JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

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27. "Implementation of Minimum Appraisal Standards for Valuation of Pension Fund Real Estate Unit Values" for Appraisal Reserach Committee of Pension Real Estate Association (PREA) by Robert Gibson and James A. Graaskamp, October 14-15, 1986

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IMPLEMENTATION OF MINIMUM APPRAISAL STANDARDS FOR VALUATION OF PENSION FUND REAL ESTATE UNIT VALUES

Discussion Paper for Appraisal Research Committee of the

PENSION REAL ESTATE ASSOCIATION (PREA)

Washington, D.C.

October 14 and 15, 1986

Prepared by Professors James A. Graaskamp and Robert Gibson

CHAPTER I

INTRODUCTION AND UNDERLYING PREMISES OF STUDY

A. General Background Information

This study of appraisal practices for pension fund real estate investments was initially funded by the Homer Hoyt Foundation in the amount of $15,000 and further funded by the Pension Real Estate Association in the amount of $18,750 in May of 1985, and May of 1986.

The initial thrust was to explore the need and possible effectiveness of a letter of engagement which provided a minimum standard of performance for appraisal services required for pension fund real estate problems. It was presumed that appraisal played a role in the development process, acquisition decision, the disposition decision, and intermittent adjustment of asset values during the period of post-development fee ownership. After discussion with PREA Appraisal Research Committee members, it was decided to focus only on appraisal standards relative to valuation of assets during the post-development fee ownership phase. Preliminary review of a cross-section of actual appraisals performed indicated that appraisal quality was both a matter of professional methods of the appraiser and procurement ability of the client. There is also a close relationship between accounting and appraisal standards, but this report had to be completed before better real estate accounting standards could be defined by other committees. Researchers also attempted to coordinate with appraisal/accounting reviews undertaken by the National Council of Real Estate Investment Fiduciaries, but there was limited cooperation and no formal exchange of ideas or results. Nonetheless, it would be most desirable if the two groups synthesized their final conclusions into a single statement of appraisal objectives for those who manage pension fund real estate assets.

B. General Professional Objectives for Appraisal Process

Real estate property investments are relatively unique, one-of-a-kind, investments which lack daily market quotations like those of fungible stocks and bonds in organized markets so that the investor depends on periodic independent appraisal to measure asset values, appreciation or depreciation of investment, comparative performance of alternative real estate investments and in some cases, comparative performance of the asset manager. Fiduciary accounting requires fund managers to bring assets "to market value" monthly, quarterly, or at least annually while traditional appraisal methods have been somewhat insensitive to short term changes in value. The lack of precision previously found in the appraisal process when applied to mortgage lending, eminent domain, or other issues was of less concern when the appraisal was only one benchmark among many in the decision process and when the relevance of the appraisal was contingent on other factors like foreclosure, negotiation, and other adjustments. However, in the pension area investors are allowed to enter or withdraw from real estate investment pools based on precise appraised value of the real estate without mitigating adjustments and the adequacy of pension benefit funding is measured annually in terms of the future value of assets relative to present value of future benefits to be paid. These funding needs can have significant impact on profit and loss performance and working capital resources of the pension sponsor. Investment efficiency requires continual feedback of data on income and appreciation of alternative investment media if investment capital is to be effectively diversified with optimal performance. <u>The result is a drastic reduction in the permissible tolerance for appraisalvariance due to misunderstanding of these critical appraisal assignment specifications</u>:

1. Definition of the issues for which the appraisal is sought as a benchmark

2. Definition of value or values to be determined

3. Definition of the assets to be valued

4. Definition of accounting standards for relevance of asset income projections

5. Definition of appraisal methodologies which are relevant, reliable and replicable

6. Definition of the data procurement protocols required to accomplish independence, replicability, and comparability of valuation

Aside from the general interest of the ultimate pension beneficiary, four major groups have responsibility for a consensus on the critical specifications above, namely the pension investment trustees, the asset manager responsible for a specific real estate item, the professional societies responsible for the appraisal and accounting process, and the professional societies responsible for the asset managers. Since <u>much of the non-systematic risk in real estate investment decisions and valuation is found in quality of data which is the basis for decision</u> and the willingness to invest in good data, the specifications process ultimately is reduced to a contract for financial, real estate, and market information services between a knowledgeable client and a truly professional appraiser, a contract which is termed a Standard Letter of Engagement. The drafting of such a contract can only follow the directions provided by three major sources of control, in many cases formal control documents which can be incorporated by a reference in the Letter of Engagement:

1. A standard appraisal policy statement from the Executive Board of Pension Fund Management or the real estate asset manager as to the issues for which appraisal is required as a benchmark, the values to be determined, and certain rules that will be observed in the appraisal procurement process to improve reliability, relevance to performance, and comparability. Reliability is defined as reasonably free of systematic bias, subjectivity, or self-serving convenient assumptions which lack empirical or ethical validation. Relevance to performance and comparability will require the appraiser to provide certain standard rations and value components which are not currently or customarily provided by appraisers to show reasonableness or riskiness of professional judgments.

