JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

G. Miscellaneous Company Lectures

4. "Appraisal Trends for Large Investors", sponsored by Salomon Brothers, January 29, 1987

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SALOMON BROTHERS - PIERRE HOTEL

Thursday, January 29, 1987

APPRAISAL TRENDS FOR LARGE INVESTORS

I. Changing Perceptions of the Appraisal Process

   A. Implicit conspiracy and advocacy.

   B. Neutrality of a term of art-fair market value.

   C. Appraisal as a critical element in presentation of financial information for rational decision making and enterprise monitoring.

   D. Recognition of need to tailor interest to be appraised, methodology and information content to the function of the appraisal.

II. Institutional Upgrading of Appraisal Standards

   A. Appraisal societies struggle to re-establish credibility and relevance.

   B. Accounting struggles to define income and expand services to include valuation.

   C. Bank regulators impose appraisal standards on loan officers and appraisers (R-41C).

   D. Pension fund real estate asset managers seek standardized appraisal controls by means of a recommended letter of engagement.

III. To Procure or to Critique and Appraisal of a Large Investment Property in 1987, Look for the Following:

   A. Definition of legal interests or profit centers to be included in the value.

      1. There are no fee-simple interests anymore. Any power to divert or modify cash flow may be an interest real estate.

      2. There are lease-hold interests, management contract interests, ground lease controls, financial benefits assumable, etc.

      3. The ability to enhance an assets value during a time of over supply and little inflation, is the ability to recover a portion of the interests in number two (above). Since the value of the property is in the future opportunities, the appraiser must consider the opportunity to recover sub-interests and the evaluation of your asset manager should reflect in part his ability to recover these interests.

4. Market value for real estate taxes, collateral, business value, and portfolio investment value will be different numbers. Don't be careless in defining which set of economic interests the appraiser should consider.

B. Definition of value.

1. Fair market value for statutory purposes.

2. Most probable price for transaction purposes.

3. Investment value--using subjective discount rates and opportunity costs.

4. Measuring performance and productivity.

5. Liquidation value for measuring unit put prices.

C. Methodologies

1. Dilmore order, chance, and beauty.

2. Institute market, income, and cost.

3. Contemporary--market inference, simulation, and normative.

4. Demise of market comparison due to engineered prices and privilegded information.

5. Growing emphasis on the income approaches--NOI capitalized with an overall rate and distributable cash discounted at a threshold target rate for a specified holding period.

6. Testing of value conclusions for sensitivity and communication of critical assumptions which are the source of business and financial risk.

IV. Growing Confusion on the Income Approach

A. Accounting profession growing insistence on accrual accounting rather than cash accounting while real estate emphasizes cash accounting.

1. Capitalized income persumes accrual accounting with level amortization of tenant improvements, leasing commissions, building repair and passed-through collections of expenses.

Revenues - expenses - straight-line amortized marketing costs

2. Discounted cash flow is a cash accounting system which values distributable cash.

Revenues - expenses - actual outlays for TI, LC, and DM

3. Joint ventures, participating loans, as well as appraised values all require tight definition of the accounting rules or subtle shifts in the risk/return allocation among partners will occur.

B. Capitalized income works for level income streams where there is little variation between net income, cash available for distribution and resale price because of unchangeable contract limitations.

1. Overall discount rates are difficult if not impossible to derive in the market when prices are engineered and the buyer's proforma is unknown. Comparative sales at best indicate the seller's opportunity cost of money.

2. Therefore, overall rates are constructed from several alternative philosophies,

a. real rate plus loading for degredation of currency
b. alternative risk rate (say, B-Bonds) plus loading for liquidity and hassle
c. opportunity cost of capital loaded for operations spread
d. the magic 10 percent cap rate concealed with appraisal glitz

C. Discounted cash flow is much more in tune with the role of the appraisal as a financial information report and utilizes one of the most significant analytical break throughs for financial information in 25 years--the automated spread sheet which permits testing of alternative courses of action and segmentation of results by degree of certainty.

1. Spread sheet on alternative revenue sources and timing

a. base rents under contract
b. indexing of base rents
c. recovery of past expenses
d. advanced collection of CAM + fees
e. future rent increments to be hoped for at rollover and renewal
f. interest income on project dedicated reserves and reserve release

2. Spread sheet on occupancy, vacancy, utilization, and collection losses.

3. Spread sheet on operating expenses organized by categories which anticipate recovery formulas and passed-through.

4. Below NOI line there is a new class of capital outlays and receipts which measure capital items financed out of income.

a. spread sheet of annual TI, TC, and deferred maintenance items less recoveries from escrow or financial draws
b. distributable cahs should be the basis for financing and partnership distributions
c. beware of traditional net operating income or net operating income less debt service as a basis for measuring debt cover ratios, cash dividends, or cash break-even points

d. spread sheet forecasts should cover at least two lease-rollover periods to reveal distributable cash impact of alternative re-leasing

V. Revenue and Outlay Forecasts Require Close Professional Cooperation with Adequate Funding in the Fee for:

A. Mechanical engineering review of GVAC tenant comfort, energy audit efficiency, life safety systems, seismic code conformance and similar matters of due diligence--cannot be waived by the appraiser unilaterally without permission of client.

B. Legal counsel on key lease terms.

C. Property management program for asset enhancement over projection period.

1. Independence of the appraiser.

2. Acceptance is concurrence.

D. Exciting developments in computerized architecture mean that architectural firms will have a critical data base for evaluating and planning facilities management. Some major design firms already define architecture as collection, organization, and synthesis of information and decision systems. A blue print by an auto-cad is simply one graphic report from a spatially organized data base.

E. In the long run, appraisal will become a clinic practice which attempts to convert the information systems of all the specialists into a forecast of market behavior or investment values classified by risk and term characteristics.

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Salomon Brothers Inc

December 23, 1986

James Graaskamp
Landmark Research, Inc.
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Madison, Wisconsin 53705

Dear Jim,

I look forward to your participation in the Salomon Brothers seminar on January 29, 1987, "Real Estate Markets in 1987: An Insurance Industry Perspective". I will moderate the closing session at 4:00 p.m., on real estate markets trends and outlooks. The panel will include yourself, Stan Ross and Robert Hopkins. Stan, as you know, is co-managing partner at Kenneth Leventhal & Co. Bob, formerly of Chase Econometrics, is the regional economist in our real estate research group. As we discussed, you will speak for 10-15 minutes on valuation assumptions for 1987. I will discuss supply/demand for product and Bob will provide a regional perspective. Stan will discuss deal making in a post-tax reform environment.

Please feel free to contact me if you have any questions or comments (212 747-2674). Andrea Lepcio, of my staff, will confirm accomodations for you at the Pierre Hotel.

Sincerely,

David

David Shulman

DS:jsk
Attachment

cc: R. Malconian
K. Sharkey
K. Rosen