portfolio manager, and as a result, you get a different capitalization rate. We've brought in an expert on fiduciary financing and standards to set the cap rate on that particular element. So, as we move into more complex real estate, you're going to find the real estate process is a team of people working, addressing themselves to a particular problem, and the appraiser that you choose had better be an expert on experts. For example, a major case currently in valuation in Wisconsin involves a major life insurance building, which has some interesting... it's virtually a brand new building, but it has some very interesting problems relative to humidity, and the humidity is causing deterioration of the physical structure, to the point where some panels have fallen right off the outside wall, which is always very embarrassing, and there is a technique now of thermographics which allows you to take thermal temperature pictures of a building and identify the hot and the cold spots, and the cold spots, of course, are where the condensation is occurring and where, therefore, the structural deterioration, due to a continual presence of moisture, is causing either electrolytic effects or rust to destroy the integrity of the steel structure. Now, an appraiser, looking at that building relative to the issue for which it's being valued before and after, has got to bring in that kind of expertise to measure the rate and character of the deterioration of that particular structure. It's going to be interesting in a few years to see whether, for example, a pension fund trustee is guilty of negligence if he doesn't do a thermographic picture of the industrial roof. Let's say you're buying a 200,000 square foot industrial building. Industrial roofs are, you know, notoriously unstable. A very small puncture in the membrane of a roof causes very rapid deterioration of the underlying roof characteristics, including the steel pans of the roof itself Because it costs $5.00 a square foot to replace a roof, if you buy an industrial building with 200,000 square feet of roof area without doing a thermographic picture of the roof to find out the degree of the integrity of the membrane, are you liable personally for the million dollars it's going to take to replace the roof two years later when you discover what the real conditions are? The appraiser, of course, has a disclaimer that says I didn't look at it from that standpoint. I only said if the roof was intact, it's worth so much. That may not even be a useful piece of paper, if, in fact, the specialists have not verified the general assumptions. The appraiser is an economic generalist, who is going to require more and more input from technical specialists, because he can no longer assume away all of the conditions under which his value is relevant, and therefore, it will be considerably more expensive than it has been in the past. Now, the other element that's going to be resulting in more and more interface(?) is between the CPA and the appraiser. As we'll see a little later today, the market comparison approach is becoming more and more suspect, because more and more prices are engineered to serve tax purposes or other corporate purposes of the sellers, and therefore, there is being more and more reliance made on discounted cash flow approaches to value, and discounted cash flow approaches require some degree of reliability in terms of your analysis of the leases and the operating expenses of the entity. That is going to require an interfaith between the CPA and the accountant, excuse me, the CPA and the appraiser, and we have found again and again that that's absolutely critical. In the art of disinformation, so often the income statement promulgated, let's say that you have a building owned by a bank holding company--and we've done innumerable ones of these--unless you go back in the operating expenses, you won't find out what's happened. The operating expenses have been very carefully catalogued so that the assessor thinks that the bank guards and the Japanese gardener that takes care of all the potted plants in the lobby, and so forth, are absolutely critical to the operating characteristics of the building. They're not. If you presume resale of that building to another user, all of those things that would not be traditionally and accustomarily expenses of the landlord drop out of the income statement and expense statement, and therefore, you're going to have to go back to the general ledger and rebuild that statement, because it will make a difference on a major building of probably four or five percent when you shift out of the costs that have been assigned to the building by the owner occupant, those that would be legitimate expenses of a landlord for investment purposes, and in some cases, we've even found embezzlement. I can remember in one case doing a Howard Johnsons, we couldn't believe the amount of money being spent on lightbulbs, so we discovered that the housekeeper was selling them out the back door by the case--not that it made a great difference in the value of the motel, but I still think that if you're going to be doing valuations for security purposes or income tax purposes, ultimately you're going to have to be confident of the income and expense statement on which you basing your major valuation premise of discounted cash flow. Now, the other thing that is critical there, and in essence ought to be, if you will, the income experience of that building, is the degree to which they're collecting their reimbursables. So many leases today have pass-through provisions, which they had increments in real estate taxes, utilities, etc., will be passed through to the tenant. It's one thing to say that they will be passed through; it's quite another thing to collect them. Now, in markets such as Denver or Houston and so forth, it's discretionary on the part of the landlord not to push those too hard for fear the tenant will move out to another building which is willing to give him a better short-term position. Remember, reimbursables don't being until the second year, so if you have a new lease this year, generally that encompasses the operating expenses as of the first fiscal year, and then at the end of the second fiscal year, if there's an overrun on expenses, at that point they would be assessed to the tenant, which means that they're not really collectable until the third year. Now, if you're in a very competitive market and you have the right to pass through, it may not be the prudent thing to do is to actually try to collect them. You may decide to coast(?), and in fact, we have found probably less than 50% of those income reimbursable items that the landlords are entitled to are currently being collected, either because the landlord is sloppy in administration and management of his building, or his property manager is, or because it's decided to be expedient not to push it because the lease is coming up for renewal. Indeed, one of the things you want to look for in buying a building in which the leases are coming up for renewal, and you're saying wow, look at that; they're at $9.00 a square foot, when they should be at $12.50 a square foot, and you're panting to get your hands on the property so you can realize all the appreciation. You'd better begin to look and say gee, how successful has he been in passing through his reimbursables to his tenants. If he hasn't been doing that for awhile, the tenants are not going to be just entirely overwhelmed with joy to see you come in and try to do that and may move out, wisely or unwisely, rather than renew the leases that you're anticipating that they will renew, so that unless a CPA is part of your crew, you're going to have some time in court defending some of your operating expenses. By the same token, when I size up the opposition and find out who they're bringing in as their experts, I've got a pretty good judge as to exactly where I can attack on the cross-exam and destroy their estimate of value, because I will know the degree to which they have validated their assumptions. All you get when you buy a piece of real estate or an appraisal is a set of assumptions about the future. If you can't accept the assumptions, you can't accept the conclusion. The vulnerability of the appraisal which has not chosen to validate its key assumptions is incredible. Now, as a result of all of these elements, retaining an appraiser today is not unlike retaining an architect. You really need a letter of engagement, which spells out exactly what are you doing about the program development phase, how are you and he going to define the problem and the value theory on which you're going to proceed. That's the initial program phase, shall we say. The second thing is what's the schematic phase.

What are we going to do in terms of field work and what kind of rough notes are we going to maintain and so forth. Now, that's a two-way street. We realize that under discovery today it may be that you don't want anything in writing and that you don't want anything that can be discovered, and that may be fine, if that's the way it's going to operate, but at least you should, in your schematic phase, have some sense as to what is appropriate and inappropriate relative to field work, rough notes, and the professionals that will be involved in the investigation and the validation of your assumptions. The working drawings of the architect are like the written report of the appraiser; in fact, for my graduate students I've hired an English instructor, and I said if the architects are expected to draw without smudges, you as an appraiser ought to be expected to write in the English language, because ultimately that's your product is the English language, communication; and therefore, you should be able to write without smudges like the architect can draw a straight line. Now, beyond that, however, we have shop drawings. What are we going to prepare for courtroom exhibits, and we get very much involved in that process as well, and of course, the problem is how do we extract out of the appraisal report that which will communicate best to the judge or jury, as the case may be, in terms of a courtroom exhibit, and today there are a whole variety of better techniques for better presentation, and finally, who's going to be in charge of supervising all of that and testing the validity of it as we go along. Quality control of the data becomes just critical. You know, how much research have you done on that sale, do you know why the buyer sold it, do you know why the seller sold it or why the buyer bought it, do you know what went on in that deal. Today the typical appraiser has gotten into the bad habit of simply putting a rather brief, broad-brush sketch of the transaction in his appraisal report, and then stating that additional detail has to remain confidential in the files of the appraiser. Well, mostly that's bullshit. He doesn't know anything. What he's got, you now, are two rumors and third-hand information picked up at the dining room table at lunch, and you drive for those notes. In discovery you go right for that, because the chances are good he doesn't know what went on in that transaction. The appraiser has always been in the position of on the outside looking in, or maybe like Plato in his cave trying to figure out what the real world's doing from the shadows that are reflected on the inside. People that he talks to quite often will give him good reasons rather than real reasons by the nature of the fact that they're not sure exactly where the information is going to lead to, but they sure don't want to travel all the way to the IRS. So the appraiser is in a very difficult spot in terms of ascertaining his details, but if he doesn't, it's going to get blown up. I had the wonderful time of bringing into one case both the buyer and the seller, both of whom agreed that the buyer had really been ripped off. The seller was gleeful about it; the buyer was rueful about it, but that particular transaction was being assessed at what it had sold for. When it resold, when the buyer finally found out what he had, he took about a $600,000 loss on a $1,800,000 purchase, but in the meantime, the assessor was using that as a cap(?), as well he might. It's certainly fair game. The only way you get that knocked out is you go back and do your homework. In another case, the IRS was hammering me to death with a sale that on the record showed that somebody had paid $44 a square foot for land in downtown Madison, which is ridiculous. What they didn't bother to look at is the fact that along with the land came the air rights over 75 feet of two-story buildings alongside of it, so that the savings and loan could build windows on that side of the building without worrying that the windows' view would be blocked. It was those air rights that made it worth $44 a foot, and yet that was the comparable that was being used. You've got to go back, dig it out, find out why that sold, and it's amazing the amount of money you can spend validating one comparable. You may spend three days at $100 an hour validating one comp, but it's money well worth spent if that's the pivotal comp on the opposition's case or the pivotal comp for your case, and yet it shows up as a half-page of typewritten material, and I'm sure many of you in the legal profession have the same problem of saying gee, I've got one line, no you can't do it, and it's taken you several weeks to arrive at that conclusion from review of cases. The appraiser--give him a break--has the same problem if he is a legitimate appraiser, but he should be able to demonstrate that from his work product as to how he got there. Now, as a result of the need for letters of engagement, we have a couple of them here, which will point out briefly what...this is becoming a very hot topic in the appraisal area. How do we specify the appraisal assignment and direct in terms of what he can do and he can't do? Trustees of pension programs have that problem. Certainly lawyers representing the real estate tax issues, income tax issues, securities issues, and so forth, all have the same problem of defining for the appraiser what he's expected to do, what he is not going to be permitted to do, and controlling his methodology. This has, of course, been old hat on the government's side. The government for years has specified by its Fanny Mae forms, its Freddie Mac forms and so forth, exactly what the appraisal procedure shall be, but today there are more and more constituencies of customers for appraisal services who are beginning to band together and establish a standard letter or engagement. This is a really hot topic in the pension area right at the moment. It is becoming a much more significant area in the securities area at the moment, and certainly desirable in the real estate tax area and the bankruptcy area. Now, we have one exhibit here, page 11, which I have permission to use. Many of these letters of engagement are proprietary. This is one I happened to draft for our own asset management firm, which by the way is a rather interesting departure for a bank. Banks decided they didn't know anything about real estate, which I think is dependable on historical record, and therefore, the trust department set up a separate division, which represents five practitioners, so we have Mike Kelly, who runs Center Company, which is the country's largest operator of shopping centers, Ken Stensby of United, who is a preferred office building developer, Bob Boblet, who's an industrial property specialist, excuse me, Austin Evans, who's from England, originally representing MPEC, which is a major English investment house, and myself, representing the theoretical side, and we are the board of five that buys and sells and operates First Asset Realty for the bank, without interference by the bank. And relative to that, we operate a comingled fund for pension fund clients of the bank, but a new vehicle, which I think is going to have a significant factor for attorneys working with estates is a common unit fund in real estate, in which all you need is a legitimate trust account--whether it's an administrative fund or an estate trust doesn't matter--a legitimate trust account with a trust purpose at the bank, and you are then permitted to buy \$25,000 units in a real estate fund managed by First Asset Realty, and you can withdraw that in any quarter that you wish, so as a result the trust fund officers can now operate in the real estate area, and the investments of that particular fund, the common unit fund, are only in those states in which there is no income tax or the state of Minnesota, so that they do not have to file state income tax reports for every beneficiary in every state in which we own property, and I think it's the first of the common unit funds for real estate for personal trusts, as opposed to pension funds and corporate trusts and so forth, and then we operate segregated accounts as well for state agencies and other agencies which are not allowed to delegate investment responsibility to a comingled type of fund unit. But in that process, we are developing appraisal engagement letters and several of us are reasonably well experienced. We know each appraiser personally before we use them, and one of the things that's been very interesting is those that we've considered often to be topnotch appraisers have been very disappointment and others that are younger and less well known have been much more in tune with contemporary appraisal thought, so that we select the appraisers and monitor them very carefully relative to our operation. But notice in this letter of engagement we're laying on the appraiser a number of responsibilities which he might not otherwise have wanted, and we're indicating we'd like to engage his services, etc., for the fair market value of the legal interests owned by the comingled fund to that end, and before accepting the assignment, the appraiser should consider the following requirements as to definition. Fair market value will be defined as the most probable price which the property would sell for to a knowledgeable buyer on a given date if placed on the market for a reasonable length of time by a well-informed seller. Now, cash to the seller or cash plus debt owed or assumed by the buyer where appropriate; in other words, if it's an assumable mortgage, then it may be sold with the property. That's different; that's not a fair market price because we're expanding it to be including assumable debts. Fee title will be encumbered by leases in place and possibly other covenants. That again is not a fee simple title; it's fee simple encumbered by existing leases. This is an important distinction. There is some suspicion that in many cases pension funds are reporting fee simple title, because that's the assignment they gave their appraiser, but in fact if they were to sell it, they would be selling a title encumbered by the existing leases and they're selling an investment interest, not a fee simple interest. It's a very important distinction, and if the wrong assignment is given the appraiser, deliberately or accidentally, you get an overstatement of value. Now, we want to know both. We want to do know what it would be if it were all rented at the current market rate and how much is leasehold interest, because that tells us really how much upside there is in the property. If the property should be leased at $12.50 a square foot net and it currently has average rents of $9.00, we know what the upside is by the time we recapture the leasehold interests of the tenant, and we also have some idea that we've got a weak tenant with a real leasehold position where we want to go and buy him out. That's the way you create value in property. Third, the appropriate exposure on the market has occurred prior to the date of the sale so that it is the conditions which existed prior to the date of sale that control the value as of the date of sale. Too often you see appraisals that go back to January 1, let's say '83, as the date, but then take the interest rate as they know it now, and that produces a significantly different value, so you have to be sure that you're internally consistent with all of the conditions that prevailed at that time, and that means that you may have to ignore the fact that somebody discovered oil on your land a week after that date and so forth. Buyer motivation is profiled as an assumption by the appraiser. In other words, he has to say, o.k., this property would be bought by an institutional tax exempt investor, or this property would be bought by a redeveloper who is interested in converting it to such and such a use and taking advantage of the tax investment credit for older commercial property, or this property would be purchased by a syndicator for conversion to syndication, or this property is likely to be bought by a condominium converter because it has the following characteristics, etc., etc., etc., which are preferred by that kind of buyer. So you have to be very, very careful how you segment your market relative to the buyer motivation and that has to be spelled out, rather than a big, airy wave of the hand that says the market would do this. We don't accept that they would do this anymore. Fee title may be encumbered by leases, mortgages, as well as conditional use permits and private covenants. This conditional use permit is a real clinker. Would you be permitted to do that again? Would you get that kind of license? For example, some states the property sells with the bar licenses; in other cases, the business gets the bar license, but it's not attributable to the real estate. You have to determine, you know, what comes with it. For example, a case in Missouri, a corporation had decided to go into recreational real estate at some point because that's what its corporate president wanted to do. They were extremely politically adroit, and for 3,000 acres of land, they eventually got a federally subsidized sewer plant from the adjacent township with a lateral run to their property, they got a permit to create a manmade impounded lake of some 25-30 acres, and they apparently had negotiated on and off ramps to Interstate 70 falling right onto their property. That particular president then retired, and the rest of the board looked at what he was doing, and said what are we doing in the recreational business in Missouri. It has nothing to do with our product line. Let's get rid of it, and they said let's sell it, and so somebody says let's get a fair market value appraisal, which they did. And with that, the State of Missouri said we'll buy it at fair market value. Now, fair market value was horrendously less than they had in it. But then you had to look at it and see what they did. Well, they had gotten fee simple title, that's true; but that's not what they were selling. All of their permits were assignable. The State wanted the on-off ramp because they owned the park land to the north of the interstate. The State wanted the lake because their park didn't have any water resources, and in order to have a lake, you had to have sewer because the ground has no percolation characteristics at all and you would have polluted the lake if you had had septic in the area, and so they were really selling a piece of ground with entitlements. It's not fee simple title that you get today; it's fee simple title plus entitlements. And if the appraisal assignment had been addressed correctly, those entitlements become part of the bundle of rights, if you will, which they are appraising in the process. Now, the instruments and other encumberances and relate to them appropriately, and goes on to suggest that they read them. I can't believe the number of designated appraisers who haven't read the leases. For example, in a case out in Seattle not too many years ago, we were brought in all the way from Madison for reasons I'm not quite sure of, other than we did a lot of work for Seefirst(?), and in that particular case, you had an emiment domain taking place, the City was acquiring downtown property, and they had arrived at a particular value, which they then allocated between the owner of the land, the owner of the building, and the tenant in the building. But when you read the leases, the owner of the land was entitled to condemnation awards only during the first 25 years of his lease, and his participation in the award declined by 4% annually of the value assigned to the building in the eminent domain proceeding. The tenant had a clause in his lease which said after five years he wasn't entitled to any reimbursement out of eminent domain proceedings at all for the tenant improvements. As a result, the total award went to the landowner, which fortunately, was held in trust by Seefirst. But nobody had bothered to read the leases, for Pete's sakes. You've got to start there, and it's unfortunate when you've got to put it in a letter of engagement to a professional, but you'll find that they don't read it. In another case, in a partnership dissolution in which we were involved, again we were brought in from out of town--kind of the hired gun, wearing the black hat, riding the black horse. And the appraiser for the other side called and said are you going to read all the leases; then I've got to do that. I assured him I was going to read all the leases and that it was in his professional self-interest that he did likewise. But he hadn't bidded that way because the attorney on the other side didn't want to pay much for the appraisal. It was a divorce action, and gee, we want to keep expenses down and save as much for the kids as possible; you know, the whole routine. Well, the way you save as much for the kids as possible is get a good appraisal in the first place. Now, I see it's lunch time and I see that the program has allowed you exactly 60 minutes, which I wish you a lot of luck here at the hotel in doing lunch in 60 minutes, but I will return at 1:00. If you have questions which you would like us to address specifically, please hand them in on a piece of paper, and I will reserve some editorial options and use those immediately after, at 1:00, and answer those questions before proceeding further.