2. A specified set of professional ethics and standards of professional practice defining the critical premises of the appraisal process and the expected levels of performance by the appraiser as reviewed by and policed by appraisal peers.

3. A standard set of appraisal protocols which control the source of data and critical assumptions among the appraiser, the other professions such as law and engineering, and the client in order to identify those sensitive areas of information exchange which might encroach on the independence of the appraisal function. Protocols are concerned with defining where professional ethics must be absolute relative to appraisal use and occurrence in certain types of data and where the appraiser can rely on the expertise of other professionals on a hold harmless basis.

Appraisal assignment specifications must grow out of the centers of control above and eventually be manifested in a Letter of Engagement format which provides both a set of minimum provisions common to all pension real estate and a set of specific goals deemed useful by the asset management team and pension sponsor. In addition to reducing the variance in appraisal results due misunderstanding of the assignment, the Letter of Engagement and policies from which it stems can push the appraisal profession toward superior performance and compensation for value added by reducing the investment risk. In the long run, greater consistency of appraisal services purchased will permit pension real estate asset managers to better manage their assets and to communicate to their client the exact nature of the asset enhancement accomplished with their stewardship so that real estate will continue to enjoy a stream of investment dollars.

C. <u>Appraisal as a Specialty Within the Industry of Financial Information</u>

Seven major accounting firms under the leadership of Larry F. Horner of Peat Marwick prepared a paper addressed to the board of directors of the American Institute of Certified Public Accounts entitled <u>The Future Relevance, Reliability, and Credibility of Financial Information</u>. Significant parts of their observations and conclusions directly apply to the objectives of this report on appraisal standards. The following paragraphs plagiarize and paraphrase generously from this report:

<u>The Vital Need</u>. Referring to the "awesome pace and cumulative impact" of changing conditions, the paper cites five specific influences on financial information:

1. Technological breakthroughs that result in obsolescence before expected products maturity;

2. Communications advances leading to a single world marketplace;

3. Price fluctuations of unprecedented volatility for vital resources;

4. Deregulation that has led to new financial instruments and innovative devices for business combinations and restructurings;

5. Litigiousness, now so pervasive that the ability to ensure against risk has been impaired.

The paper states that the public accounting profession "has a critical role to play in the process of recognizing, evaluating, and adapting to the powerful forces of change and uncertainty." The authors stress that accounting firms have an obligation to the public, and their clients, to devote their best efforts toward assuring that audited financial statements "maintain the relevance, reliability, and credibility necessary to assure their utility." So too for appraisal.

<u>Relevance</u>. The paper recommends that the relevance of financial statements be enhanced through improved disclosures of risks and uncertainties, because the increasing complexity of business means that users of financial statements need more of this information that they currently receive. Examples cited of such disclosures are information on risk concentration (internal risks and external risks); information on uncertainties; information on significant judgements, assumptions, and estimates in the financial statements; and enhanced "management's discussion and analysis" section (these accounting disclosures are critical to the appraisal which relies on discounted cash flow as a primary basis for value).

Reliability. While acknowledging that the United States has the most reliable financial information in the world, the paper states the pace of change demands further action, and it makes two recommendations concerning reliability:

1. Audit the enhanced financial statement disclosures of risks and uncertainties, including management's discussion and analysis;

2. Extend SEC jurisdiction to all classes of entities for which financial statement reliability is of sufficient interest to the public.

Credibility. Again, the United States is described as having the most credible financial information in the world, but rapid changes demand further action, and the paper makes three recommendations (easily extended to appraisal by analogy) for improving credibility:

1. Enhance the public's perception of the independence and objectivity of auditors, by pursuing various means to assure auditor's continued compliance with the obligation to be and to appear to be independent and objective;

2. Enhance public confidence in the Special Investigations Committee of the AICPA's Public Oversight Board;

3. Eliminate the potential abuse of "opinion shopping" by clients, through such steps as strengthening SEC disclosure requirements on auditor changes.

And, in a nutshell, the interest of PREA in encouraging statements of appraisal policy, appraisal information protocol, defined appraisal product, and letters of engagement is to "enhance the public's perception of independence and objectivity of _appraisers_ by pursuing various means to assure _appraisers'_ continued compliance with the obligation to be and to appear to be independent and objective."

