

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

F. Miscellaneous Professional Associations

9. "The Pension Fund Appraisal Boondoggle",
presented to the National Council of Real
Estate Investment Fiduciaries, April 7, 1983

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March 3, 1983

Professor James A. Graaskamp
University of Wisconsin
Graduate School of Business
1155 Observatory Drive, Room 118
Madison, Wisconsin 53706

Dear Professor Graaskamp:

On behalf of the National Council of Real Estate Investment Fiduciaries, we are very pleased that you have accepted our invitation to speak at our meeting to be held in New Orleans at the Royale Orleans Hotel on April 7th.

The meeting for that day is expected to be divided into four topics, each of which will be presented by one speaker and one respondent. Each topic will be allotted approximately one hour for presentation, response, and discussion. We have attempted to pair an academic and an appraisal professional on each topic. Blake Eagle has agreed to serve as moderator.

As you can see by the questions, the overall thrust of this session is to get at the real issues of valuation of real estate in the pension fund accounts, particularly as it relates to valuation methodology, accounting policies, and performance measurement. The National Council feels strongly that there are substantial issues here that have to be resolved among the professional groups represented.

The specific questions with the name of the speaker and respondent are expected to be as follows:

1. What is meant by the valuation boondoggle?

Professor Graaskamp, University of Wisconsin / Dennis Anderson,
President, L. W. Elwood & Company

2. How should real estate be valued?

John White, Chairman, Landauer Associates / Professor Mike Miles,
University of North Carolina

3. How does volatility of real estate impact valuation?

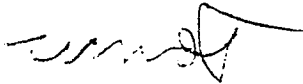
Professor Jim Hoag, University of California, Berkeley/
Charles Akerson, President, Akerson Valuation Company.

4. What is the appraiser's responsibility to the investor or pension client in a closed-end or commingled separate account?

Leanne Lachman, President, Real Estate Research Corporation /
John McMahan, President, John McMahan & Associates.

If you will let my secretary, Debbie Cook, know your expected time of arrival, we will arrange hotel accommodations and, where applicable, necessary transportation. Please let me know if you have any other requirements.

Sincerely,



WMW:de

P.S. The National Council has agreed to cover your reasonable costs of transportation, hotel, and food.

THE PENSION FUND APPRAISAL BOONDOGGLE

National Council of Real Estate Investment Fiduciaries
The Royale Orleans Hotel
April 7, 1983

Professor James A. Graaskamp, CRE, SREA
University of Wisconsin School of Business

- I. The reliance on an annual appraisal of the Commingled Real Estate Fund for Pension Investment dramatizes the underlying weaknesses of appraisal methodology and of appraisal profession governance to a point that the best minds in pension investment are seeking alternatives to the real estate appraisal process.
 - A. The failure of real estate appraisal professional organizations to meet the new challenges of institutional valuation requirements will become apparent and their impotence will mean the end of viable professional organizations and substitution of appraisal standards and licensing by ERISA.
 - B. The American Institute and Society of Real Estate Appraisers have never issued a white paper or suggested a standardized set of accounts by which income property valuation could be combined into aggregates, compared to determine adjusted means and ranges, or combined income statements into meaningful indices of performance. (in fact, these societies have never issued a white paper other than a principles text and a terminology handbook).
 - C. Contemporary appraisal begins with the simple syllogism as follows:
 1. What are the issues for which an appraisal or a given date is required as a benchmark?
 2. Which definition of value is appropriate to the issue?
 3. Which assets are to be included in the valuation?
 4. What is the most probable use scenario for the defined assets?
 5. Who is the most probable buyer for that use?
 6. How did these buyers set prices on similar properties in the past?
 7. How would those buyers simulate a purchase price in the future?
 8. Failing that, how would appraisers recommend the price be set?
 - D. Any price determination from the market has to be tested for externalities and qualified for terms and conditions governing the transaction.
 - E. Traditional appraisal simply has not addressed the issues in a commingled fund for which an appraisal is required:
 1. Measurement of investment unit value at a particular point in time to reflect entry and exit values for the investor.
 2. Measurement of investment performance and profitability over a specific period of time.
 3. Allocation of asset values among land, improvement, and soft assets including unrecoverable sunk cost.

