JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

2. Appraisal Topics

cc. "Pension Fund Real Estate Valuation Issues", no date, (Also see VII. H. 4.)

PENSION FUND
REAL ESTATE VALUATION ISSUES

Presented by

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INTRODUCTION

I. Appraisal is a specialty in the rapidly evolving information business in a society where a majority of the people are involved in information processing. Appraisers systematically collect information, organize, analyze, and interpret the data, reach decisions and communicate essential information to a client.

A. Real estate appraisal is a pivotal benchmark for decisions involving social equity (eminent domain and real estate taxes), validation of value for regulatory purposes (loans and pension security), benchmarking of asset management performance (pensions and fixed assets on balance sheets), and counseling for allocation of land uses and cost effective capital allocation. Ethical issues pervade the process.

B. Information processing by appraisers is similar to the work of accountants, lawyers, investment counselors, and insurance people. Unlike accountants and others, appraisers receive little help from their professional organizations in the form of position papers which define appropriate methods for a particular question.

1. Financial Accounting Standards Board (FASB) continually modifies generally accepted accounting principles to fit new problems such as mergers, current values of fixed assets, accounting for real estate operations, etc.

2. The Lawyers' Ethics Committee has placed responsibility for "misleading" appraisals in tax work and eminent domain on the attorneys. The IRS can blacklist appraisers whose values exceed 150 percent of ultimate courtroom settlements.

3. Securities people have the SEC, Midwest Securities Associations, and various licensing agencies.

4. Appraisers have no such independent source or consensus. Even the eighth edition of the American Institute of Real Estate Appraiser's (AIREA) textbook, The Appraisal of Real Estate, disclaims any responsibility for being a standard.

C. In the absence of professional standards, appraisal clients have taken responsibility for initiating true reforms or exploiting nominal format disinformation.

1. In the 1930s, reform of the residential mortgage markets led to development of the three approaches and creation of the Institute in order to define a standard of malfeasance and self-policing organization to control malpractice. The hope was that a very systematic format would provide a standard for evaluating performance.

2. The volatility of real estate values due to inflation and the legal risks and costs of enforcement made it difficult to operationalize professional enforcement for 25,000 appraisers. However, pension fund real estate may involve only 250 appraisal firms or appraisers.

3. Systematic formats once taught to everyone dealing with appraisal without stringent review leads to the potential for disinformation.

4. Disinformation is military intelligence language for providing information which appears to be correct in form and terminology so that the reader rationalizes to the wrong conclusion.

5. Disinformation through an appraisal format is a conspiracy of cooperation between the appraiser and his client to satisfy regulators, provide cover against second guessing on transactions which go awry, or rationalize common objectives to make a mortgage loan, negotiate real estate taxes, negotiate divorce settlements, etc.

D. The opportunity for disinformation has been enhanced by low cost minicomputers which encourage standard formats for word processing and use of large data banks of unknown quality.

1. Sophisticated formats and boilerplate prose in industrial volume tend to conceal the validity of assumptions driving the process.

2. Data banks lead to unknowing or deliberate misues of statistics. Ultimately, the Home Loan Bank had to disallow single family home appraisals

using Ellwood because of the subtle potential for distortion of the appraisal process.

3. The ethics of data analysis, manipulation, and communication is overwhelming the professional societies and the costs of abuse are falling on public institutions such as FSLDIC and ERISA, rather than the appraiser or his client.

E. The appraisal process was therefore unprepared to deal with real estate investment and fiduciary account where values had to be determined monthly, quarterly, or annually.

1. Real estate is a long-term investment which does not lend itself to constant measurement of value perceived, actual or by inference, from a market of fungible goods.

2. The cost of proper valuation as well as the time to conduct the appraisal make any result untimely and less than cost-effective.

3. The cost of cheap appraisal is a loss of sensitivity to the value fluctuations necessary to validate asset values, measure performance of the asset, or monitor the skills of the asset manager.

F. Quality control of the appraisal process for pension fund assets will require a broad set of administrative efforts by associations of pension sponsors, asset managers, and appraisal organizations to overcome the general distrust of appraisal created by its use for disinformation in other areas and to accomplish its goals in facilitating efficient use of real estate capital.