Might have, and we have one here which I think is on point. A gentleman is inquiring as to how do you use the contemporary approach in states which, by statute in tax appeal and condemnation require use of the three traditional methods to arrive at value. This is a tricky question for a couple of reasons. One, I do, and two, I'm not sure I want attorneys across the country to know how I do it, in that I may meet you one day on the other side of the table. But first of all, the contemporary approach can be contemporary in terms of technique, and cloaked in terms of format and language in the traditional manner. Fair market value, whether it's contemporary or traditional, is still defined as defined by the law. Where the contemporary part would come in is in how you do that. For example, in looking at the market comparison approach, I would probably not be caught dead saying this is 5% better than this or 10% down for that and so forth. We would probably use a point system, such as we're going to look at in just a few minutes. We might use statistical inference. We'll probably use set theory. We have used very extensively something called

Euclidian(?) distance, which is a way of ranking the degree of comparability of property, given multiple attributes, in which we have whole assessment systems operating and in which the federal government is making extensive use of in the acquisition of the Everglades areas in Southeastern Florida, in the acquisition of border lands, wilderness lands, and so forth; in fact, we're using it in Alaska for the valuation of native lands for part of the asset valuation for the land reform that's going on in Alaska, and therefore, contemporary may be a format where we go from alternative courses of action to the most probable use, the most probable buyer, and so on, and that's quite consistent with conventional theory. The most probable use, as defined in the terminology handbook, is quite compatible with the contemporary approach. We can talk about doing the income approach, when in fact we're doing simulation, and we can, under the canons of appraisal today, write off the cost approach as inappropriate where we're talking about a building that is obsolete, no longer the best use of the side, and/or economically obsolete in terms of its location, and do that perfectly legitimately within the traditional approach, so that what happens is we use the traditional format and use contemporary methods, and as a result, we meet the letter of the law in those three states, but do introduce what we feel are better techniques, which eliminate the potentially inherent bias in traditional methods when they're misapplied. So we just change the language. I would much prefer, of course, if you're dealing with a pension fund, where I'm concerned with estimating what's the most probable price at which this asset would sell at a given date and stay with the contemporary terminolog but it's not necessary. I can stay within whatever the logic framework is. I think the important point to realize is that the logic system is determined by those first couple pages in your appraisal which you never read. The definition of value is an editorial constraint on everything that can follow therefrom, and the definition of best use is an editorial constraint on everything which is a legitimate consideration thereafter. Even the date is an editorial constraint on what is legitimate data thereafter, and so that as you move through that process, you are limiting the range of choices which the appraiser really has in valuing that property. Once you understand what logic system is for a particular point, whether it's the real estate tax value, in which you have to be very careful to be looking only at the real estate and not at a variety of peripheral business and personal property interests that are typically viewed as integral with the real estate; or whether you're looking at investment value from a particular viewpoint. Each one of those is a logic system which has to be defined at the outset and then simply pursued through consistently and rigorously in the process, and as soon as you fail to do that, you start to manipulate the values. I think that answers your question as to contemporary appraisal. I'm on page 14 of my notes, exhibit 5. I've introduced what the chartered surveyors are using--that's the Royal Institute of Chartered Surveyors, or RICS, guidance notes--simply because this is the precourser to a very similar set of guidance notes in the U.S., and as we mentioned earlier this morning, somewhere in 1985 or perhaps no later than 1986, the appraisers and the accountants are going to arrive at a similar set of notes to counteract, if you will, the emergence of engagement letters that are espoused by particular groups. I'm sure that the pension asset managers will, within the year, espouse a standard letter of engagement, in hopes that they can improve the comparability of appraised values in one investment fund with the appraised values in another investment fund, so that you can begin to get some horizontal comparisons of performance and potential of that particular set of alternative investments, and the FASB is currently attempting to adapt, if you will, the European standards to the American scene as part of a proposal that will come out later this year. So, that's the financial accounting standards for FASB. And they will resemble, to the degree applicable to American business, these conditions of engagements from RICS, and they have made explit a number of the choices that you really have to make in doing the appraisal. First of all, counsel is advised, and you will notice at the very bottom of the page, that the appraisal report must state the purpose of the valuation. It's not sufficient to say the purpose is to do fair market value. The initial purpose is to say this is to be a benchmark in a real estate tax dispute relative to such and such a property, as of such and such a day, or this is to be used for a prospectus prepared for sale of limited partnership units on such and such a date and so forth. So traditional appraisal language distinguishes the function which is the issue for which the appraisal will be used as a benchmark from the purpose. The purpose has always been to estimate fair market value, and they then go through and define fair market value, which is a little bit like by graduate students, who, they don't know what the question was on the comprehensive, but they said if by that you mean, they redefine the question to what they're prepared to write on, and then they gush, and the appraisal profession for years has been Little Johnny One Note. We don't know what the issue is, but here's what we're prepared to give you. That no longer, I don't believe, is a professional exercise, but I think you have to recognize that fair

market value definition and the definition of which property rights are included in the appraisal, and so on, very much are a function of the issue for which the appraisal is sought, and that you have to be very careful that in dissecting the rights, the dates, the conditions and limiting constraints which are appropriate to focus the appraisal on the issue at hand, and now, that means any qualification to which the property then is subject, or the report is subject, and those qualifications can be of various kinds. One may be relative to the use to which the property can be put, you may be valuating on existing use or potential use, or you may be valuating it from a standpoint of liquidation. We'll look at that in a moment, in that the accountants in the U.S. have been very explicit about that. Are we interested in an accounting system which is concerned with exit values, as they say, or values as business goes forward in the normal course of operation, or are we interested in perhaps the resale value of the securities, and so on. And finally any set of caveats that might be placed on the use of the appraisal have to be agreed on up front. So, as a result, there should be a letter of engagement which defines the area of responsibility for the appraiser and any hold harmless clauses that he wishes to incorporate, and that letter of engagement then is reincorporated into the appraisal report, either in the letter of transmittal specifially or in some page or two of limiting conditions relative to the report.
A number of the traditional clauses are identified in 1.3 there on page 14, a clause indicating that valuation is not a structural survey. Up to a point, that may be appropriate, but then you don't have a very useful piece of property if you have a structural problem. Our investment fund has found it more appropriate to do our engineering survey of the building first and then provide that to the appraiser, rather than