D. _Organization of Report_

The research procedure for this report involved a survey of pension fund sponsors and asset managers to uncover examples of written appraisal policies presently applied, letters of engagement currently employed to reveal subject matter and protocols believed to be in need of contract definition, a sample or cross-section of appraisal reports for an indication of what appraisers thought was required of them and relevant to the purpose intended, and finally a formal questionnaire and many additional interviews of influence centers to focus on current thinking among asset managers relative to valuation. We propose to report findings and recommendations in the following sections or chapters:

Chapter I
Introduction and Underlying Premises of Study

Chapter II Appraisal Policy Statements: State of the Art and Potential Application

Chapter III Protocols Controlling Data Sources and Proper Appraisal Assumptions

Chapter IV Letters of Engagement: A Prototype

CHAPTER II

APPRAISAL POLICY STATEMENTS: STATE OF THE ART AND POTENTIAL APPLICATION

A. Present Practice of Pension Sponsors as to Appraisal Policy

A full appraisal of a specific property as a benchmark for investment decision and review may be appropriate as a condition to acquisition, renovation and capital improvement, annual valuation during ownership phase, or as a control on disposition and sale. Nevertheless, 25 of the 44 asset management and pension sponsor groups responding to our survey were silent in terms of any written appraisal policy and less than half a dozen had established written guidelines for procurement, use, or content standards governing appraisal of real property. From comment and observation, the research concluded that in the past appraisal was a mundane requirement relative to mortgage lending or asset management so that pension fund procedures have not yet recognized the new priorities placed on reducing the valuation variance attributable to poor definition of the assignment, systematic bias of appraisal firms, or non-standard data definitions.

The fact that a few fiduciaries specifically addressed these possibilities both in terms of policy directives and procurement practices indicates growing recognition that some policy standards are necessary and that some investment sponsors may wish to enhance the relevance of appraisal reports by requiring additional elements which are optional with the client. The recognition that certain standard definitions and procedures are critical for communication, cross-comparisons, and evaluation of appraisal performance has already appeared in the directives of the Federal Home Loan Bank Board for mortgage finance appraisals of investments properties, currently termed R-41 (b), an annotated version of which is attached as Appendix A to this chapter. It is understood that an amended version is proposed called R-41 (c), but the exact details are not as important as the subject matter and the precedent for a written policy by those who have fiduciary responsibility for assets viewed by the government agency Federal Savings and Loan Deposit Insurance Corporation (FSLDIC). Certainly there are parallels in terms of pension fund relationships to Employees' Retirement Insurance Security Act (ERISA) and pension fund trustees as fiduciary managers of pooled savings for commercial investment.

In Europe, a more elaborate set of standards and policy guidelines has been developed for fixed asset valuation and reconciliation of the appraisal/accounting interface, a policy manual prepared by the Royal Institute of Charted Surveyors (RICS), excerpts of which are in Appendix B, in conjunction with the International Assets Valuation Committee of London, England. Both of these guidelines above are more detailed and elaborate than is appropriate for PREA at this time, but they do provide some suggestions as to the appropriate subject matter for a policy statement draft.

As an initial example of policy concerns, the authors have prepared Exhibit II-1 for comment and review.

EXHIBIT II-1

SUBJECT MATTER FOR APPRAISAL POLICY STATEMENT
BY PENSION FUND MANAGERS TO INFORM INVESTORS
OF APPRAISAL POLICY RELATIVE TO REAL ESTATE

A. Definition of real estate investment categories and appraisal value relevant to each:

1. Investment grade properties (operational and 80 percent occupied)

a. Market value of leased fee
b. Leasehold value to be recaptured by property management
c. Financial or contract agreements to be transferred with sale which add or detract from market value of leased fee (such as discount for high-interest mortgage without right of prepayment or additional value of transferable development rights or surplus land).

2. Development properties* (vacant, in transition, or less than 80 percent leased and occupied)

a. Cost outlays or market value, whichever is lower and value
b. Future value discounted by cost to complete and value created by development process (as in R-41 (b) prototype)

3. Financial participation contracts:**

Investment value as discounted cash flow less reserve for resale cost. (Custom crafted, hybrid equity contract unlikely to meet presumptions of fair market value)

B. Specific questions to be addressed by independent appraisal value determination:

1. Market value of a specific interest in a specific property given income and resale prospects for the underlying collateral as of a specific date.

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* Not subject of current study: Recommend R-41 (b) model
** Valuation process subject of PREA research under direction of Prof. William Brueggeman of Southern Methodist University

EXHIBIT II-1 (Continued)

2. Appraiser shall provide selected tests of appraisal conclusion that may indicate reliability, such as, (tests are illustrative and will vary depending on nature of property and critical assumptions and are intended to reveal error or suggest reliability):

    a. Indicated compound growth rates for effective gross rent, operating expenses, and net operating income compared to assumed market rental growth rates or expected rates of inflation.
    b. Financial risk ratios such as debt-cover ratio, cash break-even ratio, or range of tenant turn-over cost to projected revenue compared to average vacancy loss in the local market.
    c. Ratio of projected potential rent rate to current market rental rate projected at standard growth rate.
    d. Sensitivity analysis should be applied to critical assumptions.
    e. Whatever formula is used to hypothesize resale price at the end of the investment, the appraisal should compare the resulting resale cap rate with the inferred "going in" cap rate, computed by dividing NOI for year one by appraised value conclusion.

3. Where appropriate, appraiser should unbundle the value conclusion as to the proportion of total value contributed by certain categories in order to facilitate understanding of the relative significance of existing contracts, operating assumptions, and future contingencies.