1. Pressure must be taken off the cost-effectiveness of the appraisal process by reducing the frequency, but increasing the quality of independent appraisal by changing existing administrative policies.

2. An association of pension sponsors and ERISA must establish the standards for selection and performance of appraisers since appraisal organizations are not well-equipped to deal with narrow specialities within a generic profession.

3. Appraisal clients and appraisal organizations specifically concerned with pension real estate

will have to create their own appraisal methodology to meet objectives in a proactive format.

G. To that end, it will be useful to review various efforts to interface appraisal theory, methodology, and institutional regulatory objectives, in general, as well as in reference to pensions, in particular.

II. Purchasing an appraisal has never been treated in the literature as a financial service which must be legitimately tailored to the problem for which the appraisal will serve as a benchmark. The cynics have a fine time with mis-application of instructions to the appraiser so that both the customer and the appraiser are often reluctant to discuss the assignment with very legitimate purposes. Moreover, the client assumes that the task is defined when you ask for a fair market value appraisal and the appraiser assumes that the client understands there are multiple approaches for defining the rationale and appropriate application of fair market value, most probable price or investment value.

Assuming client and appraiser are more concerned with substance than with form, there will be a meeting of the minds on the following matters, "without intending to limit by enumeration."

A. Purpose of the benchmark

1. Validate purchase price as appropriate.
2. Validate in-house valuation adjustments periodically.
3. Indicate liquidating value of asset in current period.
4. Estimate future value of current assets.
5. Independent inspection of property, review of property management effectiveness, and audit of local markets.
6. Measurement of change in price or price trend over time, if any.
7. Estimate historical or future return on investment, real or nominal.
8. Measure of adequacy of collateral or liquidity of collateral.
9. Measure value of partial interest.
10. Measure of spread between full market value and encumbered fee value for purchase of leasehold interest or anticipation of future unencumbered value.
11. Fair market value eminent domain.
12. Insurable value for adequacy of insurance.
13. Resolution of partnership allocation, lease modifications, etc.

B. Definition of value to be sought

1. Fair market value versus most probable price. (Exhibit 1)
2. Investment value where conditions of fair market value cannot be met.
3. Exit or liquidating value.
4. Value of investment composites.

C. Definition of assets to be valued

1. Specific combination of land, building, personalty, intangible assets, and entitlements.
2. Accounting rules or IRS classifications for definition of assets.
3. Specific type of property rights to be appraised.

D. Perspective of the appraisal

1. Going concern value of total assets.
2. Liquidating value of individual assets.
3. Share value of total portfolio.
4. Presumed mode of liquidation.
5. Presumed date of sale.
6. Presumed period of market explosion.

E. Definition of methods to be used

1. What constitutes comparative market data?
2. What constitutes objective market comparisons?
3. What constitutes an income approach to value?
4. Relevance of the cost approach to appraisal and appraisal adjustments.
5. Which appraisal methods are appropriate to which appraisal functions?

F. Definition of elements income approach

1. Cash or accrual accounting.
2. Going concern value or value attributed to land and buildings.
3. Accounting rules for income.
4. Forecasting rules for changing income and expenses.
5. Estimating rules for changing income and expenses.
6. Provision for resale cost.
7. Conformity with historical pattern and leases in place for project.

G. Definition of appraisal/client relationship

1. Who is considered an independent observer?
2. Frequency of appraisal.
3. Who is the arbiter of methods into cohesive standardized formats suitable for measuring comparative performance?

III. Ironically, quality control of the appraisal process is in the hands of the customers for appraisal services, specifically those who stand to lose by permitting current conditions to continue. Historically, reform of the appraisal process has always been in the control of the customer who invests or guarantees real estate capital.

A. Historical origins of the three approaches

1. The cost approach and the life insurance industry.
2. The income approach and academia and the FHA.
3. The market approach and the National Association of Realtors.

B. Standardized reporting requirements of the American Institute of Real Estate Appraisers begin with Canon 5 of their Code of Ethics and is provided in Exhibit 2.

1. The Institute has never issued white papers on specific appraisal problems to standardize professional response to changing issues of common interest.

