

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

F. Miscellaneous Professional Associations

26. "Elements of Appraisal Standards Program for Reporting Pension Fund Real Estate Units Following Purchase of Real Estate", preliminary draft prepared for Annual Research Meeting of American Real Estate Society by James A. Graaskamp and Robert Gibson, April 4, 1986

ELEMENTS OF APPRAISAL STANDARDS PROGRAM FOR
REPORTING PENSION FUND REAL ESTATE UNIT VALUES
FOLLOWING PURCHASE OF REAL ESTATE

Preliminary Draft Prepared for Discussion at Annual
Research Meeting of American Real Estate Society

April 4, 1986

Prepared by

Professor James A. Graaskamp of the University of Wisconsin and
Assistant Professor Robert Gibson of Old Dominion University

- I. Three Major Components, or Relationships, To Be Defined to Improve Equity and Communication in the Real Estate Markets for Pension Funds for Pension Fund Manager
 - A. A standard appraisal policy statement should communicate from the executive board of the fund management to the investor certain rules that will be observed in the appraisal process to improve reliability of the appraisal process. Reliability is defined as reasonably free of systematic bias, subjectivity of the inhouse appraisal by the single individual, and unqualified by self-serving or convenient assumptions which avoid empirical validation (see Exhibit A).
 - B. A standard set of appraisal protocols defining the relationship between the appraiser and his client in order to identify those sensitive areas of information exchange which encroach on independence or can be misinterpreted as encroaching on the independent execution of the appraisal function, such as the sharing of electronic data sources, or management strategies for realizing the optimal potential in a given property or accounting for near-term and long-term performance (see Exhibit B).
 - C. A standard letter of engagement format with a set of minimum provisions for preparing the appraisal. The letter of engagement articulates the policies of the asset management team, improves communication of real estate values and potentials to the investors, and pushes the appraisal profession toward a level of performance that is both consistently superior to trade practice and more internally consistent for pension funds to generate comparative measures of property and manager performance (see Exhibit C).
- II. Subject Matter of Appraisal Policy Statements by Pension Fund Managers
 - A. Specify decision role of appraisal and value sought relevant to decision
 1. Unit price of investment shares
 2. Benchmark for buy or sell transactions

3. Analysis of collateral values
 4. Benchmark for performance of asset manager in terms of periodic expectations and realizations for improved revenue or resale value
 5. Measurement of liquidation value of existing portfolio
 6. Forecast of future cash values of existing portfolio
- B. Definition of real estate investment categories and appraisal values relevant to each
1. Investment grade properties (operational and 80% occupied)
 - a. Market value of encumbered fee
 - b. Leasehold value of encumbrances to be recaptured
 2. Development properties (vacant, in transition, or less than 80% leased and occupied)
 - a. Cost outlays or market value, whichever is lower
 - b. Future value discounted by cost to complete (as in R 41 (b) prototype)
 3. Financial participation contract:

Investment value as discounted cash flow less reserve for resale cost. (Custom crafted, hybrid equity contract unlikely to meet presumptions of fair market value)
 4. Frequency of appraisal by outside independents
 - a. Annual appraisals for open-ended fund
 - b. Three-year appraisals for closed funds
 - c. Whenever value changed by in-house managers exceeds 5 percent of previous independent appraisal or 1 percent of total portfolio value
 - d. Change in capital investment through partial sale or expansion and refurbishment of more than 10 percent
 5. Definition of in-house appraisal standards
 - a. Eligibility and size of in-house review committee
 - b. Frequency of in-house appraisal
 - c. Maximum adjustment permissible based on judgement of committee