C. Definition of frequency of appraisal by independent appraisers:

1. Annual appraisals for open-ended fund

2. Three-year appraisals for closed funds

3. Whenever value changed by in-house managers exceeds 5 percent of previous independent appraisal or 1 percent of total portfolio value

4. Change of more than 10 percent in capital investment through partial sale or expansion and refurbishment

5. Independent appraisals scheduled to reappraise approximately 25 percent of portfolio value each quarter.

D. Protection of appraiser independence and control of accidental or systematic bias in the independent appraisal process:

EXHIBIT II-1 (Continued)

1. Requirement that appraiser be controlled by a specific professional code of ethics and standards of practice and definition of terms whether or not a member of that professional organization.

2. A specific individual with experience in property type must sign the appraisal and be accountable for it (as contrasted to accounting practice of using a firm name, etc.)

3. Sponsor should provide guideline limiting percentage of portfolio value assignments to be assigned to the same appraisal firm and percentage of appraisal firm gross income consisting of fees generated by one asset management firm. Fees to be due and payable upon receipt of report, rather than upon review or acceptance.

4. Appraiser should be guaranteed at least one update before reassignment to reduce intimidation.

5. Appraisal assignment should be reassigned to an alternative appraisal firm after a specified number of updates, such as three annual consecutive valuations.

E. Supply appraisers with engineering report, investigation allowance or waiver of responsibility for the influence of:

1. Engineering reports on structural matters, expansion capacity or programmed improvement budgets.

2. Analysis of HVAC system relative to BTU and kilowatt hour deficiencies or cost to cure know trouble spots.

3. Toxic wastes in the ground or spilled on the site

4. Asbestos removal or other building code internal hazards

5. Survey, deed restraints, or development code restrictions whose impact could adversely affect building value in the marketplace

6. Existing studies of programmed renovation budgets or cost to cure studies of parking, life safety, vertical circulation, or other systems critical to long-term value trend.

F. Pension sponsor should set guidelines which permit the appraiser to accept the abstracts of leases, engineering studies, electronic accounting data, and other information from others subject to some guarantee as to authenticity of the data and the degree of accountability of the appraiser for spotting errors or due diligence review of data provided. Pension sponsor may request appraiser to indicate alternative cost of using profferred material or independent study by the appraiser and his subcontractors.

G. Definition of in-house appraisal procedures to protect reliance of the investor on independent value estimates:

1. All valuations are ultimately the responsibility of an in-house valuation, since the in-house procedure will set the value at least 3 out of the 4 quarters each year and may override the conclusions of the independent appraiser. The independent appraiser is essentially auditing the objectivity of the in-house group by referring to external market facts, local conditions, and freedom from contagious collective optimism of the ownership. The in-house committee must avoid the subjectivity of a single individual, must establish a consistent procedure, and must record critical factors in their valuation process to be explicitly addressed in the next scheduled independent appraisal. Fund management must limit the deviation of annual independent values from in-house values to no more than 5 percent from the lower value, before calling for an independent update.

2. The in-house review committee will consist of no less than three persons, one of whom must have appraisal background while the third may be the property manager responsible for the asset to be valued. Acquisition agents, general management personnel, or institutional officers involved in fund marketing cannot be official members of the in-house review committee.

3. In-house appraisals of individual properties shall be provided as necessary to set portfolio values for official purposes and a summary of appraisal considerations must be put in writing in the property file on each occasion that the appraisal is reviewed or adjusted indicating the reasons for the action taken. Key assumptions of in-house committee must be explicitly analyzed by outside independent appraiser at the time of the next independent appraisal.

4. Period values should be reported in a format to indicate value reported by the last independent outside appraisal, value added by additional capital investment from that date, value lost from partial sale, equity withdrawal, or other financial adjustments, and value lost or gained due to in-house adjustments and the net value at the close of the subject period. Finally, the report should indicate the total change in value since the previous period of valuation.

EXHIBIT II-1 (Continued)

5. Fund managers must define accounting rules for operating income distinct from capital investment outlays for amortized leasing commissions, tenant improvements, lease re-purchase, and for renovations. Added investments between independent appraisals will be superseded by the next independent appraisal with an appropriate adjustment to additional capital investment.

H. Optional policies of pension-fund sponsor or fund management:

1. Explicit rules for spot-checking appraisals on a random-audit basis by contracting with a real estate counseling, appraisal, or qualified pension fund consulting firm for an appraisal review (not unlike similar revenue of property specific insurance).

2. Specific rules for property inspections by an independent engineer/architect observer to spot check properties owned and managed by a co-mingled fund in which the pension sponsor has invested.

3. Specification of accounting format for real estate assets by class of asset or enterprise unit with possible asset allocation among land, building, tangible personal property, or intangible going-concern values.

4. Special studies where fund sponsors or asset managers perceive a risk concentration by property type within a specific market area. (It may be desirable to contract for specific research on supply and demand trends related to economic base and demographics, fiscal trends related in the community which will affect the real estate tax and resulting cost of occupancy, and other land use trends or plans which may have a foreseeable affect on investment concentration or changing institutional ownership patterns in the market.)