doing them separately in a vacuum, since they're obviously interrelated and by allowing the appraiser to make some interpretation of any significant flaws that might be found, and if the appraiser wishes, come back with some sense of what cost of cure is by asking the engineer to do that. The latent defects clause. The latent defects clause at the moment is an extremely broad concept, but as we pointed out beforehand, a number of techniques are coming to light which fairly cheaply will tell you what those defects are in certain areas, thermography being a major tool, relatively inexpensive, say $5,500 to look at 100,000 square foot industrial roof, and yet to be wrong on that industrial roof is going to cost you $4 to $5 a square foot. That's a $500,000 potential risk against a $5,500 professional fee to discover what the situation really is. We suspect that the latent defects clause is going to be modified and that there are certain latent defects which can be reasonably and economically discovered if you make the effort and others which continue to be truly latent. The other element that latent defects has to be qualified on is, for example, where you're doing FHA kinds of properties. When the property is sold, the reserve which has been accumulated for short-lived items and the escrows which were created at the outset to cover latent defects go with the property, and therefore, would tend to offset that, and quite often the market comparisons that appraisers make fail to recognize the fact that the prices which they are taking from the marketplace included purchase of these reserves, which in many cases they are quite substantial, and so there's a real estate plus a cash factor there, and the cash factor may neutralize the latent defect, which, if that isn't brought out somewhere in the report, tends to overstate the problem. A clause relating to high aluminous cement concrete and other deleterious materials. That's a stinker, and creates some very real problems because at some point they begin to operate on the marketplace. For example, right now we're doing some appraisals of railyards in which there were roundhouses and so forth. We have reason to believe that over the years the railroad sort of just dumped everything out of their locomotive repair thing and that we've got PCBs and we've got asphalts and a whole variety of other things into the ground and that any development of that land is going to require somebody to come in and excavate and remove those PCB materials and so forth. The railroad, of course, would like to give a quit claim deed and say here it is, baby, take it and run; and if you do that, you've got real problems, and so a split spoon test, for example, with chemical analysis, as well as, you know, the traditional soil study for those kinds of industrial land is really appropriate because you can get some very interesting environmental liability problems with those kinds of lands... Is permitted to simply overlook that and say well, you know, if the lands didn't have any problems that this would be the case. A clause excluding liability of third parties and other principals ________________________that's the malpractice laws in England, that's not relevant to here at the moment. A restriction on publication clause. The restriction on publication clause is a really messy one, and you have to watch that. For example, our firm would require that you could not publish our appraisal in a securities prospectus, unless our firm gets to approve the language in the prospectus. In other words, it's silly to do an appraisal for a syndicator and then say that he can't publish it. That's just sticking your head in the sand, and then using that as your hold harmless clause. Instead, what you really have to say is what he does to interpret what you put in your report, and that's what you really want control of, and finally, general assumptions as to title. Title is a marvelous problem today. I'm not sure what the appraiser is trying to protect himself against. You can have title insurance and the exclusions on the title make it virtually worthless. On the other hand, I've seen title insurance issued which was issued to decease(?) existing debt. A classic case here in Chicago of a gentleman who bought an apartment building...a major apartment building, financed by an FHA 5-3/4% loan sometime back in the past, owned by a Mutual Savings Bank on the East Coast, and when the developer asked to pay off the loan, they insisted on a prepayment penalty of 5%, which was in the contract. He said you got to be out of your gourd, you ought to pay me to pay off your loan, which is at 5-1/2%, and they decided to stand pat on their penalty fee, in which case he simply went to the title company here in Chicago, deposited the amount of money necessary to pay off the loan under its scheduled payment plan, with 17 years left to run, something like that, and they wrote the title insurance policy as though the mortgage didn't exist, because it had been deceased(?) by the deposit, Now, what does an appraiser do about that sort of thing. Well, the general assumptions have to title, I think the appraiser ought to get in writing from his client. In other cases, title is not the real issue; it's entitlement that's the real issue. What set of entitlements are you going to presume for the appraisal? Are permits to build a dam transferrable? Are permits to get access to the immediate highway going by; or the width of the driveway aprons locked in; or building permits for a certain number of units on the site locked in? You really should add a second category, and not worry so much about title as you worry about entitlement, and the entitlements that are vested in the property become the critical source of value of that property in the future. Now, the next area of concern is spelled out in the relationship between the client, the chartered surveyor. We're not going to arrange all of that, but it's important that you begin to get some definition of the interest to be valued and what covenants and so forth is to be restricted to. They go on to confidentiality, valuation fees, conditions of engagement, and as I say, I include those because the letters of engagement or conditions of engagement are going to become a very important and significant part of the relationship with the appraiser and are going to control him relative to his professional society and control him relative to those that are involved in the case. We'll come to that in just a moment when we start to look at problems of matching the appraisal to whether it's a fiscal equity problem or a validation item or a benchmark item. Now, I'm on page 24 of our notes, which is where I intended to be by this time of the day. Typically, lawyers do a better job of cross-examination if they would understand the basic definitions a little bit. The definition of highest and best use requires that the appraiser demonstrate, rather than simply assert, or prove by assertion, that, one, what he is proposing on that piece of land is physically feasible, and that requires, you know, some effort on his part. Physically feasible may have to do with the soils, it may have to do with the building envelope that is permissible, it may have to do with a number of physical clarifications as to where you can get on and off the site, whether there is enough driveway space to handle the traffic volume, and so on, and it's the first point of attack. I remember one of the very first cases I handled for a highway department in Northern Wisconsin that the economic base of Northern Wisconsin became defrauding the Federal Highway Department while building the interstate, and in one case, they were taking a piece of property, in which the owner was asserting through his appraiser that it had almost become, if it hadn't been for the highway, a very high income area in LaCrosse and that this super residential site was decimated by the arrival of the interstate, and there were only two problems. We simply went to the Soil Conservation Service, and they said that the soil type there was...I'm trying to think of the name of it. Well, anyway, it had a percolation that was less than the concrete that the highway department was going to put on it, about .001 inches per hour, and therefore, a septic tank would never be permitted on that site. He had based all of his premises on the spetic tank. We then got the City Planning Department in LaCrosse to testify that there was no sewer slated for that sector of the county because nobody wanted to live on that side of town either, and at that point, all the rest of his appraisal fails. They argued that, as an appraiser, I wasn't an expert on soils. I argued that the Soil Conservation Service in the courthouse was as publically accessible as the Register of Deeds and that we had simply asked them about the suitability and that that is where our opinion came from, and therefore, you are on constructed notice as to what the potentials of those are, and the Wisconsin courts agreed that the Soil Conservation Service is constructive notice as to the sewerability of soils for the purposes presumed or alleged by the buyer. The legal political acceptability is another major issue. The black letter law is one thing, but the political reality of realizing that has become a very significant dimension. There are two aspects to that. One, of course, is how the politicians will in fact interpret the law as it applies to a particular piece of property, and second of all is the larger collective issue of how the community views development of that area, and more and more, you have to be able to establish that in fact the property is not negative to the interests of the community. For example, a community that has on its books, you know, a zoning area for trailer parks. On the other hand, the physical reality of the trailer courts are that you get a very low tax base per individual, and therefore, they find that the trailer park is a fiscal deficit for the community which takes on the residents without the tax base. In the old days, for a small town, you couldn't have gotten a trailer park approved on the land, even if it was zoned appropriately. Their life depended on it. It was simply the political reality--they couldn't afford the negative fiscal flow that resulted. Now, in Wisconsin, we've changed the law so that your entitlement to state funds is a function of the residents per thousand dollars of the tax assessment, and one thing which can actually increase tax flow to a community, particularly a small community, is allowing a trailer court, because you get a very low increase in tax base, a high increase in residents, and the number of dollars of assessible ratable base that you have residents declines, and you get a larger share of the state income tax refund, so that the probabilities of different land uses are more likely to be controlled by fiscal zoning than they are by land planning zoning, and the appraiser has some responsibility in dealing with possible alternative future uses of the property to demonstrate why it's in the community's self-interest to permit that kind of land use, regardless as to what their codes might nominally permit. Third, the appraiser must prove effective demand; that no only would it be nice to have that, but there are people who can afford that, and more appraisals, particularly in eminent domain actions, fail for a failure to demonstrate effective demand for space in terms of an absorption rate at a price for a certain amenity package than virtually any other. Fourth, the definition requires that you show that it's a financially viable plan. It's not enough that it's technically feasible and that people would like it; the next problem is can you build it at a price they can afford to pay, and what is financially viable differs, obviously, with the cycle of the interest rates, and it's getting more and more difficult to make that call, given the volatility of financing available for real estate developments today. Finally, and this is part of the definition of best use now in all the textbooks. The use must be compatible with the community goals, environment, and fiscal self-interest, and that puts a significant constraint on the degree to which the appraiser is allowed to let his fantasy as to future uses move around. Now, many appraisers specify the problem is limited to justification of the existing use, and that's extremely dangerous in some cases. On the other hand, it would be required in others. For example, in tax assessment you arguee the existing use, rather than the potential use, because the potential use is not a vested interest, or you argue the resale value of the vacant land as it stands with whatever risks are inherent in getting the appropriate zoning and so forth appropriately recognized in the choice of comparables; or you can value it on the anticipation of the next use, and you can also distinguish the sale from a sale in the ordinary course of business from a foresale. For example, here are some cases recently that we have dealt with in terms of the real critical issue being best use. In the first case, involving a new apartment project, the land had been originally owned as a coalyard and pipe storage area by a utility, an electric utility, who had it zoned M-1 industrial, and then gave the land as part of the funding of their company pension, and after some years, were able to sell it to a developer, who then changed the zoning to apartment zoning and built a major apartment building, which was syndicated. In the process of building the apartment building, it was necessary to do about $300,000 worth of soils work, because the site is marshy and would not sustain a three-story brick apartment building without going into a very elaborate compaction process. The utility had taken credit for about 55¢ a square foot on the land at the time they had transferred it to their pension plan, and following the sale to the developer, who then changed the zoning to residential, the Internal Revenue Service challenged the initial deduction, and said that given the number of apartments that had been built and so forth and so on, the land was worth about 18¢ a square foot, rather than 55¢ a square foot, and as a result obviously wanted a tax refund. The __________ part was that they got a cheap appraisal to begin with to justify the transfer...one of those $200 specials, which was later followed, by the way, by the same appraiser coming in as a broker about three months later and offering to buy it at his appraised value. But in any event, they finally are now in deep water, and so we did the appraisal for them. Well, when you went back and searched the records, you found out it was zoned M-1 because the soils were considered so bad by the Planning Department that it would only support a light steel industrial building on a floating foundation, and the tapes of the Planning Commission meetings in which that zoning was available had been saved, and they were available as evidence to why it was zoned M-1. There were a lot of sales of M-1 land in the area at 60-65¢ a square foot. Now, by the same token, the developer zoned it down because he wanted to build residential for syndication, and the city was perfectly happy to have him do that. There was a park across the river from this particular piece of land. If he wanted to pay for the foundations, that was his problem, and he did pay for the foundation, and he had an overrun on the syndication, and he had a second mortgage back to the general partner. Now the Internal Revenue Service comes in, and their appraiser is a retread appraiser from FHA, who sees an apartment building on the land and immediately lights up and presumes that what exists is best use. It was not best use. If the land had been left as M-1, it could have sold for 55¢ a square foot. Therefore, the fact that there was building already on it, as an apartment building, did not in fact determine best use. We were able to go back and dig out the Planning Commission tapes and records, we were able show that there were other sales in the area for industrial land, but that at the time that had been sold in '73 or so that there was in fact no further industrial expansion going on in that immediate area, but nevertheless, given the soils, given the physical characteristics, given the fact that a rail line existed on the land when it was sold, it could have been industrial park use, and it would have sold for a higher use. However, the profit center for the purchaser was in syndication, and so he proceeded to do that which he thought would syndicate best, and that doesn't necessarily demonstrate the economic use of the site. So the fact that the site is developed in a certain way and the existing use does not necessarily control what was best use at the time that was put on. Go back and dig out the initial set of assumptions. The second one that we mentioned was scenic quality versus timber. We've done a number of those types of things, and we've been able to establish an objective measure of scenic quality. In fact, in that particular case where the Forst Service was on the other side, we used nothing but Forest Service techniques, one of which is called visitor evaluation photography, in which you hand out cameras to the hikers and you ask them to take pictures of that which contributes most to their scenic and aesthetic enjoyment of the area, and we then rated those for the physical presence of 59 different physical factors that were ascertainable from aerial photography--rock form, land form, water form, and vegetative cover, and we evaluated some 3,000 photographs and established a very clear physical correlation between the diversity of physical factors and the score given by the hikers. That was done first on the St. Croix by Ben Nieman out of our landscape architecture department. We used that in the Cascades and we have now used it in several other areas, and the visitory evaluation photography allows you to move into an area which, in the past, really was out of bounds for the attorneys, i.e., aesthetics, and we believe now if we can find the right case that we can do the same thing using visitor evaluation photography to evaluate the aesthetics of physical structures and the damage done to an area by the infusion of a building which is non-compatible, or conversely, the increment in value attributable to the aesthetics of a particular set of structures. In any event, having defined what scenic quality was in an objective way and being able to rank scenic quality, we were then able to pick comparables that were purchased for scenic quality, based on their degree of comparability, and I won't go into Eclidian distance at the moment, but it will stand up. It's a very rigorous technique, and eliminates much of the subjectivity of the market comparison method. We have a number of tax assessment systems running on it as well that will pick the five best comps out of 200 sales to a subject property, make the adjustments on it, arrive at the weighted mean adjusted price for that property, and make it stick. A third case, the argument in this case was that the property was worthless because they had drilled hell out of it looking for minerals and hard metals and found nothing, and therefore, they thought the property could be regarded as worthless. In fact, it's unique as an energy farm(?). It's a mountain pass and it has since leased at approximately $500 an acre per year for a wind farm generating energy. Another one that we found in the back of the Cascades couldn't understand why a little piece of ground out there was selling for $2,000 an acre, absolutely barren. It might have looked like it was in the moon, until we settled down on the ground in our helicopter and found a little building in the stream of the Pelton waterwheel producing electricity, which was being sold to the local utility under the 1978 Energy Act, and the present value of that was worth $2,000 an acre. So much for your location, location, and location theory of real estate. Looking at other best use issues, let's take a look at how we might handle one in a simple local appraisal relative to a flophouse, and Exhibit 7, will give you an example of that. Here we have an old hotel building. It had had a history of being transient male housing with a somewhat questionable saloon on the first floor and it had a fire and at that point was not permitted residential occupancy, but the bar had continued to operate, and we're asked to appraise that building, and in order to look at a building which is now in the transitional phase, as it were, in its history, we have to really look at alternative courses of action and say, alright, one is to return it to its former use. Another is to modify that former use. A third is to convert it to office. A fourth is to convert it to apartments with an office on the first floor, and the fifth is to convert it to apartments with the bar remaining on the first floor, since the bar had a lease, which gave it a leasehold advantage, and the last scenario was to demolish the building and start over with vacant structure. The appraiser has to examine these alternative courses of action and demonstrate that he has done that. We now have to look at some of the critical factors of feasibility. The first element was market demand. There was a tremendous demand for transient male housing, and if you had made some minor repairs to the building, you could have returned it to that use. The demand was actually being subsidized by welfare agencies in the community, who really had no place to go with those kinds of cases. However, if we look at the legal political aspects of that, it was inconsistent with what the City Planning Department had announced for redevelopment of the area, and the Fire Department and the Police Department's interest in breaking up essentially what was sort of a Bowery area, and therefore, the city was not in favor of returning it to its former use, even though there was an effective demand for it. From a technical standpoint, there was very little construction risk at all. What was needed to regain an occupancy permit was defined, the costs were known, and so forth. If you did a residual value on that, you got the highest value of all for the building--about $192,000. We'll look at what we call back-dooring to determine that residual value in a very short form in a moment. There was no real income tax advantage for doing that, and there was no great fiscal real estate tax advantage to the city for doing that. Alternative number 2 would be to have a welfare agency take over and restore the building and run it for welfare purposes. The welfare agencies themselves were the principal customer via vouchers for the building, and the only problem was none of the available welfare agencies had the power or the capital budget to acquire it. There would have been mixed acceptability in city quarters. The alderpersons--half of them would have been in favor of that; the other half, who obviously related best to the downtown area, were not, and that produced a somewhat lower market value or cash value for the building. There would have been no income tax advantages to a non-profit, and the city would have lost whatever the current ratable base was on the building. On the other hand, if we began to look at a conversion to a class A-B-C office, there was almost no demand. It didn't have the parking necessary to support it, and so that zeroed out almost immediately. If you looked at conversion to apartments with an office on the first floor, there was strong demand for the apartments, for two bedroom apartments within the CVD area. The city preferred that solution to the others. There was significant tax advantage to those who did it. There was fiscal advantage to those who did it for the city. But notice the value of $103,000 was the third highest of the alternative residual values. If you looked at only that which would produce the highest price to the owner, you would have chosen option 1, but if failed to meet the test of best use and feasible use on the other counts. If we looked at it with a bar in it, the bar tended to destroy the attractiveness of the apartments, except for those who wanted something just a short crawl home, and we end up with a negative residual value, and if we then demolish the site, the site per se, which wasn't in any great shape, was relatively low value in site. So as a result of the analysis, which is summarized in capsule form, the determination was that best use was redevelopment into a two-bedroom apartment building with some innocuous commercial use on the first floor, presumably office, but as it turned out, restaurant; and that becomes then a recap on one page of how did the appraiser get to his best use assignment. It's no longer legitimate simply to write that away on the first page in a single line that says the highest and best use of this property is for redevelopment as an apartment building. The appraiser is expected to show why that fits the context that he is expected to touch on in terms of physical capacity, effective demand, financial viability, and political compatibility of the property. O.K. Now, when we're looking at the best use, the question is, of course, best use of what. Best use of the land with or without entitlements, best use of the land with current improvements or not, and how much of that is real estate, and how much of that is relevant to the decision that I'm making. If we're looking at a hotel for mortgage lending purposes, typically that's structured so that all of the elements, including the furnishings, the book of business, the franchise, the entire set-up, is pledged as collateral to the loan, and additional loans are subordinated, with an after required property clause to the first mortgage, and therefore, it's appropriate to look at the hotel in terms of all of its cash income after real estate taxes being available for debt service to the exclusion of other interests. However, looking at it from a real estate tax standpoint, it's entirely different issue. None of those things are in fact real estate, and therefore, all of them have to have the income attributable to them removed. So you start out with the total income stream and then take out that portion of income attributable from the furnishings, that portion of income attributable to management and advertising, that portion of income attributable to the franchise that says Holiday Inn on the door, and so forth, and get it down to real estate, and most people don't do that, but they should. Subsidized housing the same way. You arrive at the value using market rents, not you have to have more rents(?? and you arrive at the value using conventional financing, not tax exempt bond financing, or something of that sort, and you get it back down to the real estate, and not to the personalty. If we're looking at a land and shopping center, land and zoning are clearly real estate, the cost of the building shell is clearly real estate, but monopolies that are created by operating agreement are a franchise, an intangible personalty, and therefore have to be pulled out of the percentage rents. In fact, most assessors I think are pretty touchy about using percentage rents as an indication of income from the real estate. Percentage rents are income from superior management. Appraisal assumes average management. Since percentage rents are not a vested interest, but are contingent on performance of the tenants, they can be legitimately excluded from a real estate tax on the income, as long as the base rents that are being paid can be shown to be market rents at the base. Property management fees are personalty. Utility sales, as we mentioned earlier, are business income. Only possibly the distribution system is real estate, and even that may be personalty, just like cable t.v. installations are personalty and not realty. Tenant improvements can be realty or personalty, depending on how the leases are set up and how the bookkeeping is done among the parties. Recently, we had an eminent domain case, in which an industrial building was built for a tenant, but the tenant said that all tenant improvements were his and he could take them with him when he went, and both parties treated it in their accounting accordingly, and so forth; yet most of the tenant improvements are such that they don't travel very well. They are heaving foundation mountings or punch-press machinery, and so forth and so on. The initial award assumed all of that was real estate, when in fact it wasn't, and so you have to go back and reallocate it, as between what is real estate and what is personalty under the intent of the parties. The fact that something's attached to the real estate, the presumption is that it becomes part of the real estate, but the presumption can be rebutted by in fact how people handle it. Another area is distinguishing revenues that are from a business enterprise from that which is in the real estate. For example, looking at a parking ramp, it is what the parking ramp will lease for as a total entity that is real estate income. The income from renting individual parking spaces, minus that base rent for the total ramp, is income to a business. We got into that with one of the big accounting firms here in looking at the Big John next door, in which they have an observation deck floor. The position of one of the parties in that case was that the total revenue from the observation floor was part of gross rents. It's not. It's the base rent that they paid for the floor that's rent. The gross revenues are from selling their recreational business, or whatever you want to call it, and therefore, you look at the wholesale value of the place, not the retail gross from the space. So once you start leasing parking places or selling the ticket to go stand on the umpteenth floor to look into the fog and look for the city and so forth, you're no longer in real estate income, and quite often those kinds of things are not adequately broken out. Income from the reservation service, like a Holiday Inn reservation service, something of that sort, has to be broken out. Bookings assumed for a hotel, and so on, are not part of the value of a hotel, although most hotel prices are reported are sales of a going concern. There is no proper allocation to the individual elements. Entitlements which are point specific are part of the real estate; entitlements which are portable are not. So a franchise from Holiday Inn is portable. Should you break the rules and so forth, they can come down and take their sign off the building and their doilies out of the dining room and go home, and therefore, it is a portable entitlement and it's personalty. Wholesale control versus retail we've talked about. Services customarily inherent in a project would be considered real estate or available alternatively from off-site suppliers. So the building that has basic janitorial services in the corridor, but janitorial services in the office space and so forth, that revenue from janitorial services is not real estate revenue and has to be pulled out of there. The same would be true for electricity sales and so forth and so on. The income tax category may indicate the intent of the parties in terms of how they're handling it as intangible personalty or realty. And fees for arbitraging the conversion are not real estate values. For example, let's assume that a syndicator buys an apartment building, which, if it were to sell as an apartment building investment would, let's say, sell for $25,000 a unit. Instead, the seller takes back paper for $27,500 , which is payable after the syndication is completed. The $2,500 premium is a participation between the seller for a long term, effectively a long term, option to participate in the arbitraging fees of moving from that building as an investment property to a syndication interest and is not necessarily real estate value. The same thing would be true of a condo conversion type thing. In fact, what you have today is a three-tiered market in real estate. You have real estate which sells for utilitarian purposes. It's going to house a business, it's bought by the user, it contributes a certain element to his business. The second kind of real estate is bought because it provides a medium for the sale of your services, a syndicator who wants to get paid for conversion to syndication, condominium converter, the architect who buys land in order to get the architectural commission, and so forth. It provides access to a captive customer for services. The third kind of real estate today is a transaction-and it can be all the same property--in in fact purchased as a commodity. For example, in Madison, we appraised a building fair market value, a relatively new office building at $3.9 million that had a $3.3 million mortgage on it. The developer had gotten himself into trouble because at about the time he decided to build 120,000 square feet of leasable area, so did several other folks, and things went a little slow, and by the time he finally had the building rented, he had not only his first mortgage, but he had a second mortgage and a third mortgage, and in the third mortgage, the developer had signed personally, and therefore, put everybody in his partnership on an at-risk basis, and they had lost the balance of their shelter in the process. At the same time that we won the real estate tax case on what the fair market value of thebuilding was, we turned around and sold it for $7,000,000 to a syndicate of doctors--$700,000 down and $6.3 million to go, interest only, ten year note on a land contract. The developer leased it back to operate the building for this ten years at exactly the same amount as the interest due on the land contract, so that the parties could swap checks periodically, and you then have on one side interest only payments, and on the other side you have a triple net lease payment for the property. This was several years ago before the '81 tax law. Now, what you really got is a classic commodity speculation in square foot of class A office space. The developer has a...excuse me, the buyer, has a call on the property at $7 million ten years from the date of purchase. That works out to about $65 a square foot of GLA, which isn't a bad price for a high rise office building that's very well located and has about 200 parking stalls underneath it, and so on. It probably can't be touched. On the other hand, given the 6.3 he's going to have to carry, if interest rates are at 18%, rents are going to have to be at $25 a square foot, and rents are currently at about 12-1/2, so he's speculating that rents will rise to cover interest costs, or that interest costs will fall to about 9-1/2, whereby he can carry it at the current rate. Now, at the same time, the land contract form in Wisconsin is a strict foreclosure form. If for any reason at the time it matures the interest rate or the rent level don't justify taking down 6.3 million in debt, he simply takes a walk on the contract and puts it back to the seller, who will be only too happy to have it. That's a classic straddle in the commodities market. Now the question is, is it a perfect straddle in the commodities market? Well, the $700,000 downpayment, of course, is recovered out of depreciation, probably about the end of the fifth or sixth year. By the end of the tenth year, the depreciation alone, even if they default on the land contract, will give them a 10% return on their money. Now, that's a whole different market for real estate that never existed before. For the appraiser, it raises hell in terms of what he can do with the market comparison approach to value. Cash equivalency doesn't anticipate those kinds of distortions to the pricing mechanism, and there's probably no really reliable way in which the outside appraiser can convert that sale to a market transaction. Now, notice that what you're really doing at that point is looking at the real estate transaction as a risk management device in which the parties are divvying up the what-if's, and of course, hoping to have the higher probability of variance on the upside than on the downside, but nevertheless, it becomes a financing risk management device, rather than a pricing mechanism in the traditional appraisal set. Now, given those kinds of rules, the definition of market value requires that you define who it is you're selling to, for what purpose, on what financial terms, and whether you're looking at inherent asset value, whether you're looking at the sum of the liabilities because of a bankruptcy reorganization, or whether you're looking at investment value where the property has to be put in the context of its portfolio. In fact, we have a number of situations in which properties sold collectively sell for more than they would have sold for individually. A number of the liquidations of Monumental Life, for example, Dayton Hudson's liquidations of shopping centers, a number of other cases of similar bulk sales of real estate, have shown that if you bundle those up and you take one good shopping center and put it together with one lousy shopping center, they'll both sell for a total higher price than they would have if you sold them individually, just as the retailer puts two good tomatoes and one not so good tomato under cellophane and you take them all or nothing. So it's conceivable that collective sales of real estate will have higher aggregate prices than individual properties within the collection. Now, economic rent has to be again, when you're talking about real estate, adjusted for space, rather than services, and again, appraisers are doing a lousy job of doing that. One other area relative to market value and economic rent is that the market value of real estate, as we mentioned earlier, presumes cash equivalency, but the appraiser is finding more and more difficulty in reducing prices to cash equivalency because that apparently isn't what happens in the marketplace. Theory would tell you that if you had a series of income payments on a land contract to a seller, that if you took the present value of that series of income payments at the interest rate that prevailed at the time of sale, you should get the cash equivalency. Indeed, that's what the IRS is arguing in their new tax law, in which you discount the payment stream to the seller at 120% of the appropriate treasury rate in order to arrive at the inferred real estate value. The problem that leads to is an overstatement of the discount, because what apparently happens in the marketplace is that both parties share that. If you look at what happens in a single-family home sale when somebody buys, let's say, the FHA paper, the premium that's paid for the house is approximately one half the cost of obtaining the FHA or VA assumption, so that if there's, let's say, 8 points due to make it an equivalent market interest transaction, the price of the house goes up about 4 points. Obviously, the seller has an interest in selling the house, and therefore, is willing to pay some of the points of the buyer. The buyer, on the other hand, has an interest in assuming some advantage from the existing mortgage. But more often than not, they tend to split that, so that if you look at a cash equivalent price, it won't work out as theory tells you it should in terms of discounting the paper at the interest rate that was due. Only about half the discount is built into the price, so it's going to be interesting to see how the IRS handles that problem as there's more and more __________ data to support that position. More and more appraisal reports use nominal prices on property as their market comparison price. The argument is that creative financing has become the norm and that, therefore, that meets the test of market value. It does not meet the test of market value. The test is cash to the seller, and there's just no way around that. If you want investment value, then obviously the nominal prices may represent investment value, and it really represents the sum of the investment interest in, which may include first mortgage, second mortgage, limited partner, general partner, and whoever else has their hand in the till, and therefore, the use of nominal price can be very easily attacked. Objectives in appraisal may require different sets of assumptions as to the focus for values and events that are legitimate in appraisals. You look on page 30. This was taken from the hierarchy of accounting perspectives, which define the methodology and an acceptable assumption for financial information reporting, and the first issue is, what's the focus of the report going to be--past, present, or future. Typically and traditionally in real estate you had an entry cost, with actual modification for depreciation or whatever, and you ended up with an historical cost. Relative to the corporate balance sheets, this would be the typical result is the submerged value of the real estate. The real estate doesn't appear, for example, on a real estate equity trust book at what its real value is, because they have taken a past view. What did we pay for it in the past? What has been the entry cost, if you will? What's been the depreciation factor, and we now have an historical record. Obviously, it's significantly misleading when we want to measure current values. Indeed, the whole reason for creating a commingled fund reporting current values on assets was to avoid this problem of submerging the real value of the assets in equity trusts, and it's the submerged value of the equity trust which, of course, has accounted for recent efforts to raid equity trusts which were underpriced in the market. On the other hand, if our focus is present, what would it sell for right now? Now, we have two interesting problems. One is exit value, assuming ordinary liquidation, and the other is exit value, assuming forced liquidation. Why does that make a difference? For example, if we're making a construction loan and it's a million dollar building when it's finished and we're going to spend, let's say, $900,000 building it, and we make a $900,000 loan, but for some reason our investor is intercepted midway in the process, we may have laid out $450,000 from our loan to build the project. But if it were to sell at that particular point in time, uncompleted and with the necessity of finding a new contractor to finish it and so forth, it might only sell for $300,000. So the exit value is not our historical outlay, nor is it the fact that we have completed 45% of our finished project. The exit value at that point is a somewhat disorderly liquidation, is going to leave us $150,000 short, and it may very well be for the purposes of making the contruction loan, or that kind of transaction, that we're interested in forced value. What's the liquidating value? What's it going to take to get out of the project? Indeed, we try to instruct the income lending people that we work with at the Banking Association and the Mortgage Bankers Association, that today when you're making an income property loan with an exculpatory clause that says that the only remedy essentially is for the lender to take back the property, you're really selling the put, and the way you value the loan is what's the salvage point on the deal at any particular point in time, less the legal costs of getting your hands on the property. So, if you think the salvage value halfway through the project is $500,000 and the lawyers are going to get $100,000 getting you title back and getting rid of the borrower and cleaning up that whole affair, then the maximum amount of cash you can have on the outlay at that particular point in time is $400,000, and you, therefore, scale your draws on your loan to match that approach, rather than scaling them on some more, you know, proportionate basis on the completion. On the other hand, if you want exit value assuming completion in the normal course of business, you get a different set of values for the property. Why is that important? Well, we've won a tax case, a real estate tax case, in which we argued that the office building, which the assessor assessed on the cost to replace on the grounds that he didn't have any other basis--the building was vacant--and so he used cost to replace to assess it, which, of course, only increased the rate of bankruptcy of the developer. We argued and said, no, wait a minute. It's an income property investment, we estimate--and I think we had a very good, solid estimate--that it's going to take three years to rent up the building. Therefore, our cash flows look like this--negative for the first two years, and finally turning positive toward the end of the third year, and the value, once it was rented at the end of the third year, would be X. We can treat this as the present value of the income stream, all the way back into the construction phase, in which we say, hey, we still have a year to go to finish completion of construction, and then we have three years to rent it up; and therefore, rather than take cost to replace times 15-20% completed to arrive at the assessment value, we'll take, in fact, the exit value, assuming normal course of completion of an income property back to now, and here is the present value of that negative income stream at that point, which is considerably less, and the Wisconsin courts upheld that, and stated, yes, even during the construction phase, the income approach is an appropriate course of appraisal, where the building has no prospect of income for the immediate future, and where the investment was motivated initially by expectations of income. So once you begin to look at, hey, which value am I interested in here...an orderly liquidation value or immediate liquidation value. The assessor should be interested in immediate liquidation value, because he can't tax a non-vested future interest...at least he's not supposed to. Now, the alternative may be to interest it in future value. For example, if we're going to evaluate a pension fund to the asset manager, his current cash on cash may be low because he's been attempting to position himself to be in a position to capture a leasehold interest and an inflationary rise in rents in a particular property, and therefore, to appraise him entirely on the current income value of the property is unfair, and certainly underestimates the true value of the portfolio. However, to look at the future value of the portfolio, you have to make some kind of hypothetical estimate at the rate of inflation that's going to occur in rents and the succession with which leases will be rolled over without vacancy, and the costs of rolling those over in terms of leasing conditions, tenant improvements, and the like. Now, here's where the English and the American positions differ very significantly. The American future value people...the net present value people...take the hypothetical view, in terms of rate of inflation that's going to be occurring, and they tend to annualize tenant improvements and leasing commissions, which tends to overstate the value of the property. The English tradition is to assume that leases that are renewed in the future will be renewed at today's market rates, thereby flattening the rate of increase in the total rental of the structure, and then they use a capitalization rate which attempts to remove the inflationary factor or loading on the real rate. So you'll hear the European and the English appraisers talking about equated yield. They are dealing with future incomes, but expected based on current data; whereas American appraisers are tending to extrapolate current inflation rates to future rents, as well as current inflation rates to current expenses, and then leveling cash expenditures for tenant improvements and leasing commissions that are occasioned by the rollover in the leases. This distorts the cash flow significantly, so if you have a tenant that represents 40% of the building moving out at the end of the third year, and you then have to have new tenant improvements and leasing commissions to fill that space, you're going to have a tremendous flood of cash going out at the beginning of the fourth year, as you re-lease that space, indeed, perhaps arriving at a zero cash flow, before you go forward to presumably restore the building to a better cash flow position. The American appraisal would tend to overstate the value of that property. The English approach would tend to understate the value of that property, because it doesn't recognize the positioning against inflation that the American investor is subject to. Nevertheless, we suspect, in fact we know, that those who regulate financial institutions, pension funds included, are attempting to make some decisions in defining the specification for appraisal that says o.k., for purposes of a construction loan you will take this view of exit value and you can make these determinations about the collateral value of the property, based on presales or based on some other absorption rate. Whereas, in the pension fund area, for measurement of the adequacy of funding, we will take the expected value, given a rollover of leases at market rate. Whereas, if we want to measure comparative performance of asset managers and make some hypothetical assumptions about inflation rates and so forth, we can then have a second value measuring the value of the portfolio, given a set of assumptions or a scenario, if you will, about the economics of that investment. So notice that we can move into the same area in which accounting will distinguish for different reporting purposes, whether you have a past, present, or future focus, whether the value you're interested in is entry value or exit values, and finally, whether the eventsyou will use as the basis for your assumptions have to be in fact historical and ascertainable from a current situation or can be hypothetical about what will happen in the future, and that's going to considerably complicate the purchase of appraisal services. Any questions on that? That is a subtlety and a sophistication that has crept into the European appraisal process already to a considerable degree, but which is just now beginning to enter the American scene. Yes.

Q: If your assumptions on inflation are the same as the manager, doesn't that simply tend to just verify the manager?

JAG: Sure. But the question is not whether you agree, but whether the regulators of ERISA agree that your sponsor has adequately funded. Obviously, the sponsor has a bias to take the highest rate of inflation possible to get the highest value possible to have as low a gap between the liability for vested benefits and the amount of asset values already in place, right? So ERISA may take the more conservative view that say you can't roll those at anything other than the current rate to measure the adequacy of your funding, and therefore, the inflation that may occur will simply be to the greater security and solvency of a program, as opposed to reducing your current funding requirements

Q: Well, what I'm concerned about is when you're theoretically evaluating your manager using appraisal purposes that end and at some degree the manager has a voice in selecting the appraisal base, does it not? Or is it totally independent?