- d. Accounting rules for capital investment in investment properties between appraisal dates
6. Definition of independent appraiser standards
 - a. Professional designations and code of conduct
 - b. Experience with property type
 - c. Accountability of a specific individual within appraisal firm
7. Control of accidental or systematic bias in appraisal process
 - a. Preservation of independence defined by aggregate fees collected, relationships with subsidiaries, and protection of appraiser from intimidation through conditional fee collection
 - b. Maximum number of up-dates prior to reassignment to alternative appraisal firm
8. Specification of standardized appraisal reporting of selected financial components to facilitate comparative analysis of performance
 - a. Unbundle total value attributable to cash flow, change in cash flow, equity build-up from amortized debt and resale components
 - b. Key financial ratios such as expense ratios, cash break-even, collection ratios on pass throughs
 - c. Lease renewals and recapture of leasehold values since the previous appraisal date
 - d. Approval of accounting conventions to govern appraisal/ accounting interface
9. Decision to spot-check appraisals on a random audit basis directly by pension fund managers by-passing asset managers
10. Determination by pension fund trustees for random audit inspections of properties owned or contained within unit shares of co-mingled fund investors
11. Requirements of pension fund managers for specialized engineering reports of properties with possible latent defects on some periodic basis furnished to the appraiser or requested by the appraiser

III. Appraisal protocols of independence and hold-harmless assumptions altered by responsibility to corporate fiduciary

- A. Responsibility of appraiser to flag legal, engineering, traffic, or structural issues requiring professional review
- B. Legitimacy of appraiser accepting audits of leases, operating budgets, and revenue collections provided by other professionals
- C. Legitimacy of appraiser accepting data on electronic media such as a floppy disc for use in cash flow or data management models provided by:
 - 1. The asset manager client
 - 2. The accountant for the client
 - 3. Independent purveyors of software and operating data
 - 4. Investment broker - marketing
- D. Primary appraisal responsibility for external or off-site market and financial data as compared to accounting and property management responsibility for on-site data
- E. Legitimacy of appraiser accepting property management program being implemented by asset manager as a point of departure for future revenues, expenses, and project characteristics
- F. Redefinition of certification of value to clarify the nature of vested interest to include not only property ownership or vested interest contingent fee, or maximum number of dollars of professional fees of all types received by appraisal firm or parent company

IV. Procurement of appraisal services governed by Letter of Engagement

- A. Specification of assignment
 - 1. Purposes of appraisal assignment
 - a. Basis for investment share unit value
 - b. Basis for evaluating management
 - c. Basis for monitoring buy-sell transactions
 - d. Inspection of property and independent review of leases
 - 2. Definition of real estate interests to be valued
 - 3. Definition of value to be sought
 - 4. Definition of date, perspective, and terms of sale
 - 5. Definition of allocation to fixtures, personalty and intangibles

B. Appraisal protocols

1. Responsibility for leases
2. Responsibility for accounting theory and preparation of cash flow forecast
3. Responsibility for reflecting or critiquing property management program of asset manager
4. Responsibility for engineering assumptions
5. Client responsibility for accounting data

C. Appraisal methodology

1. Market comparison approach (fully documented)
2. Discounted cash flow using cash accounting before tax
 - a. Agreed format for cash flow pro forma
 - b. Agreed format for capital outlays
 - c. Unbundle cash returns to measure present value (PV) of first year cash, change in cash throw-off, and increase in net worth from mortgage amortization and from increased resale price estimate
3. Capitalized income approach
4. Cost approach is optional and used for insurance purposes
 - a. Number of vacant land comparables
 - b. Specification of cost new estimating technique
 - c. Specification of methods for estimating depreciation

D. Appraisal business arrangements

1. Fee structure
2. Allowances for technical assistance
3. Specific personnel responsible

4. Penalties for late appraisals
5. Insurance for errors and omissions
6. Requirements for operational meetings with fund and building managers
7. Delivery dates of final reports
8. Requirements for final review meeting
9. Number of copies of report
10. Need for including legal documents such as title reports, lease abstracts or other contracts defining interests
11. Need for relevant zoning ordinances, building codes or code violations or non-conforming waivers
12. Need for maps, photos, floor plans, and graphics to be included in report
13. Agreed upon reference for standard terminology
14. R 41(b) controls on self-contained report or listing of reports incorporated by reference
15. Ethical standards published by _____ Appraisal Institute and _____ Asset Management Association control
16. Source of documents available for appraiser and rights to copy or retain documents
17. Appraiser has right to review and approve printer's proof of any portion of appraisal report published or quoted in public materials, prospecti, or circulars