CHAPTER III

PROTOCOLS CONTROLLING DATA SOURCES AND PROPER APPRAISAL ASSUMPTIONS

A. Need for Data Protocols

The explosion of data, the recognition of the investment risk inherent in the quality of data provided, and the discipline and cost of electronic data processing have outstripped the working ethics and rules provided by professional appraisal societies. Many appraisers use outside market and engineering studies as a starting point for their work, relying on limiting conditions to provide a hold harmless assumption on the reliability of the outside data. At the same time, the professional societies are arguing that use of an outside data source requires concurrence by the appraiser that it is reliable and implies the appraiser has exercised due diligence as to the quality of the data on which he is relying. Recent investment banking prospecti have advanced appraisal value conclusions where leases were read by on professional group of investment bankers who forecasted revenue, operating expenses were studied by a CPA firm and converted to a forecast of outlay, with or without engineering assistance, so that the appraiser began by placing a value on a net income figure estimated by others.

These practices conflict with the concept of an independent valuation at a time when the professional appraisal societes and accounting groups want to strengthen the appearance of independence. However, the costs of assembling detailed financial information as input to electronic data processing models suggest the practicality of permitting the appraiser to accept abstracts of leases, legal descriptions, accounting data, and engineering data prepared by others. Extensive hold harmless clauses undermine the utility of an estimated sales price when legal, engineering, or environmental pitfalls have been ignored. The appraiser has become the economic interpreter who must synthesize the significance of information from multiple professional sources into an estimate of the most probable price at which a property would sell if buyer and seller were fully informed about the facts available upon diligent search. The relevant available detail must be available to the appraiser and assumed acceptable if received from a professionally designated accountant (CPA), certified property manager (CPM), professional engineer (P.E.), attorney (J.D.) or registered architect (A.I.A.). Alternatively, the client or investment banker could provide necessary data with a guaranty of reliability and financial guaranty of damages for misrepresentation.

Indeed the appraiser of the future may have these other professions in the appraisal office as a natural clinic of professional real estate services. The professional societies must issue a white report on data protocols and some major data incompatability issues must be addressed in terms of the interface of appraisal with accounting, legal concepts of real property, and pitfalls inherent in land use control, legal liability for environmental degradation, and opportunity for subtle distortion of the future by extrapolation of the past using computerized modeling of incomplete systems and invalid assumptions.

B. Major Data Gaps for Appraisal/Accounting Protocols

Research will show that the valuation of income real estate properties is relying more and more on discounted cash flow simulation of property performance or a single price earnings ratio method called direct capitalization with a single overall rate. Discounted cash flow presumes the real estate is simulated on a strict cash accounting basis while the Financial Accounting Standards Board (F.A.S.B.) is advocating accrual accounting for real estate including adjustment of nominal debt to economic equivalents. This will become a major source of confusion for both appraisers and those who will rely on appraisal reports. Here the asset management association can have an impact by setting a standard to which all members would subscribe. Ironically, the direct capitalization rate method is often based on an economic accrual method with reserves for replacement of short-lived items a method of smoothing net income which would be unfathomable to F.A.S.B. and its goals to measure economic productivity. The method of building a capitalization rate conceals implicit assumptions about a trend line of future property income.

The major conflicts in the accounting/appraisal interface concern amortization of deferred expenditures or tenants improvements, leasing commissions, points paid for long-term financing, and deferred maintenance combined with capital improvements.

A second major area of concern in the accounting/appraisal interface is the necessity to allocate or attribute income to land, building, tangible personal property, intangible personal property, and working capital. When should the appraiser delineate revenues from the real estate enterprise and when should the appraiser value the whole as a going concern? Again, the asset management association has an opportunity to set standard to which the accountants must accommodate. Further detail on these subject areas can be found in the footnotes to Table III-1.

C. Major Issues for Appraisal/Engineering Protocols

Traditionally, the appraiser side-stepped encroachment on the other professions by denying responsibility for legal or engineering issues, unless physical structural failures were clearly apparent to the untrained eye. However, appraisal evaluations that ignore basic engineering obsolescence relative to energy consumption, maintenance cost, or environmental risks for such things as asbestos and toxic waste can be construed as misleading and the major concern of those leading appraisal reform is to avoid the sin of omission which is implicitly misleading. Therefore, the logical sequence of appraisal would be to incorporate engineering surveys of the structure, its equipment, and its site done prior to the appraisal.

D. The Appraiser and Building Management

The appraiser relying on discounted cash flow is forecasting future productivity, but many dollars depend on execution of the management plan for the property which will alter size, tenant mix, and operating characteristics. Should the appraisers accept the management plan of present ownership in forecasting or review several alternative scenarios for the future of the property? One view would be that pension sponsors have a right to know that the asset manager's plans have been reviewed by an independent appraiser. The other view is to assume the asset enhancement will be achieved by the professional property manager and failure will be recognized in subsequent updates of the appraisal. A third perscpective would be to value the property exactly as it exists on the day of valuation, extrapolated into the future as though the property were not to be enhanced. We feel the latter position is the correct position to avoid a systematic upward bias of value contingent on successful completion of ground plans.