- II. The Primary Function of Appraisal is Initially Measurement of Investment Unit Value in a particular point in time to control or establish entry and exit values for the investor. By default there seems to be a presumption that exit and entry values are the same, presumably because these are no load funds. That is a cop-out on some tough conceptual issues:
- A. First of all accounting distinguishes between exit values assuming successful completion of the on-going business plan and exit values assuming liquidation; and liquidation must assume bulk sale of assets or piecemeal sale of assets.
 1. Although withdrawal of unit investments is discouraged, a commingled is nevertheless a demand account with the cooperative feature of being able to go "on call" to avoid technical insolvency.
 - a. On call suggests partial liquidation rather than bulk, orderly completion of the business plan;
 - b. Portfolio liquidations such as Dayton-Hudson, Monumental Life, and others have suggested that group sales bring higher prices than individual sales since the weaker tomatoes are packaged behind the better tomatoes.
 - c. From an ERISA standpoint a conservative liquidation value serves their purpose of measuring additional funding requirements while the present obscurity and ambiguity of real estate economy favors under-funding of future pension liabilities.
 - B. Should asset values in a portfolio of properties be consolidated or treated as a series of separate enterprises? Each property will have its own working capital fund, reserves for replacements, intangible assets in the form of licenses, operating agreements, deferred expenditures, and capitalized expenses.
 1. Appraisal of 26,000 properties in the Receivership Trust were valued as a single cash flow unit but on the other hand stock and bond portfolios value each security set individually.
 2. How does the appraiser value the developers interest in a shopping center if the net income is a combination of base rents for unfinished space, additional rent for tenant improvements, additional income for maintenance and management services, additional income for the sale of electricity and utilities?
 3. Out of habit, the appraiser thinks he is appraising fee simple title for fair market value when in fact he is appraising a property encumbered by a group of leases, financing package, conditional use permits, permits, and contingent incentive contracts for management, and contingent commitments for tenant improvements. How should these be recognized on the accounting sheet for the real estate enterprise and/or the co-mingled fund.
 4. Since the commingled fund is not subject to the income tax, we would submit that the appraiser should be valuing the market value of a cash accounting enterprise; those who exit receive no value for expenditures with a deferred pay-off; those who enter pay a pro-rata share of all working capital assets plus going concern value of the real estate.

5. See Exhibit 1.
 6. The pension fund should be required to report cash investment value, fair market value, and leasehold value to be converted over a five-year span.
- C. Each real estate investment should be reported as the sum of cash reserves and cash escrows, five annual distributable cash items, and a fifth year realizable cash on sale, discounted by an appraiser-determined discount rate.
1. From period to period, the analyst will be able to see whether the investment of the escrow is producing correspondingly higher values for the investment as well as the degree to which management is achieving recapture of the leasehold advantage or exceeding forecasted expectations as well as the relationship of sales proceeds to total resources employed by the property.
- D. Definition of the investment unit value components and the appraisers responsibility therefore as compared to accounting verification therefore would be more clearly defined.
- III. Before looking at the relationship of appraisal and accounting responsibilities in measurement of investment performance, it will be useful to look at evidence of confusion among pension appraisers currently in the field.
- A. As part of the Ph.D. dissertation currently underway by Richard Johnson, 30 appraisers, currently doing significant amounts of pension property appraisal and appraisal reviews, were surveyed, and the following elements are taken from initial survey results:
1. Sixty percent of the appraisers indicated they relied primarily on the income approach to value, 28% stressed the market approach and only 12% emphasized the cost approach. (There's progress.)
 2. Keep in mind that all of these appraisers are nationally or regionally prominent and that in some cases they will answer more than one item on a question.
 3. Among those who use the market approach, 27 were using cash equivalency but with some skepticism, while 3 said they did not adjust prices for terms. No wonder they prefer the income approach.
- B. If you are using the income approach, which calculation of value do you prefer? (The reversion will be covered in Question 12.)
- 15 Direct capitalization of stabilized net income assuming no leverage
- 3 An investment band approach assuming normal financing (which one? _____)

- 2 An investment band approach assuming actual financing terms
- 19 Discounted cash flow or throw-off before taxes projected each year for 5-10 years
- 6 Discounted after tax cash flow projected each year for 5-10 years