2. The Institute doubts if it is cost-effective to develop special standards for those who do pension work if only 150-200 of its 6,000 members have substantial business responsibility.

3. Recently the Institute has tried to issue white papers as guidelines, and a sample of such an effort is provided in Exhibit 3.

C. More recent efforts at quality control include:

1. The Home Loan Bank redirecting appraisal attention to R-41-b. (Exhibit 4).

2. FNMA and FHLBMC and requirements for appraising multi-family development.

3. Residential form appraisals for FNMA, VA, FHA, and FHLBMC.

D. The Royal Institute of Chartered Surveyors and the European Common Market Accountants have been developing a standardized language and procedure for the valuation of and reporting balance sheet assets. (See Exhibits 5, 6, 7, 8.)

E. Requirements for developing consistent appraisal performance standards for pension programs requires a six-step process:

1. Development of a written policy statement by pension fund trustees relative to reporting of real estate asset values by money managers responsible for real estate.

2. A written appraisal standard followed by a specific real estate fund manager's report covering both minimum standards shared with an association of managers and unique features

believed to provide better communication to fund trustees of important underlying facts and assumptions inherent in the appraisals.

3. A standard letter of engagement when contracting for appraisal services implementing the written policies of sponsor and money manager.

4. A standard procedure for in-house appraisal reviews in the interim between independent outside appraisal reviews, including tolerance for variance before reporting changed values.

5. Auditing and monitoring of appraisal reports by specially trained, CPA reviewers as part of the accounting audit process.

6. Spot checking of appraisal procedures and a review process for disapproval of appraisal firms found to be likely of misinformation or misapplication of technique by ERISA.

F. An early effort at appraisal control was a Letter of Engagement used at First Asset Realty Advisors (FARA) together with knowledgeable efforts to select the best local assessors. (See Exhibit 9).

1. The best appraisers are difficult to pick by reputation as the big names delegate their work to apprentices.

2. Some appraisers admit to being intimidated and avoiding the assignment or charging extra for the assignment, anticipating that FARA will be more demanding.

3. On balance, we are getting better appraisals than most of the funds we have seen in our research at a higher average cost.

G. The FARA letter was followed by an effort by the National Council of Real Estate Investment Fiduciaries (NCREIF) to develop guidelines and the result of that effort currently is shown by Draft #2 in Exhibit 10.

1. NCREIF Committee dominated by Prudential accounting firm.

2. It concluded that standardization was not possible without review of a broad range of appraisals throughout various sectors of the industry.

3. Many of the NCREIF Committee felt that empirical investigation of the appraisal practices might

discourage the utilitarian use of real estate in a pension portfolio and opposed independent study.

H. Appraisal standards are ultimately the responsibility of those funding the pension program and directing the money manager, rather than any failure by the appraisal profession. The profession has always done what it is paid to do and if its tasks were not fully defined, that is because it served the purposes of the customer who was ambiguous. The pension sponsors must determine what they are willing to pay for relevant appraisal value in terms of:

1. Frequency, quality, and independence.

2. Parameters for market comparison or inference.

3. Responsibility for structural and mechanical engineering integrity.

4. Accounting issues for income projection and discounting.

5. Relevance of cost approach.

6. Comprehensive interpretation of fiduciary responsibilities and relationship to appraiser.

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Market Value

The most probable price in cash, terms equivalent to cash, or in other precisely revealed terms, for which the appraised property will sell in a competitive market under all conditions requisite to fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress. [1]

Fundamental assumptions and conditions presumed in this definition are

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

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

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

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

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

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

[1] American Institute of Real Estate Appraisers, The Appraisal of Real Estate, Eighth Edition, Chicago, IL, 1983, p. 33.

EXHIBIT 1

CONTEMPORARY DEFINITION OF MOST PROBABLE PRICE

"Most Probable Selling Price", as defined by Professor Richard U. Ratcliff:

> The most probable selling price is that selling price which is most likely to emerge from a transaction involving the subject property if it were exposed for sale in the current market for a reasonable time at terms of sale which are currently predominant for properties of the subject type. [2]

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[2] Unpublished quotation, Richard U. Ratcliff speaking on his book Valuation for Real Estate Decisions, Santa Cruz, CA, Democratic Press, 1972.