JAG: Well, that's one of the other interesting issues that's coming up. Right at the moment, he apparently has something to say about that, although some would deny it, but there's been considerable criticism of pension fund operations today where property values seem to be going up in a straight line. It's the only financial instrument in the United States which doesn't have any volatility to it at all, as you look at Chris'(?) line or the others until a year or so ago, it went up in a straight line. O.K. You can only do that by having not easily smoothed your appraisals to some degree, and now they're beginning to take another look at that and saying, hey, what can we do about those appraisals? How responsive and sensitive should the appraised values be? O.K. And should we use the same values that they're using for touting their performance as the basis for determining the funding by the sponsor? Right? Those are not the same numbers, and the same appraisal shouldn't be expected to serve each well. O.K. Now, the broader area of technique or the narrower area of technique, if you'd like to talk about the trends in the three approaches to value. The market comparison approach to value has always been the darling of the courts. It's always presumed to be the most objective,and conventional wisdom tells us that the value of the thing is the price it will bring, and therefore, there is considerable preference in the courts for the market approach, and secondly for the cost approach because presumably that too is objective, and lastly to the income approach which they regard as highly vulnerable to manipulation by assumption, and the irony, of course, is that the market approach and the cost approach are the most highly subjective, manipulative methods around, and that there's probably more data to support this kind of cash flow on income properties than any other single method. The trisk is to get the judges to realize that, and the trick is further, of course, to be able to communicate that effectively to a jury of one's peers. Now, there are two major trends appearing in the market approach. First of all, there's considerable improvement in quantitative methods for screening the similarity of comparables and for adjusting for the differences. However, there are a number of pitfalls in that, as we'll look at in a moment . There is much less reliability, however, in that the terms of reported nominal sales prices than ever before. Creative financing is one factor. Creative accounting for depreciation purposes, and so forth, is another, and creating marketing of property is a third. And so you really have to begin to look at that. For example, looking at tract home sales, everybody says there's nothing to appraising a house. Single family homes are some of the toughest things around to appraise, either because of the irrationality of markets or because of temporary shortfalls in supply, and so on. But in any event, the single family home sold in a tract area almost always sells for a premium, while the marketing capabilities of the developer are being brought to bear. Once those model homes and weekend hype are removed, the guy who wants to sell his house the next time around out of that, his corporation is relocating him and so forth, will find a considerable drop in value from the price that he paid for it, and it may be several years--it may be many years--before the tracts reach a normal sales price equal to the price that the individual is paying for them in the first place, particularly where you had buy-downs by the developer on the financing, where you had a variety of other benefits built into the price of construction, but that's also true, of course, of the major income properties which are being continually manipulated for a variety of reasons. So, getting good, clean sales data to do a market comparison appraisal is no mean trick. But assuming you can get that, there are some very interesting elements to the quantitative methods of manipulating it. The first element that you have to look at very, very carefully today is the definition of the unit of comparison. It is possible...first of all, I think you have to appreciate, many people think real estate is statistics, and it's not. Real estate market comparison is set theory. You're much more interested in a small cluster of 5 or 6 sales, maybe less, 3 sales, which are most like each other and most unlike everything else. That's set theory. So you're not dealing in statistics. You're dealing in parameters. Second of all, you want those parameters which are most correlated to price, and unbelievable as it may seem, you can explain most of the variants between one property price and another property price by one or two key variables. For example, looking at a single family home, I can explain 75% of the difference between one home and another by the amount of living area enclosed and heated in that home. The other 25% of the variance is all the other differences in the house. If I select correctly the right unit of comparison, I will have explained anywhere from 65% to 80% of the variance in the various properties in my set, and everything I'm doing in market comparison after that is to explain the residual error. That's a very difficult concept to comprehend, but it is true. Once I've figured out--as we talked about this morning--that people were buying barrels of production of cranberries, I could explain 90% of the difference between the sale price of one cranberry bog and the other by simply knowing the five years' production history of cranberries from that bog. The other had very minor differences in terms of the varietal of the cranberry buying and the degree to which the owners were selling the vines rather than the berries. There were also some minor differences on how the water features were controlled and how the harvesting water flows were controlled, but that had to do with 10% of the pricing of the product. Ninety percent could be simply explained by barrels of production. For example, looking at, we have buildings. The first thing I do is having first of all cleaned up the prices and made sure that I filtered out of it any distortions due to cash equivalencies, bargaining position, and so forth, and so

I now say what are all the different ways of measuring how much space time I got for my money. And so looking at--this is a current project that we're on; it's a major department store--we said, o.k., let's look at the six sales that I've got that have to do with buildings bought for commercial redevelopment within let's say a four block area of the subject property. I said, well, one thing I can look at is gross building area; another thing I can look at is front footage on the main street, because they're all on the same avenue; another thing I could look at is cubage; another think I could look at is first floor area; or I could do some transformations and take first floor area times frontage because I think, you know, maybe people want to be closer to the street and less depth, you know, the old depth table syndrome and so forth. Now, I take those elements and I run them against price in a simple linear regression in my little IBM PC, and instantly it comes back and says o.k., first floor area has a correlation with price of about 30%. Gross building area has a correlation of price--this is the R squared factor--of about 84%. But cubage has a correlation with gross price of 94%. You've got to say to yourself, hey, self, developers seem to be able to explain what they're doing more with cubage than the other factors. So, I'll tell you what I'm going to do. I'm going to make my unit of comparison cubage for the moment, and that's how I select a unit of comparison. I don't go with the conventional thought that, hey, retail space goes on front foot and office space goes on square foot and so forth, because these buildings have all kinds of different kinds of things going on inside. Some of them were really high floor retail spaces; some of them had movie theaters in, as well as office space, etc. But developers were buying space time in a reasonably consistent fashion. Now, sure, I only got six in my set and I've got one variable, you know, so my degree of freedom isn't spectacular. I'm not going to go into court and argue that I can value the building on linear regression. I'll probably get killed. For one thing, juries don't understand it, and another thing it seems kind of black boxy. But I can go in and defend my unit of choice of comparison, because I can show a really tight distribution, and ultimately the market comparison approach is driving toward reducing the differences or explaining the differences between one comparable property and the subject and another comparable property and the subject. So far so good? So now I've got a unit of comparison. My next problem is, alright, how do I begin to look at the property in terms of differences without presupposing what the financial impact of that is in isolation. So often you see the developer say--or the appraiser say--well, this neighborhood is 5% better than that one, and you say, well, how did you get 5%, and he says, well, I've been going to Rotarian lunches for 20 years, and I've been in the brokerage business and my credit rating's good, and I just think that's the way it is, and that's my professional opinion. There's nothing wrong with his professional opinion; that's dealing in beauty as we described it today--intuition. But it doesn't necessarily sail well as an objective element. So, what I'm really looking for is some methodology where I can go back in and assign some sort of better than, worse than, or equal to kind of element to it, and then take that ordinal thing and convert it to some kind of cardinal ranking of degree of similarity or non-similarity, without having to make a direct transformation on each attribute or amenity relative to the subject property. One way of doing that is with a point system, that you will see in just a moment in Exhibit 9. One other thing I want to...well, I'll come back to multiple progression in a minute. Let's take a look at Exhibit 9, and then we'll take a quick break for coffee. This is a little office building in Madison, and take a look at the righthand scale first. Over and beyond gross building area, which is the only number we had that was reliable and consistent between comparables, because we weren't allowed to go in and look at necessarily rentable area and so forth. But anyway, we're going to say, o.k., if it has ample private parking on the site, or available on contract, we're going to give it a 5; if it's got limited parking, it's got a 3; if it's got little or no parking, we're going to give it a 0. Now, I can sell that to a jury. Remember, one of the elements of an appraisal is that the other fellow will be able to replicate my thought process, that it not be black box. I can go to a jury and say, hey, you know, we've got one parking stall per 300 square feet here and that's ample for this, and we've got one parking space for 1,000 square feet on a class 3, and so forth, and I may even spell it out to that degree of detail, as we do in the next case. So I can get a jury to go with me, it's better than average or non-existent kind of thing, and that will replicate that logic with me. Now, we can make a good argument that instead of using 5, 3 and 0, we might want to use numbers that don't imply quite such a great weight, and when we use a 5 versus a 1, we're assuming that 5 in a point system is 5 times more important as a 1, and we could factor that out by changing these numbers, if you will, to 35, 30, and 25, and then the relative ratio of the best to the worst is only a 35/25 factor, rather than a 5 to 0 or a 5 to 1 factor, but these are fine points, which you can leave to the appraiser for the moment. Now, the second element is location, and we've defined that locational factor very specifically. The next one is whether we had a good strong first floor lease in place. The next one was whether renovation was required by the buyer, modest renovation required, or intensive renovation required. The next one had to do with the visual quality of the office entrance. You'll see that this factor--excellent design and location and different design, poorly defined and adjacent to incompatible uses. There was a euphemism created for just this one office building. This one office building had an entrance way which faced Madison's red light district, and therefore, you were likely to be propositioned on your way to your lawyer or your doctor, and the building tenancy was suffering significantly as a result. So the subject property suffered from that problem. The rest didn't and so we have to recognize it. And finally, vacancies existing at the time that the building was sold. Now, notice, in the first case, on the right hand side, we have ordinal rankings--5, 3, and 1, or 5, 3, and 0--is only within that topic area, but it doesn't say what the relationship of that is to the larger overall project. So we then have to assign a waiting factor, which becomes the common denominator, and in this case, we took parking as 25%, location was 20% wait, first floor retail 15%, and we had a 10 and a 15 at the bottom. Initially those weights come from the experience and judgment of the appraiser, but when he applies it and he finds out that he doesn't seem to explain what's going on in the property, he can go back and manipulate those weights. He cannot change the score; he can change the weights to find out what buyers are looking at most importantly. For example, if this particular office building exists--it's a 1920 style art deco 10 story job which recently sold for our firm, marketed for the trust fund for the bank, as a matter of fact, and so forth, but in another case in Madison, we started looking at vacant office building sites, and we applied our point system, and we gave the best to soils and the best to convenience to public transportation and all of the conventional things that urban land economics told you you should do, and we then applied that to our system, and we got variance, although we didn't have any clustering at all. We got a very high residual error when we did that. We didn't seem to be explaining the transaction. So then we went back and we said, well, just a minute, who bought these things. Well, we found out life insurance companies and banks bought them, and they didn't give a damn about the suitability for building. They wanted visibility. When we changed our scale to weigh visibility, ignored the soil conditions, looked at its proximity to where the executives lived, rather than the convenience to public transit, we explained what they paid for their home office sites perfectly. But we had a sub-segment of the market--financial institutions buying for home office buildings. Now, we backed into that. We assumed initially they were rational. We then assumed they were irrational, and then we realized they were quite rational from the viewpoint of the guy who got to buy the site. In fact, I think somebody once wrote that irrationality is in the mind of the beholder; not the decision maker. So that the point systems allow us to identify physical, ascertainable, you know, differences and presume logically some ranking for that. Even that logical ranking doesn't necessarily apply. For example, if we were in a market that was interested in rehab or a user's market that was interested in moving their own operation into it, the fact that the building didn't have any leases would be a plus, rather than a negative. It would reverse the score. We'd say, hey, you know, 50% of the building was immediately available for rehab, or the first floor was immediately available for the user to put in his own store operation. So once we get to that segment, the building with the hole in it is the more attractive investment. He doesn't want to wait a year for the lease to expire and then move his own store in. So, at any rate, you can begin to manipulate this, and we just have computer programs which do this for us, and we'll back into it. This then turns out to look a little bit like you see on the next page. There are comparable sales on the subject property. Just to read one line of that, on the parking factor, weigh the 25%, 30 West Mifflin was one sale that a 5, which was the best situation, and then had a 1.25 score. 50 East Miffling wasn't quite so good; it had a 3, weighted for 25%, it's .75. 16 North Carroll got 0, 0, and so on, all the way across. Down at the bottom then we end up with our total weighted point score for the buildings--5.0, 2.95, 2.50, and so on. We then have our selling price. We have our total rentable area, in this case, which we were able to obtain, and we then have our price per square foot of rentable area. We then divide that by our points and we come up with our price per point per square foot of rentable area. Notice what a nice type cluster we get when we get down to that. We've begun to explain two things. One, our linear regression told us the rentable area was the most reliable unit of comparison in this case, and now our adjustment of that price per square foot of rentable area for points starts to give us a really tight cluster of price per point per square foot. Now, on the next page, we calculate the mean price on that, and we come up with a central tendency of $7.07 per point per square foot of rentable area and a 52¢ dispersion around that, and notice now, we compare the prices. X in the middle of the page is the price per point per square foot of a certain building. 7.07 shows the dispersion around that. That's a pretty tight cluster, as a matter of fact, and our value range then is 7.07 plus or minus 53¢. We then get an estimated central tendency of $1,150,000 for the property at the bottom of the page using our pricing formula, with a dispersion, a high estimate of $1,240,000 and a low estimate of $1,006,000. We want fair market value--it's $1,150,000. Now our next step in that appraisal was to test that for the investment reality of it, and we did that. We built a discounted cash flow. The irony, by the way, is that the discounted cash flow on this project comes out at $1,150,000 also, which is really embarrassing, since we teach continually that there is no reason in the world why the market comparison approach, the income approach, and the cost approach could ever come out as the same number. In fact, if they do, you know the guy's lied on two of them, and I then proceeded to do that on this one, and I got the same number; but in any event, there is a market comparison approach which has eliminated a lot of the indefensible black box assumptions, in which it is a good example of the difference between contemporary inference and traditional comparison, and we have no problem with the juries at all. The juries understand that much better than they do the black box approach. Now, I think maybe at this point--it's what, quarter of three--we'll give you ten minutes or so off for good behavior and coffee, and then I want to pick up two other happy approaches; one, the investment approach, and two, multiple progression, and the pitfalls in the cross-examination of tax accordingly. If you have any questions that you would like us to discuss, take the opportunity during the break to give them to me on a slip of paper, and I'll take care of them.

You have to be able to establish that in fact the property is not negative to the interests of the community. For example, a community that has on its books, you know, a zoning area for trailer parks. On the other hand, the fiscal reality of the trailer parks are that you get a very low tax base per individual, and therefore, they find that the trailer park is a fiscal deficit for the community, which takes on the residents without the tax base. In the old days, for a small town, you couldn't have gotten a trailer park approved on the land, even if it was zoned appropriately if their lives depended on it. It was simply the political reality. They couldn't afford the negative fiscal flow that resulted. Now, in Wisconsin, we've changed the law so that your entitlement to state funds is a function of the residents per thousand dollars of the tax assessment, and one thing which can actually increase the tax flow to a community, particularly a small community, is allowing a trailer park, because you get a very low increase in tax base, a high increase in residents, and the number of dollars assessable ratable base that you have for residents declines, and you get a larger share of the state income tax refund, so that the probabilities of different land uses are more likely to be controlled by fiscal zoning than they are by land planning zoning, and the appraiser has some responsibility in dealing with possible alternative future uses of the property to demonstrate why it's in the community's self-interest to permit that kind of land use, regardless of what their codes might not only permit. Third, the appraiser must prove effective demand, that not only would it be nice to have that, but there are people who can afford that, and more appraisals, particularly in eminent domain actions, fail for a failure to demonstrate effective demand for space in terms of an absorption rate at a price for a certain amenity package than virtually any other. Fourth, the definition requires that you show that it's a financially viable plan. It is not enough that it's technically feasible and that people would like it. The next problem is, can you build it at a price they can afford to pay, and what is financially viable differs obviously with the cycle of the interest rate, and it's getting more and more difficult to make that call, given the volatility of financing available for real estate developments today. Finally, and this is part of the definition of best use now in all the textbooks. The use must be compatible with community goals, environment, and fiscal self-interest, and that puts a significant constraint on the degree to which the appraiser is allowed to let his fantasy as to future uses move around. Now, many appraisers specify the problem is related to justification of the existing use, and that's extremely dangerous in some cases. On the other hand, it would be required in others. For example, in tax assessment you argue the existing use, rather than the potential use, because the potential use is not a vested interest, so you argue the resale value of the vacant land as it stands, with whatever risks are inherent in getting the appropriate zoning and so forth appropriately recognized in the choice of comparables. Or you can value it in on the anticipation of the next use, and you can also distinguish the sale from a sale in the ordinary course of business from a foresale. For example, here are some cases recently that we've dealt with in terms of the real critical issue being best use. In the first case, involving a new apartment project, the land had been originally owned as a coal yard and pipe storage area by a utility, an electric utility, who had it zoned M-1 industrial and then gave the land as part of the funding of their company pension, and after some years, were able to sell it to a developer, who then changed the zoning to apartment zoning and built a major apartment building, which was syndicated. In the process of building the apartment building, it was necessary to do about $300,000 worth of soils work because the site is marshy and would not sustain a three-story brick apartment building without going into a very elaborate compaction process. The utility had taken credit for about 55¢ a square foot on the land at the time they had transferred it to their pension plan, and following the sale to the developer, who then changed the zoning to residential, the Internal Revenue Service challenged the initial deduction, and said that given the number of apartments that had been built and so forth and so on, the land was worth about 18¢ a square foot, rather than 55¢ a square foot, and as a result, obviously wanted a tax refund. The __________ part was that they got a cheap appraisal to begin with to justify the transfer. One of those $200 specials, which was later followed, by the way, by the same appraiser coming in as a broker about three months later and offering to buy it at its appraised value, but in any event, they finally are now in deep water, and so we did the appraisal for them. Well, when you went back and searched the records, you found out it was zoned M-1 because the soils were considered so bad by the Planning Department that it would only support a light steel industrial building on a floating foundation, and the tapes of the Planning Commission meetings in which that zoning was available had been saved, and they were available as evidence to why they were zoned M-1. There were a lot of sales of M-1 land in the area at 60 to 65¢ a square foot. Now, by the same token, the developer zoned it down because he wanted to build residential for syndication, and the city was perfectly happy to have him do that. There was a park across the river from this particular piece of land. If he wanted to pay for the foundations, that was his problem, and he did pay for the foundation, and he had an overrun on the syndication, and he had a second mortgage back to the general partner. Now, the Internal Revenue Service comes in, and their appraiser is a retread appraiser from FHA, who sees an apartment building on the land and immediately lights up and presumes that what exists is best use. It was not best use. If the land had been left as M-1, it could have been sold for 55¢ a square foot. Therefore, the fact that there was building already on it, as an apartment building, did not in fact determine best use. We were able to go back and dig out the Planning Commission tapes and records, we were able to show that there were other sales in the area for industrial land, but at the time that had been sold in '73 or so that there was in fact, you know, no further industrial expansion going on in that immediate area, but nevertheless, given the soils, given the physical characteristics, given the fact that a rail line existed on the land when it was sold, it could have been industrial park use, and it would have sold for a higher use. However, the profit center for the purchaser was in syndication, and so he proceeded to do that which he thought would syndicate best, and that doesn't necessarily demonstrate the economic use of the site. So the fact that the site is developed in a certain way and the existing use does not necessarily control what was best use at the time that was put on. Go back and dig out the initial set of assumptions. The second one that we mentioned was scenic quality versus timber. We've done a number of those types of things, and we've been able to establish an objective measure of scenic quality. In fact, in that particular case, where the Forest Service was on the other side, we used nothing but Forest Service techniques, one of which is called visitor evaluation photography, in which you hand out cameras to the hikers and you ask them to take pictures of that which contributes most to their scenic and aesthetic enjoyment of the area, and we then rated those for the physical presence of 59 different physical factors that were ascertainable from aerial photography; rock form, land form, water form, and vegetative cover, and we evaluated some 3,000 photographs and established a very clear physical correlation between the diversity of physical factors and the score given by the hikers. That was done first on the St. Croix by Ben Nieman out of our Landscape Architecture Department. We used that in the Cascades, and we have now used it in several other areas, and the visitor evaluation photography allows you to move into an area which in the past really was out of balance for the attorneys, i.e., aesthetics, and we believe now, if we can find the right case, that we can do the same thing using visitor evaluation photograph to evaluate the aesthetics of physical structures and the damage done to an area by the infusion of a building which is non-compatible, or conversely, the increment in value attributable to the aesthetics of a particular set of structures. In any event, having defined what scenic quality was in an objective way and being able to rank scenic quality, we were then able to pick comparables that were purchased for scenic quality, based on their degree of comparability, and I won't go into eclidian(?) distance at the moment, but it will stand up. It's a very rigorous technique and eliminates much of the subjectivity of the market comparison method. We have a number of tax assessment systems running on it, as well, that will pick the five best comps out of 200 sales to a subject property, make the adjustments on it, arrive at the weighted mean adjusted price for that property, and make it stick. A third case, the argument in this case was that the property was worthless because they had drilled hell out of it in looking for minerals and hard metals and found nothing, and therefore, they thought the property should be regarded as worthless. In fact, it's unique as an energy farm. It's a mountain pass, and it has since leased at approximately $500 an acre per year for a wind farm generating energy. Another one that we found in the back of the Cascades--couldn't understand why a little piece of ground out there was selling for $2,000 an acre; absolutely barren; it might as well looked like it was in the moon, until we settled down on the ground in our helicopter and found a little building in the stream with a Pelton(?) waterwheel, producing electricity which was being sold to the local utility under the 1978