C. Do you use a standard work sheet like the NIREB form?

Yes 0 No 30

D. Do you use a computer model for your projections?

Yes 18 No 9 In-house 8 Time-share 5

If "yes", which one? _____

E. How do you arrive at the reversion price?

- 19 At some multiple of gross or net income in last year of projection
- 2 Assumed equal to the purchase price
- 2 By using a debt cover ratio and constant to determine optimum mortgage in year of sale and adding value of cash dividend capitalized at cash-on-cash rate
- 3 By inflating purchase price with an index
- 7 Other, please explain: _____

Six of the seven respondents who checked other explained their approach. Four indicated that they capitalized the last year's income. Two said they used current value.

F. When using the income approach, how do you forecast future rents?

- 7 Assign average market rent to each type of space and inflate at an average annual rate of increase.
- 17 Begin with current contract rents and adjust each lease at renewal in terms of base rents, vacancy loss, and modification of terms.
- 5 Based on rents that could be obtained in the market at the time of appraisal.
- 15 Use two or more of the above

G. When forecasting gross revenue and gross expense, do you:

21 Include an additional revenue line for reimbursements from tenants including escalator adjustment, indexes, etc.? or

9 Net all expense pass-throughs against expenses and report only a net expense to the investor?

17 Project future increases in overage rent for shopping center tenants?

3 Other, please explain: _____

Nineteen respondents checked more than one response. The bulk of the comments can be summed up by the following statement of one respondent: "different properties, different methods."

H. For some projects, rents are not the only source of revenue. For example, additional revenues may be generated from furnishings, special services, sale of electricity, heat, etc. In such a situation, which of the following best describes your revenue recognition method.

15 We group all revenues together and value the total enterprise.

18 We distinguish between revenues attributable to the real estate and other income from sales of electricity, etc. and value only the real estate income.

I. If the project generates parking revenues, do you:

25 Include gross revenues less related expenses.

5 Include only net parking revenues.

J. How do you forecast overage rents?

7 We forecast population growth, employment, and disposable income within trade area and convert to sales times capture rate. This aggregate potential is converted to rent on an average percentage basis for one or more classes of tenants.

13 We project the sales volume based on some index such as the CPI and convert to rent according to terms of each lease.

5 We use the client's budget projections.

15 We only use the average overage rents collected from all tenants over the past two or three years prior to the date of the appraisal.

1 We do not include overage rents from retail or hotel operations.

4 Other, please explain briefly: _____

K. If you use contract rents to estimate future rents, do you read every lease?

Yes 23 No 6

Several respondents remarked that they do not read the entire lease but rather read only the lease abstracts or client prepared summaries. Two making the above comment had checked the "no" answer.

L. Do you create a listing sheet summarizing major terms and identifying existence of leasehold interests?

Yes 23 No 2 Only if requested 4

M. Do you typically assume a standard percentage of tenant vacancy loss?

Yes 21 No 15 Comment _____

The majority who commented on this question reflected concerns that were similar to the concerns expressed by this respondent: "Varies according to property."

N. Do you use a separate vacancy classification for each class of tenants in the project?

Yes 20 No 10 Comment _____

O. Do you compute vacancy loss based on turnover by tenant type and average length of vacancy times market rent for the vacancy period?

Yes 17 No 11 Comment _____

P. Do you include cleaning costs and re-leasing commissions as vacancy costs?

Yes 7 No 21 If only one, which one? _____

Q. How do you handle deferred maintenance?

19 As a single expenditure.

15 As a periodic expense that is recognized over the term of the forecast.

R. How do you forecast future utility expenses?

- 21 We use the current expenditures adjusted for inflation by some index such as the CPI.
- 8 We chart each utility category separately in terms of units (kilowatt hours, BTUs, gallons, etc.).
- 2 We use a nationally prepared utility adjustment index.
- 3 We may reduce gross utility cost waste by deducting a cost to cure energy waste as a capital sum from gross property value.

Two additional comments were made. The first respondent wrote: "With caution!" The second respondent wrote: "Remember most modern leases will call for pass throughs. We would normally anticipate the net base movement as the most important factor.