E. Professional Society Standards and Interface of One Profession with Another

As a general principle, the appraiser has his unique expertise in the collection and analysis of market data and off-site transactions as compared to the professional responsibility of the accountant and designated property manager for on-site data collection and control. Traditional appraisers were expected to reconstruct lease roles, profit and loss statements, property management strategy, and probable financial structure of a buyer rather than accept data from others without challenge and without concurrence. Given the costs of microdata review, should the appraiser be expected to serve as an auditor of data generated internally? The appraisal societies and asset managers must define:

1. Responsibility of appraiser to flag legal, engineering, traffic, or structural issues requiring professional review;

2. Legitimacy of appraiser accepting audits of leases, operating budgets, and revenue collections provided by other professionals

3. Legitimacy of appraiser accepting data on electronic media such as floppy disc for use in cash flow or data management models provided by:

   a. The asset manager client
   b. The accountant for the client
   c. Independent purveyors of software and operating data
   d. Investment broker--marketing

4. Legitimacy of appraiser accepting property management program being implemented by asset manager as a point of departure for future revenues, expenses, and project characteristics.

Exhibit III-1 underscores the complexity of the appraisal question when the process is applied to income properties. There was a time when the appraiser was the lone eagle, conversant in property management, finance, marketing, and basic engineering--and this general level of expertise and opinion presumably protected his independence. Today everyone depends on a pool of data from multiple sources and the appraiser must rethink the protocols of using other sources of data for efficiency and reality while maintaining neutrality and independence.

CHAPTER IV.

LETTERS OF ENGAGEMENT: A PROTOTYPE

The proposed letter of engagement, Exhibit IV-1, for purchase of appraisal services for the full appraisal of real estate investment asset owned by or on behalf of a pension fund is designed to allow both flexibility in defining the assignment of the independent fee appraiser and consistency in the valuation process for pension fund real estate assets. The letter is not intended to tie the hands of the professional appraiser or limit their independence in the appraisal process but rather to assure that the finished product follows guidelines approved by users in terms of relevance and utility and appraisal society governance in terms of independence and professional quality.

The letter is heavily footnoted for clarification, explanation based on asset managers' response to the questionnaire, the analysis of the appraisals submitted by the asset managers, recommendations of the research team, and feedback from PREA's research committee. The letter of engagement is divided into four sections:

1. Specifications of the assignment--including the purpose of the appraisal and definitions of value and real estate interests to be valued,
2. Appraisal protocols--setting responsibilities for leases, engineering data and cash flow preparation,
3. Appraisal methodology--a statement of the minimum content, techniques to be used, and required data to be submitted, and
4. Appraisal business arrangements--those items concerning the contractual hiring of the appraisal firm.

EXHIBIT IV-1

DRAFT OF A STANDARD LETTER OF ENGAGEMENT

Date

Name and Address

Re:

Dear

We would like to engage your services for the appraisal of the referenced property to determine the market value of the interest owned by ________________ as of __________, 19__. The appraisal shall be prepared in accordance with the definitions, specifications and professional practices of the American Institute of Real Estate Appraisal (AIREA), unless specific alternatives are identified in this letter. Your signature accepting this assignment witnesses your agreement with the terms as stated.

SPECIFICATIONS OF THE ASSIGNMENT

The purpose of the appraisal assignment is: [a]

a. Basis for investment share unit value
b. Basis for evaluation of asset performance potential
c. Basis for monitoring buy-sell transactions
d. Inspection of the property and independent review of leases
e. Other ____
____

The assignment is to estimate the market value of the subject property as defined by the AIREA, 8th edition of the <u>The Appraisal of Real Estate</u>, 1985.

The property rights to be valued are the fee simple titles and entitlements which could be sold for cash explicitly adjusted for enhancement and encumbrances of other legal interests such as assumable financing, existing leases, personal property or intangible assets. [b]

EXHIBIT IV-1 (Continued)

Final value should be allocated among the following asset clauses, check where appropriate.

[ ] 1. Total land & building	[ ] 7. Existing leaseholds
[ ] 2. Land	[ ] 8. Amortizing assets such tenant improvements
[ ] 3. Surplus land	
[ ] 4. Buildings	[ ] 9. Intangible assets
[ ] 5. Working capital	[ ] 10. Other ______________
[ ] 6. Personal property__________________________	
[ ] 7. Financing package (if transferable)	

APPRAISAL PROTOCOLS

Appraisal protocols relate to which parties will be supplying data and assumptions for the appraisal consultant with independence of the appraiser, cost efficiency and level of due diligence imposed on each profession. The following matrix details the data required, key assumptions to be made, and the party responsible for supplying the information.