Enegery Act, and the present value of that was worth $2,000 an acre. So much for your location, location, and location theory of real estate. Looking at other best use issues, let's take a look at how we might handle one in a simple local appraisal relative to a flophouse, and Exhibit 7 will give you an example of that. Here we have an old hotel building. It had had a history of being transient male housing with a somewhat questionable saloon on the first floor, and it had a fire, and at that point, was not permitted residential occupancy, but the bar had continued to operate, and we're asked to appraise that building, and in order to look at a building which is now in a transitional phase, as it were, in its history, we really have to look at alternative courses of action and say, alright, one is to return it to its former use; another is to modify that former use; a third is to convert to office; a fourth is to convert it to apartments with office on the first floor; and fifth is to convert it to apartments with the bar remaining on the first floor, since the bar had a lease, which gave it a leasehold advantage; and the last scenario was to demolish the building and start over with vacant structure. The appraiser has to examine these alternative courses of action and demonstrate that that is, you know, that he has done that. We now have to look at some of the critical factors of feasibility. The first element was market demand. There was a tremendous demand for transient male housing, and if you had made some minor repairs to the building, you could have returned it to that use. The demand was actually being subsidized by welfare agencies in the community, who really had no place to go with those kinds of cases. However, if we look at the legal/political aspects of that, it was inconsistent with what the City Planning Department had announced for redevelopment of the area, and the Fire Department and the Police Department's interest in breaking up what was essentially what was sort of a Bowery area, and therefore, the city was not in favor of returning it to its former use, even though there was an effective demand for it. From a technical standpoint, there was very little construction risk at all; what was needed to regain an occupancy permit was defined, the costs were known, and so forth. If you did a residual value on that, you got the highest value of all for the building, about $192,000. We will look at what we call back dooring it to determine that residual value in a very short form in a moment. There was no real income tax advantage for doing that, and there was no great fiscal real estate tax advantage to the city for doing that. Alternative number 2 would be to have a welfare agency take over and restore the building and run it for welfare purposes. The welfare agencies themselves were the principal customer via vouchers for the building, and the only problem was none of the available welfare agencies had the power or the capital budget to acquire it. There would have been mixed acceptability in city quarters. The alderpersons, half of them would have been in favor of that; the other half, who obviously related best to the downtown area, were not; and that produced a somewhat lower market value or cash value for the building. There would have been no income tax advantages to a non-profit, and the city would have lost whatever the current ratable base was on the building. On the other hand, if we began to look at a conversion to a class A-B-C office, there was almost no demand; it didn't have the parking necessary to support it and so that zeroed out almost immediately. If we looked at conversion to apartments with an office on the first place, there was strong demand for the apartments for two-bedroom apartments within the CVD area. The city preferred that solution to the others. There was significant tax advantage to those who did it for the city, but notice the value at $103,000 was the third highest of the alternative residual values. If you looked at only that which would produce the highest price to the owner, you would have chosen option 1, but if failed to meet the tests of best use and feasible use on the other counts. If we looked at it with a bar in it, the bar tended to destroy the attractiveness of the apartments, except for those who wanted something just a short crawl home, and we ended up with a negative residual value, and if we then demolish the site, the site per se, which wasn't any great shakes, was relatively low value in site. So as a result of the analysis, which is summarized in capsule form here, the determination was that best use was redevelopment into a two-bedroom apartment buliding with some innocuous commercial use on the first floor, presumably office, but as it turned out, restaurant, and that becomes then a recap on one page as to how did the appraiser get to his best use assignment. It's no longer legitimate simply to write that away on the first page in a single line that says highest and best use of this property is for redevelopment as an apartment building. The appraiser is expected to show why that fits the context that he is expected to touch on in terms of physical capacity, effective demand, financial viability, and political compatability of the property. O.K. Now, when we're looking at the best use, the question is, of course, best use of what. Best use of the land, with or without entitlements; best use of the land with current improvements or not, and how much of that is real estate and how much of that is relevant to the decision that I'm making. If we're looking at a hotel for mortgage lending purposes, typically that's structured so that all of the elements, including the furnishings, the book of business, the franchise, the entire set up, is pledged as collateral to the loan, and additional loans are subordinated with an after-acquired property clause to the first mortgage; and therefore, it's appropriate to look at the hotel in terms of all of its cash income after real estate taxes being available for debt service, to the exclusion of other interests. However, looking at it from a real estate tax standpoint, it's an entirely different issue. None of those things are in fact real estate, and therefore, all of them have to have the income attributable to them removed. So you start out with the total income stream and take out that portion of income attributable from the furnishings, that portion of income attributable from management and advertising, that portion of income attributable to the franchise that says Holiday Inn on the door, and so forth, and get it down to real estate, and most people don't do that, but they should. Subsidized housing the same way. You arrive at the value using market rents, not FMR rents, and you arrive at the value using conventional financing, not tax exempt bond financing or something of that sort, and you get it back down to the real estate and not to the personalty. If we're looking at a land and shopping center, land and zoning are clearly real estate. The cost of the building shell is clearly real estate. But monopolies that are created by operating agreement are a franchise and intangible personalty, and therefore have to be pulled out of the percentage rents. In fact, most assessors, I think, are pretty touchy about using percentage rents as indication of income from the real estate. Percentage rents are income from superior management. Appraisal assumes average management. Since percentage rents are not a vested interest, but are contingent on performance of the tenants, they can be legitimately excluded from a real estate tax on the income, as long as the base rents that are being paid can be shown to be market rents at the base. Property management fees are personalty. Utility sales, as we mentioned earlier, are a business income. Only possibly the distribution system is real estate, and even that may be personalty, just like cable t.v. installations are personalty and not realty. Tenant improvements can be realty or personalty, depending on how the leases are set up and how the bookkeeping is done among the parties. Recently we had an eminent domain case, in which an industrial building was built for a tenant, but the tenant said that all tenant improvements were his and that he could take them with him when he went, and both parties treated it in their accounting accordingly, and so forth. Yet most of the tenant improvements are such that they don't travel very well. They're heavy foundation mountings for punch press machinery and so forth and so on. The initial award assumed all of that was real estate, when in fact it wasn't, and so you have to go back and reallocate as between what is real estate and what is personalty under the intent of the parties. The fact that something is attached to the real estate, the presumption is that it becomes part of the real estate, but that presumption can be rebutted by in fact how people handle it. Another area is distinguishing revenues that are from a business enterprises from that which is in the real estate. For example, looking at a parking ramp, it is what the parking ramp will lease for as a total entity that is real estate income. The income from renting individual parking spaces, minus that base rent for the total ramp, is income to a business. We got into that with one of the big accounting firms here in looking at the Big John next door, in which you have that observation deck floor. The position of one of the parties in that case was that the total revenue from the observation floor was part of gross rents. It's not. It's the base rent that they paid for the floor that's rent. The gross revenues are from selling their recreational business, or whatever you want to call it, and therefore, you look at the wholesale value of the space, not the retail gross from the space. So once you start leasing parking places or selling the ticket to go stand on the umpteenth floor to look into the fog and look for the city and so forth, you are no longer in real estate income, and quite often those kinds of things are not adequately broken out. Income from a reservation service, like a Holiday Inn reservation service, something of that sort, has to be broken out. Bookings assumed for a hotel, and so on, are not part of the value of a hotel, although most hotel prices are reported as sales of a going concern. There is no proper allocation to the individual elements. Entitlements which are point specific are part of the real estate; entitlements which are portable are not. So a franchise from Holiday Inn is portable. Should you break the rules and so forth, they can come down and take their sign off the building and their doilies out of the dining room and go home, and therefore, it is a portable entitlement and it's personalty. Wholesale control versus retail, we talked about. Services customarily inherent in a project would be considered real estate, or available alternatively from off-site suppliers. So the building that has basic janitorial services in the corridor, but janitorial services in the office space, and so forth, that revenue from janitorial services is not real estate revenue and has to be pulled out of there. The same would be true from electricity sales, and so forth and so on. The income tax category may indicate the intent of the parties in terms of how they're handling it as intangible personalty or realty, and fees for arbitraging the conversion are not real estate values. For example, let's assume that a syndicator buys an apartment building, which if it were to sell as an apartment building investment, would sell, let's say, for $25,000 a unit. Instead, the seller takes back paper for $27,500, which is payable after the syndication is completed. The 2,500 premium is a participation between the seller for effectively a long term option to participate in the arbitraging fees of moving from that building as an investment property to a syndication interest and is not necessarily real estate value. The same thing would be true of a condo conversion type thing. In fact, what you have today is a three-tiered market in real estate. You have real estate which sells for utilitarian purposes. It's going to house a business bought by the user. It contributes a certain element to his business. The second kind of real estate is bought because it provides a medium for the sale of your services; a syndicator who wants to get paid for syndication, condominium converter, the architect who buys land in order to get the architectural commission, and so forth. It provides access to a captive customer for services. The third kind of real estate today is a transaction--and it can be all the same property--is in fact purchased as a commodity. For example, in Madison we appraised a building fair market value--a relatively new office building--at $3.9 million that had a $3.3 million mortgage on it. The developer had gotten himself into trouble because at about the time he decided to build 120,000 square feet of leasable area, so did several other folks, and things went a little slow, and by the time he finally had the building rented, he had not only his first mortgage, but he had a second mortgage and a third mortgage, and in the third mortgage, the developer had signed personally, and therefore, put everybody in his partnership on an at-risk basis, and they had lost the balance of their shelter in the project. At the same time that we won the real estate tax case on what the fair market value of the building was, we turned around and sold it for $7,000,000 to a syndicate of doctors--

$700,000 down and $6.3 million to go, interest only, ten year note on a land contract. The developer leased it back to operate the building for the ten years at exactly the same amount as the interest due on the land contract so that the parties could swap checks periodically, and you then have on one side interest only payments and on the other side you have a triple net lease payment for the property. This was several years ago before the '81 tax law. Now, what you really got is a classic commodity speculation in square foot of Class A office space. The developer has a--excuse me, the buyer has a call on the property at $7,000,000 ten years from the date of purchase. That works out to about $65 a square foot of GLA, which isn't a bad price for a high-rise office building that's very well located and has about 200 parking stalls underneath it, and so on. It probably can't be touched. On the other hand, given the 6.3 he's going to have to carry, if interest rates are at 18%, rents are going to have to be at $25 a square foot, and rents are currently at about 12-1/2. So he's speculating that rents will rise to cover interest costs or that interest costs will fall to about 9-1/2, whereby he can carry it at the current rate. Now, at the same time, the land contract form in Wisconsin is a strict foreclosure form. If for any reason at the time it matures the interest rates or the rent levels don't justify taking down 6.3 million in debt, he simply takes a walk on the contract and puts it back to the seller, who will be only too happy to have it. That's a classic straddle of the commodities market. Now the question is, is it a perfect straddle of the commodities market? Well, the $700,000 downpayment, of course, is recovered out of depreciation--probably about the end of the fifth or sixth year. By the end of the tenth year, the depreciation alone, even if they default on the land contract, will give them a 10% return on their money. Now, that's a whole different market for real estate that never existed before. For the appraiser, it raises hell in terms of what he can do with the market comparison approach to value. Cash equivalency doesn't anticipate those kinds of distortions to the pricing mechanism, and there's probably no really reliable way in which the outside appraiser can convert that sale to a market transaction. Now, notice that what you're really doing at that point is looking at the real estate transaction as a risk management device in which the parties are divvying up the what-if's, and of course, hoping to have the higher probability of variance on the upside than on the downside, but nevertheless, it becomes a financing risk management device, rather than a pricing mechanism in the traditional appraisal sense. Now, given those kinds of rules, the definition of market value requires that you define who it is you're selling to, for what purpose, on what financial terms, and whether you're looking at inherent asset value, whether you're looking at the sum of the liabilities because of a bankruptcy reorganization, or whether you're looking at investment value where the property has to be put in the context of its portfolio. In fact, we have a number of situations in which properties sold collectively sell for more than they would have sold for individually. A number of the liquidations of Monumental Life, for example, Dayton-Hutton's liquidation of shopping centers, a number of other cases of similar bulk sales of real estate, have shown that if you bundle those up and you take one good shopping center and put it together with one lousy shopping center, they'll both sell for a total higher price than they would have if you had sold them individually; just as the retailer puts two good tomatoes and one not so good tomato under cellophane and you take them all or nothing. So it's conceivable that collective sales of real estate will have higher aggregate prices than individual properties within the collection. Now, economic rent has to be, again when you're talking about real estate, adjusted for space, rather than services, and again, appraisers are doing a lousy job of doing that. One other area relative to market value and economic rent is that the market value of real estate, as we mentioned earlier, presumes cash equivalency, but the appraiser is finding more and more difficulty in reducing prices to cash equivalency, because that apparently isn't what happens in the market place. Theory would tell you that if you had a series of income payments on a land contract to a seller, that if you took the present value of that series of income payments at the interest rate that prevailed at the time of sale, you should get the cash equivalency. Indeed, that's what the IRS is arguing in the new tax law, in which you discount the payment stream to the seller at 120% of the appropriate treasury rate in order to arrive at the inferred real estate value. The problem that that leads to is an overstatement of the discount, because what apparently happens in the market place is that both parties share that. If you look at what happens in a single-family home sale, when somebody buys, let's say, the FHA paper, the premium that's paid for the house is approximately 1/2 the cost of obtaining the FHA or VA assumption, so that if there's, let's say, eight points due to make it an equivalent market interest transaction, the price of the house goes up about four points. Obviously, the seller has an interest in selling the house, and therefore, is willing to pay some of the points of the buyer. The buyer, on the other hand, has an interest in assuming some advantage from the existing mortgage. But more often than not, they tend to split that, so that if you look at a cash equivalent price, it won't work out as theory tells you it should in terms of discounting the paper at the interest rate that was due. Only about half the discount is built into the price. So it's going to be interesting to see how the IRS handles that problem, as there's more and more ________ data to support that position. More and more appraisal reports use nominal prices on property as their market comparison price. The argument is that creative financing has become the norm and that, therefore, that meets the test of market value. It does not meet the test of market value. The test is cash to the seller, and there's just no way around that. If you want investment value, then, obviously, the nominal prices may represent investment value, and it really represents the sum of the investment interest in it, which may include first mortgage, second mortgage, limited partner, general partner, and whoever else has their hand in the till, and therefore, the use of nominal prices can be very easily attacked. Objectives in appraisal may require different sets of assumptions as to the focus, the values and events that are legitimate in appraisal. If you'd look on page 30. This is taken from the hierarchy of accounting perspectives, which define the methodology and acceptable assumptions for financial information reporting, and the first issue is, what's the focus of the report going to be--past, present, or future? Typically and traditionally in real estate you had an entry cost, with actual modification for depreciation or whatever, and you ended up with an historical cost relative to corporate balance sheets, this would be the typical result is the submerged value of the real estate. The real estate doesn't appear, for example, on a real estate equity trust books at what it's real value is because they have taken a past view. Whether we pay for it in the past, what has been the entry cost, if you will, what's been a depreciation factor, and we now have an historical record. Obviously, it's significantly misleading when we want to measure current values. Indeed, the whole reason for creating a commingled fund reporting current values on assets was to avoid this problem of submerging the real value of the assets in equity trusts, and it's the submerged value of the equity trusts which, of course, has accounted for recent efforts to raid equity trusts which were underpriced in the market. On the other hand, if our focus is present, what would it sell for right now. Now, we have two interesting problems. One is exit value assuming ordinary liquidation, and the other is exit value assuming forced liquidation. Why does that make a difference? For example, if we're making a construction loan and it's a million dollar building when it's finished and we're going to spend, let's say, $900,000 building it and we make a $900,000 loan, but for some reason our investor is intercepted midway in that process, we may have laid out $450,000 from our loan to build the project; but if it were to sell at that particular point in time, uncompleted and with the necessity of finding a new contractor to finish it, and so forth, it might only sell for $300,000. So the the exit value is not our historical outlay, nor is it the fact that we have completed 45% of our finished project. The exit value at that point is a somewhat disorderly liquidation, is going to leave us $150,000 short, and it may very well be, for the purposes of making a construction loan or that kind of transaction that we're interested in forced value. What's the liquidating value? What's it going to take to get out of the project? Indeed, we try to instruct the income lending people that we work with at the Banking Association and the Mortgage Bankers Association that today when you're making an income property loan with an exculpatory clause that says that the only remedy essentially is for the lender to take back the property, you're really selling the book, and the way you value the loan is what's the salvage value on the deal at any particular point in time, less the legal costs of getting your hands on the property. So if you think the salvage value halfway through the project is $500,000 and the lawyers are going to get $100,000 getting you title back and getting rid of the borrower and cleaning up that whole affair, then the maximum amount of cash you can have on the outlay at that particular point in time is $400,000, and you, therefore, scale your draws on your loan to match that approach, rather than scaling them on some more, you know, proportionate basis on completion. On the other hand, if you want exit value assuming completion in the normal course of business, you get a different set of values for the property. Why is that important? Well, we've won a tax case--a real estate case--in which we argued that the office building which the assessor assessed on the cost to replace on the grounds that he didn't have any other basis--the building was vacant--and so he used cost to replace to assess it, which, of course, only increased the rate of bankruptcy of the developer. We argued instead, no wait a minute, it's an income property investment. We estimate--and we had, I think, a very good solid estimate--that it's going to take three years to rent up the building. Therefore, our cash flows look like this--negative for the first two years and finally turning positive toward the end of the third year, and the value once it was rented at the end of the third year would be X. We can treat that as the present value of the income stream all the way back into the construction phase, in which we say, hey, we still have a year to go to finish completion of construction, and then we have three years to rent it up, and therefore, rather than take cost to replace times 15-20% completed to arrive at the assessment value, we'll take, in fact, the exit value, assuming normal course of completion of an income property, back to now, and here is the present value of that negative income stream at that point, which was considerably less, and the Wisconsin courts upheld that and stated yes, even during the construction phase, the income approach is an appropriate course of appraisal where the building has no prospect of income for the immediate future and where the investment was motivated initially by expectations of income. So once you begin to look at, hey, which value am I interested in here--an orderly liquidation value or immediate liquidation value--the assessor should be interested in immediate liquidation value, because he can't tax on non-vested future interest, at least he's not supposed to. Now, the alternative may be to interest it in future value. For example, if we're going to evaluate a pension fund to the asset manager, his current cash on cash may be low because he's been attempting to position himself to be in a position to capture a leasehold interest and an inflationary rise in rents in a particular property, and therefore, to appraise him entirely on the current income value of a property is unfair, and certainly underestimates the true value of the portfolio. However, to look at the future value of the portfolio, you have to make some kind of hypothetical estimate at the rate of inflation that's going to occur in rents and the success with which leases will be rolled over without vacancy, and the cost of rolling those over in terms of leasing commissions, tenant improvements, and the like. Now, here's where the English and the American traditions differ very significantly. The American future value people--the net present value people--take the hypothetical view, in terms of rate of inflation that's going to be occurring, and they tend to annualize tenant improvements and leasing commissions ... tends to overstate the value of the property. The English tradition is to assume that leases that are renewed in the future will be renewed at today's market rates, thereby flattening the rate of increase in the total rent roll of the structure, and then they use a capitalization rate which attempts to remove the inflationary factor, or loading, on the real rate. So you hear the English and the European appraisers talking about equated yield. They are dealing with future incomes, but expected based on current data, whereas American appraisers are tending to extrapolate current inflation rates to future rents, as well as current inflation rates to future expenses, and then levelling cash expenditures for tenant improvements and leasing commissions that are occasioned by the rollover in the leases. This distorts the cash flow significantly, so if you have a tenant that represents 40% of the building moving out at the end of the third year and you then have to have new tenant improvements and leasing commissions to fill that space, you're going to have a tremendous flood of cash going out at the beginning of the fourth year as you re-lease that space, indeed, perhaps arriving at a zero cash flow before you go forward to presumably restore the building to a better cash flow position. The American appraisal would tend to overstate the value of that property. The English approach would tend to understate the value of that property, because it doesn't recognize the positioning against inflation that the market investor is subject to. Nevertheless, we suspect--in fact, we know--that those who regulate financial institutions, pension funds included, are attempting to make some decisions in defining the specification for appraisal that says, o.k., for purposes of a construction loan you will take this view of exit value and you can make these determinations about the collateral value of the property based on presales or based on some other absorption rate, whereas in the pension fund area for measurement of the adequacy of funding, we will take the expected value given a rollover of leases at market rates; whereas, if we wanted to measure comparative performance of asset managers and make some hypothetical assumptions about inflation rates and so forth, we can then have a second value measuring the value of the portfolio, given a set of assumptions or a scenario, if you will, about the economics of that investment. So notice that we can move into the same area in which accounting will distinguish for different reporting purposes, whether you have a past, present, or future focus, whether the value you're interested in is entry value or exit value, and finally, whether the events that you will use for the basis of your assumption have to be in fact historical and scertainable from the current situation or can be hypothetical about what will happen in the future, and that's going to considerably complicate the purchase of appraisal services. Any questions on that? That is a subtlety and a sophistication that has crept into the European appraisal process already to a considerable degree, but which is just now beginning to enter the American scene. Yes.

Q: If your assumptions on inflation are the same as the manager, doesn't that simply tend to just verify the manager's position(?)?

JAG: Sure, but the question is, not whether you agree but whether the regulators of ERISA agree that your sponsor has adequately funded. Obviously, the sponsor has a bias to take the highest rate of inflation possible to get the highest value possible, to have as low a gap between the liability for vested benefits and the amount of asset values already in place, right? So ERISA may take the more conservative views that say you can't roll those at anything other than the current rate to measure the adequacy of your funding, and therefore, the inflation that may occur will simply be to the greater security and solvency of a program, as opposed to reducing your current funding requirements.

Q: Well, what I'm concerned about is when you're theoretically evaluating your manager using the appraisal purposes to that end and to some degree the manager has a voice in selection of the appraisal base, does he not, or is it totally independent?

