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

f. "The Appraisal/Accounting Interface", no date

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THE APPRAISAL/ACCOUNTING INTERFACE

I. Pressure of ERISA and SEC is forcing to a head the great gap between accounting GAP and appraisal GAF (generally accepted fluff).

   A. Three basic requirements in the pension real estate fund area:

      1. Reporting annually the net investment value of assets to measure the gap between future value of vested benefits and present value of future investment income. This spread must be matched with cash by the pensions sponsor.

      2. Defining quarterly the entrance and exit values of shares in a real estate fund with equity.

      3. Evaluating the performance of investment managers in terms of real income and a real appreciation.

   B. Until recently the appraisal process dealt with something called normalized net income and a simple minded capitalization rate to arrive at something called fair market value. This approach was modified by reliance on a market comparison approach and a cost to replace approach.

      1. Unfortunately for major income properties the nominal market price has been engineered by accountants and lawyers to meet income tax and institutional portfolio regulation and it is very difficult to adjust these sales to cash equivalent prices.

      2. The cost approach is either too expensive or too unreliable and in any event is unrelated to value of a going concern.

   C. Therefore the appraiser is left with the income approach, and menaingfully, a discounted cash flow approach.

II. To provide a 5-10 year forecast of revenues and expenses, it has become necessary to establish some accounting conventions for appraisers.

   A. Each lease must be read and cataloged as to its term, passthroughs, options, amortization of special tenant improvements, etc. and the receipts reported in terms of base rent, indexing of base rent, passthroughs, CAM, overage, and amortization of improvements.

      1. The problem is at what rate do you assume a rollover, at what duration of vacancy, what percentage of releasing commission and cost of refurbishing to the landlord.

      2. The British tradition is to use the current market rate as the future releasing rate and to apply a separate discount rate to each leased area to reflect the quality of the tenant and probability of the lease going through its term, etc.

   B. There is no American standard but assumptions can be manipulated to achieve various ends.

      1. Deferral of tenant improvements as a deferred expense overstates income and understates cash income, distorting cash breakeven points and cash on cash returns.

2. Tenant improvements included in original cost are often not written off against income and resale price is projected from original cost or total cash income.

3. Reimbursements by tenants are often not lagged until collected the following year. Expenses are either netted out or gross rent includes 100% reimbursements, failing to record collection losses and failure to bill.

C. The advent of the mini computer cash flow has produced a variety of models which simply extend revenues and expenses along some premise of inflation without regard to supply and demand.

D. Then there is the problem of handling mortgages with participation features and lagging these payments to the bank.

E. There is also the problem of lagging real estate taxes to reflect local assessment practice and providing reserves from cash not available for distribution to meet government loan requirements, internal refinancing of remodeling and upgrading of the property.

F. Appraisers seldom read participation loan agreements as to the definition of cash available for distribution and the basis for contingent interest.

III. The administration of a standardized set of instructions for forecasting net income without over-anticipation of inflation or confusion of the present value of contract income with the present value of fair market rental will be brought about by users of appraisal services rather than appraisal societies.

A. The largest customer for appraisal service fees are pension funds. Many are represented by the National Council of Real Estate Fiduciaries. This council is preparing a standardized letter of engagement for appraisal services with which to specify methodology.

B. The growing recognition that appraisal is not a standardized product by anybody with a designation will also be recognized by those applying the rule of due diligence to real estate registered as a security. Due diligence will soon require a detailed analysis of individual leases, analysis of the real estate tax, and analysis of the nature and adequacy of reimbursement calculations.

C. Entry and exit prices and the frequency of appraisal requirements will be ultimately redefined by ERISA to be more demanding at the expense of greater fees while being applied less frequently.

D. For pension funds an indirect form of regulation exists in the form of private firms which monitor the investment performance of fund managers - such as the Frank Russell Index. These firms will insist on some standardization.

E. The English eliminate speculative inflationary gains with something called equated yield. Future rents are held to current market levels and future resale prices held to current income multipliers.

IV. Contemporary appraisal is always concerned with the purpose for which appraised value will be used as a benchmark and the same value may not be appropriate for each.

A. For defining entrance and exit values, some standardized conventions must be established as to premises:

1. Is the purpose to know liquidating value of the entire portfolio sold as a unit or liquidating value of individual properties. Portfolios sell for more than the sum of their parts because of income stabilization and quality as well as thepackaging principles of Dayton Hudson Monumental Life.

2. Those buying in should pay portfolio values while those exiting should receive proceeds from individual properties sold, thereby creating a penalty on early withdrawals.

3. Should pricing of sale value presume a cash sale to the seller or theprice available if seller takes back non-market financing. Many appraisers and pension work assume the seller can accept financing whenthe object of ERISA is to measure liquidation

B. In measuring finance requirements, to what degree can current cash demands on the sponsor be reduced by temporary market appreciation which may evaporate just when the sponsor is no longer able to fund the difference. Should values in the portfolio be reported in terms of value attributable to cash income, mortgage amortization, unrealized appreciation, realized gain and allocated between contract income leases improved to market rents, and non-recurring cash gains as well as realization of leasehold values as leases mature and are rewritten.

1. Without reporting of income reflecting careful accounting there is no basis for measurement and comparison of management performance or combinations of portfolio properties.

C. Real estate has reached the stage of insurance education 20 years ago. Insurance once was taught on how to run an insurance company rather than how to manage risks by using insurance; once the consumer was trained to evaluate insurance alternatives and changes in procedure on a comparatige cost basis, vast changes came about in the marketing of corporate insurance.

D. I perceive the same changes in real estate appraisal as the major consumer groups decide what they want in terms of methodology.