Refer to Appraisal Protocol Checklist As to Data Sources and Responsibility , Exhibit VII-1

APPRAISAL METHODOLOGY

Concerning the various approaches to value the following should be adhered to:

1. The Cost Approach--optional unless the data is needed for insurance purposes.

   a. In valuing the land as if vacant, follow the procedure prescribed below in the Market Comparison Approach.

   b. The cost of the building new should be taken from one of the cost estimating services, adjusted for time and geographic location, or from a local engineer or architect with cost estimating experience on this type property.

   c. Estimates of depreciation should be detailed and fully documented so that the reader can arrive at the same estimate after reading the report and inspecting the property.

d. If the cost approach is to be reconciled with or considered in the final market value conclusion, intangible value premiums or penalties (such as financing, lease encumbrances, or other onerous contract burdens) must be added to the physical cost items.

e. Fund value conclusion should include land, cost new, net depreciation, and intangible value premiums or value penalties.

2. The Market Comparison Approach must be complete and fully documented or the appraiser must provide an explanation of the nonapplicability of the approach because of lack of comparable sales.

   a. At least three comparable sales must be analyzed with a full description of the property, nature of buyer and seller, and the transaction, including terms of sale. The report should indicate if the appraiser personally visited the comparable sale and checked the public records or identified sources of data.

   b. If the sales are non-cash transactions or cash price reported is discounted from market value by buyer and seller to reflect cost to cure encumbrances, then the price must be adjusted to a cash equivalent market value. The adjustments must be specifically identified so that the reader can replicate the calculations to arrive at the same value. [c]

   c. The appraisal should identify and discuss the units of comparison to be used in the approach.

   d. Justification and explanation for each adjustment for comparability must be documented so that it can be replicated by the reader. [d]

   e. Value conclusions should be reported as a range to reflect potential error in available information or interpretation.

3. An Income Approach to Value must be performed with discounted cash flow using cash accounting before taxes. Refer to the protocols section as to who will provide key data and assumptions.

EXHIBIT IV-1 (Continued)

a. The historical operating results, where applicable, of at least the previous year must be provided in the report. If historical operating results are in terms of accrual accounting, they should be adjusted, with full documentation, to reflect actual cash operations and not accrual income. [e]

b. The projection of cash flow shall be presented for the entire holding period, with appropriate assumptions explicitly stated and either documented or referenced as to source. [f]

c. Cash flows should be assumed to occur at the end of each year. [g]

d. The method of determining the final resale price should be fully documented or referenced as to source.

e. The discount rate used to calculate present value should be fully documented or referenced as to source.

f. The cash flow and resulting present value of the project should be unbundled and presented in five parts:

    1) The present value of an annuity for the holding period equal to the cash throw-off that can be projected from the rents and expense allocations currently under contract, that is, revenue under contract less operating expenses for the subject property assuming no additional occupancy.

    2) The present value of the increases (or decreases) in the cash throw-off annuity revenues and expense allocations attributable to assumptions about new leases, turnover rates and costs, changing lease terms and other assumptions hypothesized by the analyst as established in No. 1 for the holding period.

    3) The present value of any reduction of indebtedness over the holding period.

    4) The present value of the sale at the end of the holding period should be reported in two parts:

EXHIBIT IV-1 (Continued)

a) the present value of sale proceeds net of total debt retirement costs that assumes no increase in value over the holding period, and

b) the present value of the increase (or decrease) in the actual assumed resale price compared to the original purchase price.

4. The appraiser is expected to demonstrate the prudence and reasonableness of his appraisal conclusion by applying appropriate financial ratio tests, trend ratios compared to local pattern, and where appropriate street estimates of value as indicated by gross rent multipliers, direct capitalization of normalized net income or other rules of thumb such as house profit by room.

   a. Key financial ratios would include debt cover ratios, breakeven ratios, implied annual compounded growth rates of rents, operating expenses, and net operating income, as well as capital value appreciation during the holding period.

   b. Direct capitalization of net operating income may suggest a central tendency of value which is relatively insensitive and imprecise where income and asset growth or decline will be significant. Appraisers should indicate how the direct rate was derived from comparable sale or constructed from other sources; it should be applied to net operating income on an accrual accounting basis or the direct rate should be explicitly identified as the cash return on total asset value.

5. The appraiser is required to report effective rents in comparable building where he has interviewed tenant and landlord to discover lease terms, concessions, and contingent future commitments as well as tenant improvements or other financial assistance provided by the landlord. These current effective rents must control renewal of existing leases in the existing property, new leases and vacant space, and measurement of leasehold value unless persuasive argument as to the property in question can explain exceptions to the market.

6. The appraiser is expected to provide a careful definition of the competitive district from which tenants must be found and inventory of the competitive supply and rate of absorption for substitutable space.

EXHIBIT IV-1 (Continued)

7. The appraiser should provide identification of sources of data, degree of reliability or professional independence of source, degree of due diligence exercised by appraiser in confirming reliability of data acceptability, or caveats as to suspected but undetectable bias in available information.

8. The appraiser is expected to perform or direct the inspection of the appraised property by an agent of the appraiser in his role as an independent observer and eyes and ears of the asset manager who should report significant non-conforming conditions at the property or future facts in the public domain expected to impact the property which will assist the asset manager in meeting his fiduciary responsibility.