JAG: Well, that's one of the other interesting issues coming up. Right at the moment, he apparently has something to say about that, although some would deny it. But there's been considerable criticism of pension fund operations to date where property values seem to be going up in a straight line. It's the only financial instrument in the United States which doesn't have any volatility to it at all. If you look at Chris'(?) line or the others until a year or so ago, it went up in a straight line, o.k. You can only do that by having not easily smoothed your appraisals to some degree, and now they're beginning to take another look at that and say, hey, what can we do about those appraisals? How response and sensitive should the appraised values be? O.K. And should we use the same values that they're reporting for touting their performance, as the basis for determining funding by the sponsor. Right? Those are not the same numbers, and the same appraisal shouldn't be expected to serve each well. O.K. Now, the broader area of technique, or the narrower area of technique, if you'd like to talk about the trends in the three approaches to value, the market comparison approach to value has always been the darling of the courts, it's always presumed to be the most objective, and conventional wisdom tells us that the value of the thing is the price it will bring, and therefore, there is considerable preference in the courts for the market approach, and secondly, for the cost approach, because presumably that too is objective, and lastly to the income approach, which they regard as highly vulnerable to manipulation by assumption, and the irony, of course, is that the market approach and the cost approach are the most highly subjective, manipulative methods around and there is probably more data to support this kind of cash flow on income properties than any other method. The trick is to get the judges to realize that and the trick is further, of course, to be able to communicate that effectively to a jury of one's peers. Now, there are two major trends appearing in the market approach. First of all, there's considerable improvement in quantitative methods for screening the similarity of comparables and for adjusting for the differences. However, there are a number of pitfalls in that, as we'll look at in a moment. There is much less reliability, however, in that the terms of reported nominal sales prices than ever before. Creative financing is one factor; creative accounting for depreciation purposes and so forth is another, and creative marketing of property is a third, and so you really have to begin to look at that. For example, we're beginning to look at tract home sales. Everybody says there's nothing to appraising a house. Single-family homes are some of the toughest things around to appraise, either because of the irrationality of markets or because of temporary shortfalls in supply, and so on, but in any event, the single-family home sold in a tract area almost always sells for a premium, while the marketing capabilities of the developer are being brought to bear. Once those model homes and weekend hype and so forth are removed, the guy who wants to sell his house the next time around out of that--his corporation is relocating him and so forth--will find a considerable drop in value from the price that he paid for it, and it may be several years--it may be many years--before the tracts reach a normal sales price equal to the price that the individual is paying for it in the first place, particularly where you had buy-downs by the developer on the financing where you had a variety of other benefits built into the pricing structure. But that's also true, of course, of the major income properties, which are being continually manipulated for a variety of reasons. So getting good, clean sales data to do a market comparison appraisal is no mean trick, but assuming you can get that, there are some very interesting elements to the quantitative methods of manipulating it. The first element that you have to look at very, very carefully today is the definition of the unit of comparison. It is possible...first of all, I think you have to appreciate...many people think that real estate is statistics, and it's not. Real estate and market comparison is set theory. You're much more interested in a small cluster of five or six sales--maybe less--three sales--which are most like each other and are most unlike everything else. That's set theory. So you're not dealing in statistics; you're dealing in parameters. Second of all, you want those parameters which are most correlated to price, and unbelievable as it may seem, you can explain most of the variance between one property price and another property price by one or two key variables. For example, looking at a single family home, I can explain 75% of the difference between one home and another by the amount of living area enclosed and heated in that home. The other 25% of the variance is all the other differences in the house. If I select correctly the right unit of comparison, I will have explained anywhere from 65 to 80% of the variance in the various properties in my set, and everything I'm doing in market comparison after that is to explain the residual error. That's a very difficult concept to comprehend, but it is true. Once I've figured out--as we talked about this morning--that people were buying barrels of production of cranberries, I could explain 90% of the difference between the sale price of one cranberry bod and the other by simply knowing the five years production history from that cranberry bog. The other had very minor differences in terms of the varietal of the cranberry vine and the degree to which the owners were selling the vines rather than the berries. There were also some minor differences on how the water features were controlled and how the harvesting water flows were controlled, but that had to do with 10% of the pricing of the property. Ninety percent could be simply explained by barrels of production. For example, looking at rehab buildings. The first thing I'd do is, having first of all cleaned up the prices and made sure that I'd filtered out of it any distortions due to cash equivalencies, bargaining position, and so forth, and so I now say, alright what are all the different ways of measuring how much space-time I got for my money, and so looking at--and this is a current project that we're on; it's a major department store--we said, o.k., let's look at the six sales that I've got that have to do with buildings bought for commercial redevelopment within, let's say, a four block area of the subject property. I said, well, one thing I can look at is gross building area; another thing I can look at is front footage on the main street, because they're all on the same main avenue; another thing I can look at is cubage; another thing I could look at is first floor area; or I could do some transformations and take first floor area times frontage, because I think, you know, maybe people want to be closer to the street and less depth, you know, the old depth table syndrome and so forth. Now, I take those elements and I run them against price on a simple linear regression in my little IBM PC, and instantly it comes back and says o.k., first floor area has a correlation with price of about 30%. Gross building area has a correlation with price--this is the R squared factor--of about 84%. But cubage has a correlation with gross price of 94%. You got to say to your self, hey self, the developer seems to be able to explain what they're doing more with cubage than the other factors. So I'll tell you what I'm going to do. I'm going to make my unit of comparison cubage for the moment, and that's how I select a unit of comparison. I don't go with the conventional stuff that, hey, retail space goes on front foot and office space goes on square foot, and so forth. Because these buildings have all different kinds of things going on inside them. Some of them were really high floor retail spaces; some of them had movie theaters in, as well as office space, etc. But developers were buying space-time in a reasonably consistent fashion. Now, sure, I only got six in my set, and I got one variable, you know, so my degrees of freedom isn't spectacular. I'm not going to go into court and argue that I can value the building on linear regression. I'll probably get killed. For one thing, juries don't understand it; for another thing, it seems kind of black boxy. But I can go in and defend my choice of unit of comparison, because I can show a really tight distribution. And ultimately the market comparison approach is driving toward reducing the differences or explaining the differences between one comparable property and the subject and another comparable project and the subject. So far, so good? So now I've got a unit of comparison. My next problem is, alright, how do I begin to look at the property in terms of differences without presupposing what the financial impact of that is in isolation. So often you see the developer say...or the appraiser, excuse me, say, well, this neighborhood is 5% better than that one, and you say, well, how did you get 5%, and he says, well, I've been going to Rotarian luncheons for 20 years and I've been in the brokerage business and my credit rating's good, and I just think that's the way it is and that's my professional opinion. There's nothing wrong with his professional opinion. That's dealing in beauty, as we described it today--intuition. But it doesn't necessarily sail well as an objective element, so what I'm really looking for is some methodology where I can go back in and assign some sort of better than, worse than, or equal to kind of element to it, and then take that ordinal thing and convert it to some kind of cardinal ranking of degree of similarity or non-similarity, without having to make a direct transformation on each attribute or amenity relative to the subject property. One way of doing that is with the point system, that you will see in just a moment in Exhibit 9. One other thing I want to--well, I'll come back to multiple progression in a minute. Let's take a look at Exhibit 9, and then we'll take a quick break for coffee. This is a little office building in Madison, and take a look at the right hand scale first. Over and beyond gross building area, which is the only number we had that was reliable and consistent between comparables, because we weren't allowed to go in and look at necessarily rentable area and so forth, but in any event, we're going to say, o.k. if it has ample private parking on the site or available on contract, we're going to give it a 5. If it's got limited parking, it's got a 3. If it's got little or no parking, we're going to give it a 0. Now, I can sell that to a jury. Remember, one of the elements of an appraisal is that the other fellow be able to replicate my thought process--that it not be black boxed, and I can go to a jury and say, hey, you know, we've got one parking stall per 300 per square feet here, and that's ample for this, and we've got one parking stall per 3,000 square feet on a class 3, and so forth. And I may even spell it out to that degree of detail, as we do in the next case. So I can get a jury to go with me, it's better than average or non-existent kind of thing, and that will replicate that logic with me. Now, we can make a good argument that instead of using 5, 3, and 0, we might want to use some numbers that don't imply quite such a great weight, and when we use a 5 versus a 1, we're assuming that 5 in a point system is five times as important as the 1, and we can factor that out by changing these numbers, if you will, to 35, 30, and 25, and then the relative ratio of the best to the worst is only a 35-25 factor, rather than a 5 to 0 or a 5 to 1 factor, but these are fine points which you can leave to the appraiser for the moment. Now, the second element is location, and we've defined that locational factor very specifically. The next one is whether we had a good strong first floor lease in place. The next one was whether renovation was required by the buyer, modest renovation required, or intensive renovation required. Now, the next one had to do with the visual quality of the office entrance. You'll see that this factor--an excellent design and location and different design, poorly defined and adjacent to incompatible uses. There is a euphemism created for just this one office building. This one office building had an entrance way which faced Madison's red light district, and therefore, you were likely to be propositioned on your way to your lawyer or your doctor, and the building tenancy was suffering sifniciantly as a result. So, the subject property suffered from that problem; the rest didn't, and so we had to recognize it. And finally, vacancies existing at the time that the building was sold. Now, notice, in the first case, on the right hand side, we have ordinal ranking--5, 3 and 1 or 5, 3 and 0--is only within that topic area, but it doesn't say what the relationship of that is to the larger overall project. So we then have to assign a weighting factor, which becomes the common denominator, and in this case, we took parking as 25%, loaction was 20% weight, first floor retail 15%, and we had a 10 and a 15 at the bottom. Initially those weights come from the experience and judgment of the appraiser, but when he applies it and he finds out that he doesn't seem to explain what's going on in the property, he can go back and manipulate those weights. He cannot change the score. He can change the weights to find out what buyers are looking at most importantly. For example, if this particular office building exists --it's a 1920 style art deco ten-story job, which recently sold for our firm, marketed for the trust fund at the bank, as a matter of fact, and so forth. But in another case in Madison, we started looking at vacant office building sites, and we applied our point system, and we gave the best to soils and the best to convenience to public transportation, and all of the conventional things that urban land economics told you you should do, and we then applied that to our system and we got variance, although we didn't have any clustering at all. We got a very high residual error when we did that. We didn't seem to be explaining the transaction. So then we went back and we said, well, just a minute, who bought these things. Well, we find out life insurance companies and banks bought them, and they didn't give a damn about the suitability for building; they wanted visibility. When we changed our scale to weight visibility, ignored the soils conditions, looked at its proximity to where the executives lived, rather than convenience to public transit, we explained what they paid for their home office sites perfectly. But we had a sub-segment of the market. Financial institutions buying for home office buildings. Now, we backed into that. We assumed initially they were rational. We then assumed they were irrational, and then we realized they were quite rational from the guy who got to buy the site. In fact, I think somebody once wrote that irrationality is in the mind of the beholder, not the decision maker. So that the point system allowed us to identify physical, ascertainable, you know, differences and presume logically some ranking for that. Even that logical ranking doesn't necessarily apply. For example, if we were in a market that was interested in rehab, or a user's market that was interested in moving their own operation into it, the fact that the building didn't have any leases would be a plus, rather than a negative, and we would reverse the score. We'd say, hey, you know, 50% of the building was immediately available for rehab or the first floor was immediately available for the user to put in his own store operation, so once we get to that segment, the building with a hole in it is the more attractive investment. He doesn't want to wait a year for the lease to expire and then move his own store in and so on. So at any rate, you can begin to manipulate this, and we used to have computer programs which do this for us and will back into it. It then turns out to look a little bit like you see on the next page, there are comparable sales on the subject property. Just to read one line of that, the parking factor weighted 25%, 30 West Mifflin was one sale that had a 5, which was the best situation, and it had a 1.25 score. 50 East Miffling wasn't quite so good. It had a 3 weighted for 25% as .75. 16 North Fell becomes 0 and 0 and so on, all the way across. Down at the bottom then we end up with our total weighted point score for the building--5.0, 2.95, 2.50, and so on. We then have our selling price, we have our total rentable area in this case, which we were able to obtain, and we then have our price per square foot of rentable area. We then divide that by our points, and we come up with our price per point per square foot of rentable area. Notice what a nice tight cluster we get when we get down to that. We've begun to explain two things--one, our linear regression told us that rentable area was the most reliable unit of comparison in this case, and now our adjustment of that price per square foot of rentable area for points starts to give us a really tight cluster of price per point per square foot. Now, on the next page, we calculate the mean price on that and we come up with a central tendency of 7.07 dollars per point per square foot of rentable area and 52¢ dispersion around that, and notice now we compare the prices. X in the middle of the page is the price per point per square foot of a certain building. 7.07 shows the dispersion around that. That's a pretty tight cluster, as a matter of fact, and our value range then is 7.07 plus or minus 53¢. We then get an estimated central tendency of $1,150,000 for the property at the bottom of the page, using our pricing formula, with a dispersion, a high estimate of $1,240,000 and a low estimate of $1,600,000. If we want fair market value it's a million one fifty. Now our next step in that appraisal was to test that for the investment reality of it, and we did that. We built a discounted cash flow. The irony, by the way, is that the discounted cash flow on this project comes out as a million one fifty also, which is really embarrassing, because we teach continually that there is no reason in the world why the market comparison approach, the income approach and the cost approach should ever come out at the same number. In fact if they do, you know the guy's lied on two of them, and I then proceeded to do that on this one and I got the same number, but in any event, there is a market comparison approach which has eliminated a lot of indefensible, black box assumptions and which is a good example of the difference between contemporary inference and traditional comparison, and we have no problem with the juries at all. The juries understand that much better than they do the black box approach. Now, I think maybe at this point--it's what, a quarter of three. We'll give you ten minutes or so off for good behavior and coffee, and then I want to pick up two other happy approaches--one, the investment approach, and two, multiple regression, and the pitfalls and the cross-examination attacks accordingly. If you have any questions that you would like us to discuss, take the opportunity during the break to give them to me on a slip of paper, and I'll take care of them.

Some of the questions that came up during the break--One question was essentially do contemporary appraisal methods tend to produce different value estimates that conventional estimates. There is nothing inherent in contemporary approaches that should result in different values, other than the fact that the contemporary approaches attempt to make explicit the implicit assumptions of traditional methods and attempt to reduce the residual error that are characteristic of residual methods. If buyer behavior is, let's say uses gross rent multipliers and the contemporary appraiser discovers that gross rent multipliers are in fact what set price, then the conventional method and the contemporary method should pretty much arrive at the same conclusion. On the other hand if the traditional methods are sloppy in how they define best use, or sloppy in terms of how they define the rights to be transacted under fair market value and so forth, your going to arrive at very different answers, and the contemporary method is more a method of inquiry than it is a bias toward higher or lower answers per se. We simply want to be rigorous in our methods. Somebody I think during the break defined it as more imaginative or more innovative, and I don't look at it that way. I simply look at it as far more rigorous examination of our assumptions to be more careful in the conclusions, and whether those conclusions are pro or con, the client, of course, I guess the client or the attorney can decide, but we'll call it as we see it, and if we think our client has a pretty weak case, we may suggest that the time is now to settle and run and to avoid litigation because they're exposed on this or this front. A good example of that is relative to multiple regression. Multiple regression statistics have had a great deal of literature in the appraisal area because multiple regression appears to work better in real estate than virtually any other area to which it's been applied in terms of estimating the market price of property. However, there are a number of theoretical problems with it, as well as very practical problems. The theoretical problems are that it changes the nature of assessment from market comparison of the subject property to specific comparables to comparison of the subject property to the mean of a large number of only plausibly comparable properties, and that really wasn't the objective of the market comparison approach. The market comparison approach assumes you can identify explicitly what you're being compared to, and the comparison had to be on a property-by-property base. So multiple regression is a very subtle shift away from set theory to statistical theory, and probably could fail right there, but beyond that, multiple regression has four basic assumptions, all of which are violated by appraisal. One is that, of course, you have independent variables that each of the elements on which you're going to compare the properties are unrelated to each other, and that's not true. Larger lots tend to have larger houses on them. Larger houses tend to have more rooms in them. Everything is interrelated to everything else, and this cross-colinearity eventually destroys the statistical validity of the error statements that are inherent in the multiple regression. Secondly, it assumes that the residual errors will be independent--will be random, when in fact there's typically a bias in the residual errors in one direction or the other. Third, it assumes the relationships are linear, which almost they never are. For example, it assumes that each additional square foot of living space is worth exactly what the previous square foot of living space was. Well, economics tells us that this is a disutility function setting in there someplace, and that rather than having more space, you'd rather have better quality or you'd rather have more bathrooms or you'd rather have some other feature and the tradeoffs start taking place in the buyer's mind. Furthermore, the assumption of regression is that there's a continuity factor that spreads over a broad range, for example, that two bedroom and three bedroom houses are in the same market and that at some point people make a tradeoff decision. Well, that's not true either. We can show that those people who buy two-bedroom houses are in a specific group and have a specific set of criteria for their selection versus those who buy three and four bedroom houses and so on, and that those who buy one-bedroom houses have a different--or excuse me, one floor houses have a different profile than those who buy two-floor homes and so on, and we're getting rather good in the real estate game of programming the residential consumer. The American citizen is rather programmable. I remember talking to appraisers in Denver and complaining about the fact that they never went out in the field to find out what was really going on. They always talked about the market and they never really went out in it to find out what it was, and I was getting considerable heat from a number of the greybeards in the appraisal profession, when a fellow in the back stood up--it was Mr. Wright. He said, no, that's exactly what we do. Me and two other builders that he named were doing 2200 units he said in a 10,000 unit market here in Denver between the three of us, and he says I get the style dressers, Charlie gets the buttondowns, and Herbie gets the Pendletons, and he then went on to profile their consumer groups and how that matched exactly to the type of consumer that they got for their particular home and controlled their advertising, controlled their design features, etc., etc. Those of you who have been to San Antonio know that it's probably the fastest growing market in the Southwest--perhaps in the United States--and in that market, Ray Ellison Homes controls overall 45% of all single-family home sales in the city, and 85% of many of the sub-segments of that market, and he starts with Laslow from Stanford on what the consumer profile is and goes all the way down in setting up the exact codes that turn people in a particular education income strata onto buying a home in one of his developments, and he's got Stanford Research Institute doing the psychological propensities of different segments of the market, and he's got in programmed, and the fact that it's working is pretty well demonstrated when he has 85% of certain segments of the market, so that we're getting fairly good at that kind of statistical analysis on who the most probable buyer is and what turns him on and off and whether that particular project has what's needed to meet that particular group of people, and there multiple regression works very well, but when we talk about multiple regression to appraise the property itself, it becomes a very unstable, volatile, unpredictable tool and can be very easily destroyed in cross-exams. A number of people have tried it, very able people statistically and have found, of course, the greater hehavioral problem that the jury tended to regard it as black box and mystical and dismissed it. There was a major case in Hawaii in which the Bishop Estates were trying to prove that there was a significant increment in value when you went from a leased fee for a single family home to a fee simple title and that simply by being fee simple, there was an increment over and beyond the present value of the income factor represented by the cost of the leased fee and so forth, and they got totally destroyed in court in terms of their use of regression in attempting to measure the fee. I'm not sure that they didn't in fact identify the fact that there was an increment in value. It just simply was not salable in court, and they were certainly represented by a number of really able people in terms of technique and in terms of presentation, but it just doesn't sell. Now, the Federal Home Loan Bank has further ruled out multiple regression techniques on the ground that the appraiser has not inspected personally all of the comparables that are involved in his appraisal and that he has responsibility not only for having visited and confirmed their existence and presumed comparability, but that he has personal accountability for the adjustments that are to be made between the comparables and the subject property, and the regression method doesn't allow him to do that, that the co-efficients are in fact mathematical, coincidence is inherent in the sum of the square approach, and that, therefore, he has not met his responsibilities as an appraiser. Any method which apparently generates the adjustments, therefore, is vulnerable to that attack. Hence, the use of the point system that we showed you earlier gets around that. The appraiser is personally responsible for the adjustments that he has made and the weights that he has applied to them, and it is, therefore, you know, consistent with what his responsibilities as an appraiser really are. The last element relative to statistical elements is that the statistical approach--multiple regression, linear regression, factor analysis, any other of the family of lead squares methods--can be used to identify, one, variables that should be considered in the comparison process and the weight that should be attached to them; two, they can be used to weed out the non-market transactions. Multiple regression estimates of what the price should have been relative to what it was is a great flag on the reliability of that sale as being consistent with and characteristic of that particular market. So, if you have 20 sales and you have a simple multiple regression approach and two of those sales end three standard errors out from what they should--what the estimated value is, you've got a flag on sales that really are non-acceptable as market comparison transactions. That doesn't tell you what they should have been; that simply tells you they ain't what they's presumed to be, and they can be discarded from the set of comparable sales. So the multiple regression is useful for flagging that which is not similar and relevant or too different to be within the cluster. And finally, multiple regression is very useful in the aggregate. If you want to, let's say, have, you know, 20 properties that are being acquired, you can set up a multiple regression formula and predict the aggregate price of the 20 very accurately, because the offsetting errors that are going on between over-estimates and under-estimates on another will, by the nature of the technique, pretty well cancel out, and therefore, the total value of the taking of, let's say, 20 properties will be very reliable, while the individual values assigned to any one of the individual properties will not be very reliable, so that multiple regression has its applications, but not in the direct valuation of an individual property. The other element that we want to talk about that we talked about earlier today is the need to test for reasonableness, as prescribed by the Internal Revenue Code, as prescribed now by the canons of the Bar Association themself, and I want to give you a few of those tests before we open it up to a broader base of question. Today, the income capitalization approach is receiving more and more emphasis as being perhaps most relevant to what investors or purchasers of property are really buying. The market approach, as we've seen, has become more and more engineered, and the cost approach is almost always irrelevant. If anything, I'd like to take the cost approach and just take the assessor in the direction he wants to go to prove the ridiculousness of his argument before I move on and do something more relevant, but in any event, once you begin with the income approach, the first thing you have to live down is the belief that it is relatively speculative, that you are correctly recognizing the investment pattern and that your assumptions relative to the conversion of income to capital values are appropriate and supportable. The traditional overall capitalization rate of which the real estate industry loves to talk is not a legitimate valuation method today because, one, it presumed first of all that you confirm the cash equivalent price, and second of all, you figure out what net income the buyer thought he was buying. If the cash equivalent price is troublesome, given creative financing and so forth, trying to get the buyer to state what the income was he thought he was buying is even worse. Was it the income in place at the time he bought the property, the income that he expects will be possible as soon as he recycles the leases--let's say you have an apartment building that was bought from the estate and trust department of a bank that believes that all real estate should be painted and sold--now what have you got? The seller had one perception of it. The buyer said, gee, a year from now I can raise all those rents, and I'm really buying the $400 a month rents, not the $325, as the seller has them presently. Therefore, the price he paid is a function of what he presumes the income to be a year from his acquisition base, not at terms of what it was presently; or he may not have bought the current income at all. His first move was to evict all of the tenants and change the use of the building. Well, at that point, you have a difficult time constructing a reliable overall capitalization rate. The overall cap rate, as so many appraisers love to pontificate on, is all over the map, and I love to get a chance at a cross-exam to see what kind of research they did on both sides of the equation. What did they do to set price, and then what did they do to set the income that they're capitalizing, and now what's left of the subjective measure of value? Not very much. The alternative is to take a simple cash power approach, which we call back dooring it. I don't know. Gene Glick in Indianapolis years and years ago taught me the back door feasibilities by starting with the rent and driving down to value, and it proved to be a very reliable way of measuring value. It's also similar to what Coldwell-Banker teaches its brokers on how to price a property. If you look over to Exhibit 10. You take gross rent potential minus the vacancy to arrive at effective gross. You subtract operating expenses and real estate taxes and cash replacement necessary to maintain the property, and get down to net operating income available for debt service and cash dividends, and divide that then by the debt cover ratio required by lenders on that kind of property. The best source of that debt cover ratio by type of property is the American Council of Life Insurance in Washington D.C., which publishes quarterly the mean statistics for the, I think it's 18 major life insurance companies that participate. Those 18 cover about 80 some percent of the total financing that's going on in the country, and it gives you a very defensible piece of evidence in court. Now, that particular community may be a little different, but by and large, it's one that is acceptable as apparently objective in the courtroom. That debt cover ratio then gives you cash available for debt service, that divided by the debt service constant available for that type of loan gives you the justified mortage loan on the cash power of the property. That's what we mean by justified mortgage loan. It can be carried by the income from the property, not a matter of the credit rating of the borrower or taking credit for other collateral or whatever else. On the other side, we take away net operating income minus debt service cash. We have cash available for income tax and the investors. We then take the required pretax distribution rate and arrive at a justified cash equity investment. While overall rates are very hard to get from the market, we do find consistent patterns relative to the cash on cash rate expected by investors. If you'll look at current, say, neighborhood shopping centers, it's six to seven percent for pension fund all cash investor who expects, let's say, a three-year run up on the rents. We move into suburban office and we may be at eight percent cash on cash. By the time we're into MacDonald's fast foods kinds of operations, we're probably closer to fourteen/fifteen percent cash on cash because you have a high rate of obsolescence in the facility and so on. But in any event, the cash on cash rate seems to be a good proxy for the degree to which the investor expects other forms of return, either in tax shelter or in eventual appreciation of the property. An FHA Section 8 subsidized housing project may have a cash on cash return of about one or two percent on equity, simply because of the emphasis being placed on the shelter factor and so on. Now, if we take those two elements--the justified cash equity investment and the justified mortgage loan, we end up with a total justified investment. If we subtract any existing claims on it or improvement budgets that will be required, we end up with the proceeds available for the property as is. An example of that is on the next page. The facts that we have to know, the debt cover rate, the interest rate, the mortgage term, constant, the cash dividend rate, net operating income in the first year, or whatever the base year is going to be, and we go through those numbers--I don't think there's any great mystery there--we come up with $[illegible]46,000 debt service and $2,557,000 loan, our cash throw off capped at six percent is worth a million seven. We add the two and we're down to a four million three value. That's a good check. Now if you've got an appraisal in front of you that gave you that net income and so forth and says the property is worth 5.8 million, you just failed to test the reasonableness, unless he can explain where that other 1.5 million dollars value came from. It's quick and dirty, and it puts a cap on how far you can stretch the income for a certain property. Now, if it turns out that entire increment in value is due to a hypothetical resale value, you've got a fairly soft element. Notice here there is no need to come up initially with a resale price. Now, where does the 6% cash on cash come from? What you're really saying is o.k., let's say right now the target rate of return pension fund investors is fourteen/fifteen percent per annum minimum. If they're feeling conservative, they're going to say sixty percent of that ought to come from current earning, forty percent of that can come from appreciation and who knows what down the road. I want a real rate of return of nine, in effect. Great. Then nine percent cash on cash is the real rate. The six percent increment is to cover inflationary losses and so on. When they're starting to feel a little more aggressive, the amount they expect to get out of current income begins to fall maybe to 50% or 40% and the balance will be on the upside in shelter and so forth.