S. How do you forecast future management fees?

- We use a national index to adjust management fees.
- 20 We assume a constant percentage of expense to rents which we adjust as previously indicated.
- 1 We use an index such as the CPI.
- 8 We allocate management fees between leasing commission, accounting, and general property management.

T. Do you consider the future worth of tenant financed leasehold improvements?

Yes 10 No 16

U. If the project or some portion of the project must be altered to accommodate a new tenant or tenants, are the improvement costs:

- 15 Expenses in the year incurred (cash basis).
- 14 Amortized over the term of the lease.
- 3 Amortized over the life of the improvements (assuming that the improvement life exceeds the lease period).

V. Do you provide a high, low, and most probable estimate of 'market value'?

Yes 7 No 17

W. Do you use a probability or sensitivity model to determine the possible variance in net income?

Yes 10 No 15

X. Do you assume that the existing debt, if any, will be assumed when not in violation of a due on sale clause?

Yes 20 No 9

Y. Which of the following assumptions do you use the next probable buyer?

7 The next buyer will most likely be another pension fund and therefore will not require financing.

12 The next buyer will probably require some outside financing at institutional terms.

3 The next buyer will expect wraparound financing by the seller with a debt service constant no higher than permitted by a debt cover ratio of 1.2.

Z. If you assume that the next buyer will need to obtain a mortgage, how do you establish the amount of that financing?

13 With a debt cover ratio.

-- With a default point.

10 With a loan to value ratio.

5 With seller providing intermediate term financing.

ZZ. Upon completion of the appraisal report, which of the following two terms is used to describe the value that has been appraised?

25 Fair market value.

1 Investment value.

In either case does the letter of transmittal and certificate of value qualify the conclusion with terms of financing and existing encumbrances on the fee simple deed?

Yes 18 No 7

Four or five of the respondents indicated that they did not understand question number ZZ and therefore did not respond. Four or five other respondents indicated that the answer depended upon the appraisal assignment.

- IV. Measurement of performance and allocation of asset values is at present beyond the reach of CREF managers and analysts, because it depends on the arbitrary, whimsical, capricious and creative aspects of what Miles has called, "appraisal accounting" as well as subjective preferences for appraisal methodology.
- A. There is nothing in appraisal training programs which teaches accounting, the basics of investment analysis and comparison, or the basic theory and data required for reliable investment portfolio performance data. Nor have any of the professional societies, other than the Commercial Brokers, made any serious attempt to do so. The introduction of statistics has been fought and compromised in the basic appraisal courses.
1. Accounting organizations could rise to the challenge but not the appraisal organizations. They have no demonstrated ability nor any procedure in place with which to redefine appraisal theory to meet contemporary needs by imposing order from the top down.
 2. Appraisal is a grass-roots process whereby persons of different talents search out, learn, and apply whatever methodologies are demanded of them by their customers. The sophistry of appraisal is generally carefully structured to ideally suit to the purposes of their clients.
 - a. FHA, VA, and condominium buy-downs
 - b. Use of limiting conditions to redefine value
 - c. The customer is king, and the appraisal profession has always responded instantly to the whims of its major institutional customers, whether it is HUD, SEC or Merrill Lynch.
 3. Confusion as to appraised value has also served the preliminary needs of commingled investment real estate funds very well by permitting generous statements of yield to go unchallenged, without comparison, and without verification or replication by an audit of appraisals.
- B. However, the very existence of this debate, of this organization, and the contribution of Blake Eagle and the Frank Russell Company to both suggests that CREFS have come of age and the fiduciaries who are the customers for appraisal services are prepared to define and dictate the appraisal procedures to be purchased.
- C. My concluding comments reflect the following implicit assumptions:
1. Direct specification of appraisal methods and licensing of appraisers by an agency of ERISA would be clumsy, unfortunate, counterproductive, and fought in the courts by appraiser for years.
 2. Appraisal organizations are so introverted, bitterly competitive, and compromised by the diverse interests of their members, that little leadership can be found in this quarter for at least five years.
 3. In the absence of the first two, bank and insurance regulators might be tempted to move into the breach and proceed down independent trails to provide the ultimate confusion of two absolute but different set of appraisal standards like FNMA and FHLBMC.