APPRAISAL BUSINESS ARRANGEMENTS

It is my understanding that the fee for this assignment will not exceed $____________ and that this fee includes an allowance for technical assistance of $__________________ to cover ____

____

_____. [h] It is my understanding that ________________________ from your office will conduct the appraisal and that the report will be signed by ______________________.

_________ copies of the appraisal shall be completed and delivered to our offices at ____ no later than ______________________. Should the appraisal not be delivered on or before this date, a penalty of ______________ per working day will be deducted from your fee. In addition, we understand that you and all personnel involved in the appraisal will be available for a review meeting within ___________ days of the delivery of the final report.

We understand that your firm carries and will continue to carry insurance for errors and omissions in the amount of $____. Please return current certificate with signed document.

Our fund manager ________________ and building manager __________________________ will be available to you for meetings regarding your assignment and the gathering of necessary documents.

Documents that will be made available to the appraiser and where they are available during normal business hours include: [i]

____

____

____

____

____

EXHIBIT IV-1 (Continued)

Documents that are to be included in the final report will include, but not be limited to: [j]

____
____
____
____
____

Standard terminology as contained in ______________________________ [k] shall be used in the report, Code of Ethics and Standards of Professional Practice of ______________________________ [l] shall be adhered to.

We understand that your appraisal firm maintains the right to review and approve printer's copies of any portion of the appraisal report published or quoted in any public materials prospectus or circular. We accept your appraisal firm standard set of limiting conditions and assumptions attached to this agreement unless they conflict with explicit written requirements of this agreement.

If you are in agreement with the above, please sign and return the original to my attention.

Sincerely,

Accepted by ______________________________

Title ______________________________

Date ______________________________

EXHIBIT IV-1 (Continued)

FOOTNOTES FOR PROPOSED LETTER OF ENGAGEMENT

[a] Where appropriate asset managers may attach alternative definition of value, source, and explanation for deviation from the eighth edition of the American Institute of Real Estate Appraisal.

[b] Accounting theory and full disclosure of real estate investment data needs to further consider whether each property is reported as a going concern business entity including personal and intangible assets or whether asset values should be more carefully allocated to land, building, tangible personal property, intangible personal property, and good will. Appraisers find it cheapest to presume going concern value of the property is the value, and this may be the most cost effective way of measuring sale price. The single going concern value conceals the degree to which value is dependent on management, franchise rights, or non-realizable assets which muddies the risk evaluation of the income quality. Failure to recognize leasehold interest of the tenant allows asset managers to take credit for improvement of property performance even though not all the leasehold values are recaptured when releasing or buying out a tenant during the enhancement of the property.

[c] Less than 40 percent of the comparables in the PREA research study reported terms of sale or verified sale was a cash sale.

[d] In almost 90 percent of the comparables in the PREA research study an assertion was made that adjustments were made but the reader was unable to replicate the adjustment.

[e] In particular, the appraiser should be conscious of historical rent concessions given the impact on recognized income, the recognition of overage rent, escalators, and reimbursables should reflect when the income is realized on a cash basis. The estimation of leasing commissions and tenant improvements should reflect when those expenditures will actually be made. Pro forma operating statements must ignore amortization of sunk costs or accrual and reserve accounting for future costs.

[f] For the appraisals under study there was a consistent failure in explicitly stating assumptions and/or documenting sources of the assumptions. It is not sufficient to claim it "it is the opinion of the appraiser" for assumptions, like the discount rate, that have such an impact on value.

[g] While arguments can be made for mid-year discounting, each fund and the industry must become totally consistent in this respect for there to be any hope in comparing fund values. The convention is overwhelmingly in favor of end of the year discounting (37 of 39 appraisals).

EXHIBIT IV-1 (Continued)

FOOTNOTES (Continued)

[h] Technical assistance could include but not be limited to the hiring of engineers, architects or legal counsel to review the property and/or documents relevant to the assignment.

[i] These would include historical operating results, legal documents such as title reports, lease abstracts or other contracts defining interests, relevant zoning ordinances, building codes, code violations or nonconforming waivers and maps, photos, floor plans and graphics.

[j] These would include legal documents such as title reports, lease abstract or other contracts defining interests, relevant zoning ordinances, building codes, code violations or nonconforming waivers and maps, photos, floor plans, and graphics.

[k] As an example: The Appraisal of Real Estate, The American Institute of Real Estate Appraisers, Eighth edition, Chicago, Illinois, 1983.

[l] As an example: Code of Ethics and Standards of Professional Practice published by the American Institute of Real Estate Appraisers, the Society of Real Estate Appraisers, or the recently published neutral option of the Standards of Professional Practice adopted and ratified by the Organization of North American Appraisal Societies.

These Table of Contents,
List of Exhibits
and Appendices
are far more expansive
than preceding Discussion
Paper - Page numbers not
applicable.

IMPLEMENTATION OF MINIMUM APPRAISAL STANDARDS FOR VALUATION OF PENSION FUND REAL ESTATE UNIT VALUES

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