And those patterns are pretty clear. Nothing's as clear as one would like it to be in real estate, but the cash on cash dividend patterns are more easily ascertainable than virtually most other ratios in real estate, and so that would be one indicator. The other indicator that you want to watch is the fact that pension funds tend to stick together by the fact that malfeasance in fiduciary matters is defined by not being in the middle of the pack. Everybody wants to stand in the middle of the pack, however, they can discover and find it, and therefore, their ratios will tend to define the center of responsibility, so to speak--not necessarily prudence, but responsibility--and that will begin to give you another benchmark as to about where the values should be. Now, this same kind of approach can be converted. There are cash flow programs which will convert that to a multiple income approach. I take a ten year view and say I want my cash on cash to be 1.1 in year one at a minimum, which is probably the way the lender makes the deal if I can foresee that it will be 1.25 by the end of the fourth year, and my cash flow model will solve for the value which brings that to be, given whatever assumptions I want to make about revenue and expenses and the rate of inflation and cost and so forth. The test of reasonableness further, as is demonstrated in Exhibit 11--quick and dirty. We put this in all our appraisals that have to do with tax assessment, as well as security kinds of stuff and eminent domain kinds of stuff, and what we really want to say is, o.k., take the other side's view of life. Let's find out if it really makes sense. So here's a classic example of an assessment where you have a projection period of six years, simply because we have two three-year cap agreements in place there. We have a net operating income by year--

$449,000 the first year, and so forth and on up the ladder. Notice that the income declines for three years and then goes up again and it starts to decline for three years on the change in lease pattern there, and the first number that comes in there--number 4, acquisition cost--is what the assessor says it's worth--$5,271,282. I take this back. This is an office building. And now, do you want to use standard financing? The answer here is yes. We've said o.k., we're going to in fact set it up to achieve a 1.2 debt cover ratio, which is how we calculated the amount of the mortgage. Thirteen percent interest, which prevailed in January of 1982--I guess this is when this was done; no January '83--and a 25 year term, 12 payments per year, and a ratio of improvements to total value. Notice, we're not going to bog down in a great elaborate depreciation model. One of the things I love about computer models is that they are super-precise and totally inaccurate, you know. They wallow around in super-precision to five decimal places on the tax law, but their net income forecast has only two significant numbers. So, in this case we're saying 87% of the job is depreciable and over 15 years straight line. The depreciation method, we're using 1, which is the straight line. It's not housing, so we don't have any property problems with subsidized housing or residential recapture. Is owner a taxable corporation? No, and we state what the 1981 law effective in '82 is. We ask the effective ordinary rate for an investor--50% in both cases. Resale price--by the way, the reason we use 50% is we don't believe it. In most cases security people always talk 50%, but anybody that's into that kind of investment probably is already at a lower marginal tax rate, probably has more tax shelter than he really needs. But we like to use 50% relative to a tax appeal board because they always presume that somewhere, hidden in these tax deals, the thing is producing money like it's going out of style, and if there's something they don't understand, but those bastards are getting rich on those projects. So we like to presume the most favorable position in terms of maximum tax benefit, so that we kill that argument, and make a point of telling that argument before the appeal board. The resale price we're also assuming is $5,150,000 your net of sales cost. Now again we're taking the view that, hey, look assessor, you can presume anything you want in the future, but there's no sense hanging our real estate tax on a presumption of resale value, which is a non-vested future interest. So we'll take the income view of life, but in taking the income view of life, we simply hold that relatively tight so that my demonstration would be, alright, if I was going to sell with a 3% commission, for example, at the same price I paid for it, I'll take a look at what my cap rate is relative to my sixth year and so on, but that's a reasonable premise. I don't think that the resale price is going up 30% just because you say it is. That's proof by assertion, and if your resale price as an assessor gives me a cap rate of .075 in the year of sale and you can't even find a cap rate of .075 today, you have no right to presume that rate of appreciation, as a base for assessment. Enter the owner's after tax reinvestment rate, 8%. Here's one other thing. You want to watch out very, very carefully for the internal rate of return. It's been greatly discredited in matters of real estate long ago. In fact, I think the Harvard Business Review began to take potshots at the internal rate of return in about 1953 or 1954. Unfortunately, the real estate people didn't hear about internal rate until recently, and so it's a great favorite of theirs, but it's a very unreliable indicator of return for equity, because it presumes reinvestment at the same rate at which you're discounting, which is almost never true. So in this case, we're using an assumption of reinvestment at the tax exempt municipal rate, at the best rate of 8%, and that's what we'd do with our money if we weren't in real estate and that's what we'll do with our money when we get it out of real estate, and we're using what's called a modified internal rate of return, which is a much more defensible rate than the IRR. Now, on the next page, those are all the assumptions that go in. Notice, we've kept it simple; we want the jury to understand it; we want the judge to understand it; and we even have the faint hope that the assessor will understand it. And now, we get our product on the next page. First of all, we always get a restatement of assumptions. All you get in an appraisal is a set of assumptions about the future, and if you don't provide the assumptions, the black box output is worthless, and so here's the set of assumptions on which everything else follows, and we then get a statement of the income flows underneath that. We always require that the name of those who made the assumption be identified on the output. A funny piece of testimony, by the way. In one jurisdiction, he said, no representation is made that the assumptions by James A. Grasskamp are proper or that the current tax estimate used in this projection would be acceptable to taxing authorities. That's a hold harmless that our attorneys wanted us to put in there because of the fear that it might be used in a syndication prospectus or something of that sort, and this goes out on our letterhead, and the assessor in challenging it said look at that, it's on Landmark Research letterhead, but even his own company won't stand behind him, which is an interesting twist. I tried to assure him that my own company stood behind me, but they weren't buying it. On the next page then, you get a recap on the resale price, so that the appeal board and so forth can see exactly where the money went and how that calculated, and then at the bottom--notice up at the top, first your equity dividend 3.8%, average debt cover ratio 1.3, and it says if purchased as above, held for six years and sold for $5,150,000, the modified internal rate before taxes is 4.38 percent and after taxes is 5.85 percent, assuming reinvestment on after taxes of 8 percent. Now we would submit to the appeal board that the assessor's got to be wrong. He agrees with our income estimates and if the next buyer paid what the assessor said it would sell for, the investor is only going to get 4.4 percent before and 5.8 percent after taxes, something is wrong, and therefore, we have a prima facie case for appeal. Now, the first thing we would do is then take our value and back it down. We'd say o.k., if the purchase price were this and the resale price this, this would be the result. And we back it right down and we say o.k., now we've got a return before taxes of say 15% and an after tax return of 20. Now I'll go back and look at my indexes on pension funds and so forth for institutional investments or any other form of investment I want to look at and say o.k., how does that compare? Well, equity returns in real estate have, let's say, been traditionally 150 basis points below the mortgage rate. The mortgage rate at this time was 16-1/2 percent. I've got 15 percent before tax on my money. I'm right historically where I should be relative to rates of return. Therefore, we would submit in the first case that the proper value should be X dollars, based on this approach. But now let's go back in the market place and find out if we can support this in the market place with market comparable sales. But notice, I begin my appraisal by a statement assuming, you know, the eminent domain authority is correct as to what the value is, or assuming the tax assessor is correct, and so forth--here are the investment consequences of that presumption. I like to take people in the direction in which they indicated they wanted to go, particularly, let's say, where they use the cost approach. Now let's say they've killed me with the cost approach. I would take that cost value that they gave and plug it into this model and run through it. Maybe it would come up with a negative rate of return. Then I would back it down, and I'd say the real value is $4.5 million. Currently it would cost $5.5 million to build it. Therefore, I must have, what, $1 million in location and functional obsolescence, because it's unable to justify its replacement cost. Therefore, Mr. Assessor, if you want to use the cost approach, that's fine with me, but do it right. Deduct for wear and tear, deduct for functional obsolescence, deduct for locational obsolescence; and when you do that, the only way you can measure locational obsolescence is measure it by the impact of the market rent and income factor on the property; and therefore, my income approach, rather than using it as a method of valuation, where the court in fact may shoot me down in many jurisdictions, I used it as a way of measuring locational obsolescence and bringing it into the cost approach, which they love. So I simply changed the guise in which I bring my income approach in to bear on the problem and get away with it. Now, are there any questions on that? But keep it simple. Notice, in this case, we've stayed out of any elaborate cash flow models. I can kill you with cash flow models, as the University of Wisconsin was the original developer of cash flow models, and we can get as complex and confusing as you wish, but it just doesn't sell in the courtroom. It's usable in the board room, but not the courtroom. Now, investment value of a property from existing leases or operating data presumes first of all that you want an objective, most probable price at which it will sell, and you identify all of the interests which you are selling. The investment value is what you need for pension funds, collateral values pledged to secure loans and so forth. Fair market value may have nothing to do with the loan. As we talked about earlier this morning, the hotel in which you're also subordinating the furnishings, the elevators, the kitchen equipment, the franchise name, and so forth, is now an investment value of that hotel; it is no longer fair market value with a fee simple title. I don't remember King John at the Magna Charta saying anything about the Holiday Inn franchise, the elevators, and the furnishings as being part of the fee simple bundle of rights. Now, the second element is that the appraiser has read the leases and represented them correctly, and therefore, today an appraisal must contain a lease-by-lease itemized analysis and he must extrapolate those leases into the future appropriately and he has a number of accounting decisions to make and appraisal accounting is probably the worst accounting in the world. It's probably--well, maybe not the worst accounting; second worst account. First worst accounting is for doctors and other people who have cash income and somehow lose all of the income before it reaches the books in the first place. But the appraiser isn't that clever. The appraiser just doesn't know how to do accounting. The individuals who manage to lose their case do know how to do accounting. In fact, talking about creative accounting, when I was in the building business for many years, and the way we were able to go on no capital at all was my partner and I were both graduate students, started out with $2500 apiece, and we were building prefab homes by Sholz Homes out of

Toledo--kind of a Cadillac prefab at the time--and they required a certified cashier's check on delivery of the package to the site and that occurred when the site was backfilled and the deck was on the foundation. We were able to convince our bank to give us a draft for that amount of money at that time, and we then decided to build stick, but somehow we failed to communicate that clearly to the bank, and they continued to give us a draft for anywhere from 45 to 55% of the total construction cost when we capped our foundation, which give us a tremendous amount of leverage on which to expand, but being fairly young in the business, we tended to make mistakes. We discovered that our bank loan officer was watching our gross margin all the time on jobs, so as a result, it became expedient not to credit our mistakes to the jobs and maintain a gross margin and we created an account called Tuition on the administrative expense side and we assigned all of our errors and the cost of correcting the same to the Tuition account, and finally I made really bad error out on the west side of Madison and forgot to check the depth of the sewer line and I had to go down about 18 feet in sand to pick up the sewer line from a line back to the house, and I had to bring in a back hoe and I had to shore it all, and it just cost me a bundle--about four grand, I think, to get that sewer line in. And my banker was sharp enough to note that Tuition had bounced up to $4,000 that month and we asked he said, gee, you must have been going to a lot of seminars, and I said no, that was the school of hard knocks out here on the west side, and he was finally on to me, but by that time, we were financially solvent and he didn't seem to care quite as much. So I'm a past master in creative accounting and had the first computerized accounting system for builders in the Madison area, simply because I knew my bank didn't understand it and I could have full disclosure and knew that he understood nothing.

That's something I learned from my friend in securities. In any event, appraisers have a real hard time with accounting. You have problems of accrual versus cash--for example, what do you do about commissions paid on leases. The practice might be that you get 30% at the time the lease is signed, 30% when the tenant moves in in the first year, and 40% at the beginning of the second year. Well, wonderful. How does the appraiser do that? He doesn't. He either ignores leasing commissions altogether or accrues them over the life of a lease, like an accountant does, and he gets entirely the wrong cash flow for the project. He does the same thing with tenant improvements. He can have a tenant move in for 40% of the building, the landlord puts in $12 a square foot under the tenant allowance, another $8 a square foot, which is built into the rent, and the poor appraiser misses the whole thing. He just assumes that's in the value there somewhere and takes the present value of that total cash flow. Another area where he has a difficult time is in the area of insurance, the area of bumping the lease through on, let's say, CPI indexes, pass-throughts, reimbursements, time lag of reimbursements and so forth. Today, if you're going to have the appraisal done right, your letter of engagement is going to have to specify that one, for each lease he has the base rent; second of all, he has the time adjustment; third of all, he has the date or anniversary in which the base is modified; fourth, he has the assumptions as to reimbursements, you know, what's the cap sort of thing and then at what point does it begin to operate, and there's really a significant time lag, as we suggested. Let's say that there's a 350 stop on the lease and it may be somewhere into the second year before expenses exceed 350 a square foot. Now, once you've gone through that point, it's going to be into the third year before the landlord now has an anniversary in which he can calculate that and apply for reimbursement and then there's going to be a time lag between the time he actually receives it, so with a stop on the first year's lease of 350, it's going to be the third year before any reimbursement income shows up. If you really believe in the present value of money, you've got to lag each one of those accordingly. By the same token, if you have percentage rents, there is a significant lag in the realization of those percentage rents, and the building of the cash flow sheet has been significantly enhanced by the fact that you can use lotus 1 2 3 or supercalc or any one of the minis, and any appraiser worth his salt is doing that presently and is in fact handling those lags and so forth appropriately. The appraiser has to audit, as we mentioned earlier, the pass throughs, the time indexes, and he cannot presume the lease abstracts provided by the property manager to be sufficient. He's going to have to go back and read through the leases to find out what little surprises are present there. One of the major elements today is the appraiser should indicate the energy budget in BTUs for the building and kilowatt hours and compare those BTUs per square foot or per leasable unit and kilowatt hours per leasable unit to identify the degree of obsolescence from an energy standpoint inherent in that building. That becomes a major factor in indicating the ongoing resale value of that building, which is typically overlooked. Furthermore, he should have some sense as to whether that in fact is curable or not. Finally, the appraiser should indicate whether there was engineering inspection of the building on which he could base his appraisal, and particularly whether there was thermal photography of the property available at the time of the valuation and, with those exceptions, then apply his limit of liability on latent defects. The cost approach, which we talked about briefly earlier, has a certain pseudo-science to it, which is very attractive to many courts, and sooner or later the appraisal organization, as well as lawyers dealing with real estate, are going to have to take this issue head-on. There is nothing about the cost approach which puts a lid on value. As we mentioned earlier, it is the most subjective, unreliable of the approaches, has been thoroughly discredited in the literature of appraisal, and yet it continues to haunt us in the courtroom because of the presumption that precise is accurate. Now, the cost approach is the sum of a series of fictional numbers. The English make a very clera distinction that when you're dealing with an existing building, you don't deal with the value of the land as though clear and vacant. You deal with the value of the land if it were to be sold for the use that's presently on it. That's a significant difference in viewpoint. If you take the value of the land as clear and vacant, consistency requires that you presume the building is now obsolete and would be torn down, and therefore represents a liability on the land, and if your best use decision is what you have to make, then you figure it both ways and figure out which gives you the higher value, so an English appraisal will clearly state very innocuously the value of the land in its existing use, and nobody realizes that it's a significant variance from the American view, if you're not alert to that language in the report. Now, the cost to replace or reproduce is an old argument, which we won't get into here, other than the fact that when you say replace, you have to be aware of what the currently technology is relative to what the technology was in the property that you're analyzing, and then all of the deductions for functional obsolescence are not functional obsolescence in the existing building per se, but

obsolescence to the degree that it doesn't have the features presumed by current technology
if the R factor in a current building is 35 and the R factor in old buildings was 15, then the construction cost you're using currently for replacement assumes an R value of 35, and you have to deduct to adjust for that over-improvement relative to the replacement base that you're using. It doesn't mean that the old building is, you know, particularly undesirable; it just simply means the base cost that you're using represents over-improvement relative to what you've got. It's a very subtle aspect of the bias in the cost approach toward the wrong number. Now, once you start to reduce that, you have to subtract the cost to cure deferred maintenance from wear and tear. That's a messy one, but on occasion there are budgets for that. Cost to cure functional design features which can be corrected. Here you may even have to go out and get estimates. If you're talking about an obsolete highrise building with elevators that are still manually operated, you'd better go back and get a price on what it will cost to put in contemporary elevators. If you're talking about a building that is still fueld, let's say, on oil, you'd better go back and get a cost estimate on what it's going to cost to convert to gas. If you're talking about an apartment building that still has doormen at the front end, you'd better figure out what it will cost or what you can save by getting rid of that particular amenity, or you're going to have a very significant distortion in the character of the building. Then loss in value have to be reduced to either incurable functional features or features that are not in the cost base, as we talked about earlier. Number four, loss in value because the market won't pay for super-adequacy features included in the replacement or reproduction costs of the subject property. Here's a classic case where even your Bar Association white paper is wrong.

It states the cost to replace is appropriate for subsidized housing. Not so. First of all, the cost of subsidized housing has some subtle distortions in it. One, under the Davis-Bacon(?) Act, it presumes that you have used union labor throughout, whereas residential housing most typically is not built with residential labor. That's a factor right there. Secondly, it presumes a whole variety of multiple family building standards which are in excess of what the conventional market place might require. Third, the size of the units is distorted by the fact that subsidized housing permits you to build more than you would have built for market rent, and that was recognized in 1983, when in fact the Section 8 program prescribed maximum sizes for units, which are significantly less than the unit size that was being built prior to that point in time. So if you're going to have an assessor come at you with the cost to replace on that baby, the first thing you do is you take out all those elements of super-adequacy. The second thing you do is you take out all of the costs that are involved in financing the FHA Section 8 way of doing business, and you'll find that the costs are inflated on a Section 8 by about 20% and the rents are probably inflated--fair market rents--about 20%, except for in certain areas of the country--the Washington/Baltimore area right now. Fair market rents on Section 8 and market rents are about the same. Market rents may be a little higher. In Dallas, for example, market rents are significantly higher than that which is permitted in a Section 8, simply because of the press of demand for units. But by and large, fair market rents are significantly higher than market rents, and market rents are what you have to value the project with. So you have to begin to look with care at what the super-adequacy elements are and their source. Locational obsolescence of the right structure in the wrong market area--we have a classic right at the moment--a major insurance company's home office in a small town, over $100,000,000 to build, it has 400,000 square feet of leasable area, which is obviously indicative of a pretty lousy efficiency ratio to begin with, but it's an area in which there are 30,000 square feet of rentable office space. Now you have to measure what is the resale value, and what presumptions are you going to make. Interestingly enough, in that particular case, they got an appraiser to say, well, assuming any other insurance company with a similar desire to be in a small town and similar space needs, and they arrived at a market value, for the insurance commissioner's benefit, exactly equal to the cost to construct. Marvelous. I don't ever remember reading that set of assumptions in fair market value someplace. But in any event, the value is much closer to probably 30 or 35 million than it is to 100 million, simply because of the locational aspects of the building. Interestingly enough, that particular case involves the local assessor, who is at 35 million, suing the state that's at 85 million, because the higher equalized value shifts more of the county and school board tax to the local community. You've got to think about that for awhile. Finally, of course, economic obsolescence of a specialized structure for which there's no economic need. You can have a buggy whip factory which is absolutely the highest tech buggy whip factory you could possibly build at perhaps the best location for selling buggy whips, if buggy whips in fact were to be sold, which they aren't. At that point, the cost to replace minus 100% comes pretty close to it, and then deduct the wrecking fee and you've got a negative value for the property. So, the cost approach represents a very, very fictional approach to value, and the fact that some judges and some courts still rely on it is a sad comment on how it takes the message to get through to some people. The academic literature, if any of you want it, is absolutely devastating on the reliability and irrelevance of the cost approach. Now, cost is never valued, and as I say, in the 1920's, it was regarded as unethical and probably will be again. Now, I'd like to talk briefly about what's happening in appraisal and appraisal protocols because it's going to have an impact on the law, just as your change in legal protocal relative to your responsibility for appraisal qualifications and content are going to have an impact on how you relate to appraisers. The supervision of appraisers by their own organizations is in a monumental state of flux. First of all, designated appraisers on both sides of a legal issue are no longer required to submit their appraisals to review by their peers. That become a hopeless morass, and the appraisers decided to bow out of attempting to referee the variety of assumptions and standards of performance that were on both sides. There is a process, however, for review of ethical issues, but it's dependent on the willingness of the client to pursue that review, and lenders and lawyers are reluctant to do so. There is a very small committee of two or three, who receive all complaints and pursue their own independent investigation, are paid to do so by the appraisal organizations, and then decide whether the situation deserves some collective action, such as yanking the individual's designation, suspending it, reprimanding him, or putting some kind of element in his file indicating essentially a nolo contendere-- I didn't do it and I promise not to do it again sorth of thing. Now, that process doesn't work because the average lawyer or client is unwilling to pursue it. No matter how blatant the presentation of the appraiser in the courtroom, once the trial is over, you go on to other things in which your time is being compensated, rather than one which is a pursuit of equity and so forth, and as a result, the number of complaints filed is relatively small, although the action taken where there are complaints is relatively effective, and therefore, to the degree that you don't drive some of the charlatans out of the courtroom field is your own fault, and some of them I've seen are absolutely blatant. I had one recently, which I thought was magnificent, in which the appraiser testified he had done the work on a computer, and when, under cross-exam, our side asked if we could see the output, he said he didn't have a printer, and therefore, when he turned the machine off, the work was lost. So the number stood out there all by itself. I love it. I never thought that my big mistake in life was buying a printer for my computer. The cost of cancelling a professional designation in appraisal right now is probably about $25,000, and the recertification process which they are attempting to implement is a relatively weak threshold. You have to be extremely delinquent in all your various responsibilities before you're denied recertification, but it's an effort, and the supervision that you can expect, however, from the appraisal organizations at the moment is minimal. Appraisal within and for an SEC prospectus does expose the appraiser to equal liability for sins of omission or commission with the attorney and accountant, and that probably is appropriate, and there is some effort now by the FDIC and FSLIC to pursue malfeasance cases against appraisers who obviously grossly overestimated the value of property pledged as collateral, but typically that emerges only after the bank has failed and long after any accounting records and so forth exist by which you could demonstrate that fact. Now, appraisal organizations are currently attempting to merge and establish a single standard, but the problem with that is that appraisal is no longer a generic field. To be an NAI, to be an SREA, and so forth, really signifies nothing, because no one can know all things about all classes of property under all sets of conditions.

As we mentioned this morning, pension investors estimate there are probably no more than 100 appraisers who are qualified to do large income properties in the U.S. That's an incredible statement, and yet meeting with the Prea(?) people and the Makre(?) people in attempting to do some research on what the appraisers were doing, that was--they came up with even fewer names than that. I think we ended up with about 50 names of appraisers or firms that were regarded as reliable in doing that kind of work, and I'm not sure what "reliable" meant--like, you know, they would produce what we wanted them to produce. In any event, many of the best appraisal witnesses and best appraisal reports today are being done by firms which are not recognized as appraisal firms and which have no appraisal designation. That's why you're going to have a great deal of trouble defining what is qualified appraisal content. In fact, if there's any one problem with appraisal right now, it's the term appraisal itself. It has developed such a narrow content of what the appraiser is all about, that he does fair market value and nothing else, that it may be a significant factor in holding back his career. You may be better off to recognize him as a real estate analyst, and a real estate analyst has a specialized, narrower function, one of which is doing appraisals, and that's true of major firms, like the Robert Gladstone Company out of Washington D.C. is doing a lot of pension fund appraisal work on income properties today and I don't believe to this day has an NAI on its staff. Rulack(?) for example, at Kenneth Leventhal and his group are doing a lot of good valuation work, and I believe again they pride themselves on not having an NAI on their staff, simply because they're not locked in to what they perceive as obsolete methodology and accountability which can be harassment by the professional groups in terms of innovative technique and so on, and the accounting industry is moving very, very quickly into appraisal. A number of the major accounting firms have quietly bought their own appraisal companies, in order to name(?) some independence between their auditing services and the appraisals which will be done as part of those, and they haven't quite figured out how to solve that problem of independence and the traditional auditing ethical standards. In other cases, they are developing real estate capability in house, which would probably be good for everything but a balance sheet number, and the accountants, of course, have much better credibility and training relative to accounting for discounted cash flow than the appraiser. On the other hand, the accountants tend to over-estimate their ability to analyze what's going on in the market place. A good example of that would be, let's say, a Leventhal and Horwath(?) hotel feasibility study, in which their cash flow models were way ahead of those of the appraisers, but their market data was either relatively weak or they sidestepped it by saying if it has a 50% occupancy or a 60% occupancy or a 70% occupancy, then the investment performance and value is as follows. Well, an if/then statement doesn't do it, because in feasibility you don't want to know if, you want to know that it will in fact perform at a certain level, a minimum threshold level and so forth. But nevertheless most of the big ticket appraisals are slipping away from appraisal firms that hold themselves out as appraisers. There are a small cadre of superb appraisers out there operating independently, and they operate independently because, one, it's too hard to supervise a large staff and maintain quality, and two, they can get paid sufficiently well for their own services that they don't need to leverage their name by having a whole bunch of folks running around doing appraisals in their name which they're just signing off on. But most of their really super work is not being integrated into the mainstream of appraisal process. So in selecting appraisers, you can do as well selecting a non-designated individual who has the technique as you can a designated individual who has simply a generic designation but no experience in a particular area, and this is going to make that dilemma of who's qualified extremely difficult. As you further bat with merger of the appraisal organization, the problem is going to get more complicated. Those who are outside the American Institute of Real Estate Appraisers will be more free in their assistance in the courtroom relative to the development of cross-examination questions and so forth, which is frowned on, as you're not supposed to be, if you're one of the fraternity, there helping blow up the other member of the fraternity, and as a result, real estate consultants--and there are a number, as I say, of good firms around--whether it's economic research, real estate research corporation, Robert Gladstone, Kenneth Leventhal is superb, and so forth--they're much more free to participate in the strategy of the courtroom process than would be the designated appraiser, or the designated appraiser would not appraise the property; he would simply serve as a consultant in helping select those who do appraise the property and forming critiques of their reports and so on. Now, the possibility that all of the appraisal organizations will merge is going to create an interesting problem in designated and what undoubtedly will happen is that an umbrella organization will be created that will be a federation of specialties, and it will look a little bit like the National Association of Realtors or even indeed your Bar Association, in which you have a whole series of sections and divisions with prescribed specialties, and those specialties then will become a better set of qualifications for meeting either the

Internal Revenue Code or the SEC Code or indeed the legal canons in terms of selection of appraisers. Finally, we've talked about accounting firms moving in with their own real estate divisions. The investment banking firms have some subsidiary real estate divisions. Their testimony may be more relevant in market comparables than appraisers simply because they're making the deals that they're testifying to. It eliminates the whole problem of investigation, hearsay evidence, and so forth, and they're starting to come forward and being able to use the details of the deals they've made to support their appraisals. The English have been very good at that--Richard Ellis, for example, and James Wooten Lang(?), and so forth--have traditionally operated on both sides to facilitate deal making, as well as doing appraisals, and they, therefore, use their inside knowledge of the deals as the basis for the comparables, and it makes them very, very strong witnesses, because they're not on the outside looking in. The third element that is starting to come into play are engineering firms tied with some sort of appraisal analyst. So much of value today is dependent upon the physical analysis of the asset, whether it be land's suitability for development and the number of acres that may be buildable as opposed to non-buildable because of environmental factors and so forth, or whether we're talking about buildings and the degree of mechanical obsolescence inherent in the structures, there is almost no way to define that based on the appraiser's generalized knowledge of real estate. When you combine that further with good property management information, you can build a very good case on investment characteristics of a building, and some engineering firms are starting to create a real estate valuation subsidiary. The danger, of course, is that engineers like to use the cost approach, rather than the income, and particularly the market comparison approach, and therefore, for a large property valuation issue, you're better to put a team together in which you have a mechanical engineer for the building, for example, a property manager to analyze the expense account, an appraiser to set the rents and convert all of that data into a real estate valuation on the project. Finally, we've mentioned earlier, again there's starting to appear is a whole new set of standards on appraisal in order to reduce the degree to which form becomes a medium for disinformation. You've already seen the new tax law, in which the lawyer is getting stuck with responsibility he doesn't want relative to qualification of the appraiser, and some imputation of the reliability of the appraisal product and some requirement that he go forward, and if he doesn't know about appraisal, find somebody who does to advise him sort of thing, being imposed on your by the IRS. The SEC, of course, had an earlier date. It made all people culpable in terms of accounting appraisal and legal work on the prospectus, and at the moment, the conditions under which the IRS or the SEC can impose sanctions for violation as a result of aggressiveness in appraisal are relatively limited, but you can begin to watch that parameter of encroachment drop. Currently I believe it's, what, 150% excess valuation represents aggressive and gross over-valuation. The burden of proof is on the IRS. 150% is such that they can establish that, you know, from a legislative standpoint presently without threatening anybody too greatly, but I think you're going to find that percentage is going to begin to drop because there's no reason at all why the variance in an appraisal should be 50%. The variance in an appraisal of 10 or 15% is probably about all that could be justified for most investment properties. Beyond that, you're going to find the people that regulate pension funds are either going to propose the standard or they're going to be headed off at the pass with Prea and Makre's proposing appraisal standards in order to permit comparative investment performance and comparative asset standards. HUD for years has interfered in the appraisal process and continues to do so with rules that sometimes are lyrical, sometimes are not too imaginative. On the other hand, there is considerable talk that appraisals relative to residential lending will probably be abandoned altogether. They are no longer cost effective, that the fees have dropped to the point where you don't get an adequate job. You can do as well from an automated data base as you can by sending a guy out in the field. What you really need is a property inspector to make sure the property is there, not being abused or falling down or something, but you really don't get much benefit out of a value estimate, given the mortgage guarantees of one form or another and so forth. And so you may find in the not too distant future that for many purposes the single family home appraisal will drop out of consideration and some other way of imputing collateral values will develop. By the same token, we're beginning to see the FSLDIC crack down, RB41, or I should say R41B, beginning to simply repeat at the moment what a fair market value appraisal is, is going to be intensified and those pursuing mortgage loans will find far more constraint on their choice of appraisers and the methodologies that will be employed for the purposes of income property lending. Similarly, the FDIC is going to modify that which is considered as an appraisal product, and rather than being simply a CYA document in the file, which is not playing a significant role in the lending decision itself, the appraisal will become a major part of the lending decision and the failure to abide by the appraiser's report will expose the lending officers and the bank officers to sanctions. The major element that will change there is that the lenders must use appraisers approved by FDIC and FSLDIC, that the appraisal fee will be included in the loan fee for application, so that in fact the inherent bias of the current system where the borrower selects the appraiser and the appraiser fears that his collection of his fee is going to be contingent on getting the right number in support of the loan will be eliminated and that he will be permitted to go back to being an independent observer of the market place, without intimidation as to whether in fact he's going to collect his professional fee, and that type of reconstruction will create positive incentives, whereas the IRS approach of sanctions and penalties for taxes not paid as a result of the appraisal simply says that the appraiser isn't even going to go into that field. That's a Gresham's(?) law kind of device in which the appraiser who says, gee, I can do enough volume coming up with schlocky numbers before they catch me will stay in the field, and the appraiser who doesn't choose to be smeared by the IRS for any reason will simply not do those kinds of appraisals, so positive incentives in terms of control of who pays the fee and whether it's collectable, whether they have the right number or not, will have much more to do with the reform of the appraisal process in the future. With that, I'm going to stop on the formal content and would be happy to address specific questions to the best of my ability. Yes sir.

Q: You make reference to an ABA white paper that dealt with evaluation of Section 8 subsidized housing. Do you have a reference to that? Where is it?

JAG: The reference is simply an example provided in the May 1984, what is the reference right here, Bill. I've got the paper right here under this paperclip.

Bill: It's a report of the special task force on appraisals, committee on real estate tax problems, section of taxaction, American Bar Association.

JAG: And it's in section 3, where they refer to the fact that the cost approach is still regarded as the upper limit of value in most jurisdictions and that that is appropriate--or they infer that it's appropriate for subsidized housing, which it's not.

Q:

JAG: Oh, good, alright.

Q:

JAG: Yes sir.

Q: This morning you mentioned the Elwood approach. Is that a particular type of style of...

JAG: The Elwood approach was a very popular approach, which still appears in many appraiser's guides that are about '50 or '55, which was an investment band theory that assumed loan to value ratio and a constant and then a rate of appreciation and calculated an overall rate equal to the rate desired on equity minus a leverage factor which was the mortgage ratio times the mortgage coefficient and then adjusted upward or downward, depending on whether you anticipated appreciation of the property or depreciation of the property. It became very popular because there was a specious kind of precision to it and it was advocated by Elwood, who was a loan officer for the Mutual of New York, I believe, who was a very find appraiser. The reason he developed it was to be able to sort through loan applications instantly and find out whether the value as represented was consistent with the financing. However, he tempered that with a good deal of market data and so on. What happened, however, it was espoused very quickly by the mortgage bankers because you could inflate the value significantly by coming up with a blended cap rate that was lower as a result of inflation and interest rates and presumption about appreciation, and you got higher values. The loan was based on the total value of the property--75% of value--rather than on the debt cover ratio, and as a result, you still see to this day people are using the Elwood approach, assuming a 75% loan, in which the 75% loan produces a negative cash flow. I caught somebody doing that on a major shopping center a couple of years ago in court, and they went through this whole elaborate to-do about how this was the way life was, and then I said, hey, but that produces a debt cover ratio of .9, for, you know, you don't even have enough net income to pay the debt service, and no institutional lender in his right mind is going to make that kind of a deal, and he blew his appraisal out of the water. So, the Elwood approach was a popular methodology in the '60s, which has been discredited in most areas and Home Loan Bank in fact has prohibited it from use in the application for loans at savings and loans on income properties. It tends to inflate the value. Does this get at your question?

Q: Yes.

JAG: Yes.

Q: On your write out on the feasibility of alternative uses, I had a little trouble understanding the category of relative investment power based upon revenue generation potential.

JAG: Good. That's a back door approach. You'll remember that little chart that we went through. Looking at the cash power of the property only, the ability of the property to support a loan, the ability of the property to provide cash on cash equity, ignoring income tax characteristics, ignoring residual values. O.K. So it's a cash power measure and ranking each of the individual scenarios accordingly.

Q: What is that, to your expected income?

JAG: Yes. Your net income less operating expenses. O.K. And then down to net income available for debt service divided by debt cover ratio divided by the typical constant available for that kind of property. That's right on that same chart--it was a little further on, there was exhibit 13 or 12, something like that, and just looking at the cash power of the property, it does not turn out to be the value of the property because it hasn't treated residual values and so forth, but first here, the reason we use that, the three criteria of real estate investment is the first thing you need is solvency. O.K. The enterprise has got to be able to break even. The second criteria has got to be cash on cash in terms of immediate gratification of the investor in some form of spendable dollars typically. That may be more or less, depending on the character of the investment, and then finally the overall rate of return to the investment as a result of residual values and so forth. So we're saying the first criteria is solvency. How much cash can the project carry in terms of investment because of its ability to repay debt and meet immediate dividend requirements of the investor. Alright? So that cash power line is a solvency test and has nothing to do beyond that in terms of investment return and so on. Yes.

Q: Is there an authoritative source of expected cash on cash returns for various types of properties. You were talking about MacDonalds at 15% and other kinds of items ______________________?

JAG: No, there's not an authoritative source that, you know, would be all inclusive. Depending on the investment quality properties, there's a new index which is probably as useful as any--the Frank Russell index--which represents a portfolio of 800 major income properties across the U.S. that reports quarterly on the cash on cash returns and the overall rate of appreciation and the total rate of return annually by property classification, so it's broken out by industrials, apartments, office buildings, hotels, shopping centers, and so on. That would be one area in which you can get some fairly good normative things and then that's broken out regionally as well as by property tax. Another is the American Council of Life Insurance, which will give you the debt service debt cover ratio and the constant, where you can move back from that to what the cash spread is supposed to be for the equity position. The third and fourth categories have to do with specific property types. The Dollars and Cents of Shopping Centers is published every three years as a joint effort of the Urban Land Institute and the National Council of Shopping Centers and is probably one of the best sources of measuring that by _________, by size of center, by age of center, etc., etc., etc., and will give you some benchmarking for that. Boma(?) has some on office buildings broken out regionally as well, but it's not quite as good as Dollars and Cents for Shopping Centers. Otherwise, it becomes a local phenomenon. You just have, you know, if you know what you're doing in your particular, your market, you've got a pretty good idea of being able to prove from sales what people were going for, o.k. Does this get at your question? Any others? I guess I plumb wore you down. Thank you for your patience.