JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

IX. MISCELLANEOUS PROJECTS AND CORRESPONDENCE WITH INDUSTRY

B. Appraisal Research and Reform

2. Pension Real Estate Association (PREA) Research Committee

a. Miscellaneous correspondence to organize and fund PREA Research Committee

Index

Pension Real Estate Association
PREA Newsletter - Winter 1984

Chairman's Message

PREA Comes of Age

The first few formative years of any association are tough ones. The transition from a small group of individuals who share a common interest to a full-fledged organization with staff, programs and services—along with the financial stability to support those efforts—takes a tremendous amount of time, work, effort and money. Such was the case with PREA. However, I am happy to report to you that we now see a number of very positive signs that indicate PREA has successfully made that transition.

PREA's goal has been to strengthen the professionalism of this industry. For that reason, our annual conferences have formed the cornerstone of our efforts. Over the last few years we have established a reputation of presenting the highest quality programs and speakers during these events. People are beginning to notice, as is the press. With the simplification of our registration process and the establishment of realistic fees we can look to a bright future for these important conferences. The increased revenues that our conferences in 1985 are anticipated to generate will allow us to increase the overall quality of the programs we present.

Through the efforts of PREA's Research Committee, which is chaired by Allen Anderson, and Jim Graaskamp, who is chairman of its subcommittee on appraisal research, PREA has been offered a matching grant of up to $15,000 by the Homer Hoyt Foundation.The grant would be used to finance appraisal research for PREA at the University of Wisconsin. This is a most exciting step for our association and one that will enable us to provide a close link between the financial and academic worlds. We are now seeking the necessary matching funds to begin this important research project.

It is a pleasure to report to you that, for the first time in our history, our budget for the coming year will be in the black. This will enable us to have the financial stability necessary to sustain the highest quality in member services and programs. Much of the credit for this must go to our Treasurer, John Koskinen, and the financial controls established at our national office.

PREA's membership drive is underway. It is directed to organizations and individuals that should be members but have not yet joined. Originally scheduled to conclude on January 1, 1985, the drive has been extended to April 30.

I strongly feel that PREA has now entered a new and exciting period in its history. While there remains much to do, we have made a very good beginning and are now well along the road toward making PREA a vital and essential part of the pension fund investing industry. ☐

Arthur W. Viner
Chairman

Literature Table Available At Winter Conference

PREA will provide a special table at its upcoming Winter Conference in San Francisco to all members wishing to display corporate literature that would be of interest to those attending.

Any member wishing to use this display area please contact immediately Victoria Baker, assistant director of communications, at PREA's national headquarters, 202-296-4141, for information on quantities required and shipping information to the St. Francis Hotel. ☐

Meeting Update

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PREA Committees and the association's Board of Directors will meet at the St. Francis Hotel on Tuesday afternoon, January 8th. Starting at 6:00 p.m. that evening, those registered for the conference will attend a special reception and dinner at the St. Francis Yacht Club. Wednesday's session will begin with a Continental Breakfast at the St. Francis Hotel and include morning educational sessions, luncheon and presentation, and a final educational session concluding at 3:30 p.m.

All members of PREA have received final conference materials, including registration forms. Additional program materials are available at PREA headquarters.

"Ron Silva has put together an outstanding line-up of speakers for this conference," noted PREA Chairman Arthur W. Viner, "and we are confident of a high turnout of PREA members and guests for this meeting." ☐

Matching Grant Promised to PREA For Study of Appraisal Research

The Homer Hoyt Foundation has promised matching funds assistance starting on January 1, 1985, for up to $15,000 to finance appraisal research for PREA at the University of Wisconsin. PREA is now actively soliciting a variety of other foundations to secure the necessary matching funds.

The matching grant resulted through the efforts of PREA member Professor James A. Graaskamp who chairs the subcommittee for appraisal research of PREA's Research Committee.

During its recent meeting in New York City at PREA's Fall Conference, the subcommittee set as its general task the definition of the role and content of a standard letter of engagement for appraisal services which could be utilized by pension real estate asset managers.

According to Dr. Graaskamp, "The role of the standard letter seems to be primarily concerned with benchmarking values on selected anniversary dates rather than concern for the initial acquisition transaction."

Specific questions that the subcommittee will research include:

1. What is the purpose of obtaining the appraisal and the constraints on the future that would be appropriate?

2. Which definitions of the asset to be appraised would be appropriate for which questions for which the appraisal may be obtained?

3. How should the appraiser relate to the need and sequence of engineering studies, structural integrity standards, and the discovery of latent defects?

4. What assumptions are legitimate relative to assigning rents to lease rollovers and collection of reimbursable operating expense?

5. Real estate accounting requires an accrual basis. What standards should be applied to appraisal, particularly tenant improvements and leasing commissions which may severely erode distributable cash in certain years?

6. Should values reflect distributable cash rather than total cash throwoff after debt service?

7. What rule should control in-house appraisal review of valuations between anniversary dates for independent appraisal?

8. Should there be an appraisal valuation reserve for real estate just as there is a valuation reserve for stocks and bonds?

9. What qualifications should be required of the appraiser in terms of designations, continuing education and experience with properties of the type he is appraising? Should he be required to read all leases?

10. If better appraisals are more expensive appraisals, how often should the independent appraiser be used? Should the investor be required to withdraw his funds over three or four reporting periods to dollar average against appraisal variance and reduce the frequency of in-house and out-house appraisal?

The subcommittee is now in the process of drafting a general research plan so that initial efforts can be targeted. The committee will meet during the upcoming Winter Conference in San Francisco on Tuesday, January 8, at 1:00 p.m. □

PREA in New York

continued from page 3

solution was. So we do what we usually do and that is give broad regulatory authority to the Treasury," he noted. In the next few years, according to Mr. Kies, the response that occurs from the pension fund community, in terms of what this provision does in terms of their ability to invest in real estate, could be sufficient to modify certain provisions.

Mr. Kies then identified three major policy developments that were apparent in the 1984 Act and that will have, he feels, a significant effect on future tax revisions.

"First," he stated, "there is a much greater awareness of and attention to preserving the tax base." According to Mr. Kies, Congress has paid little attention to that area in the past but there is a much higher level of concern among members of Congress, which is reflected in numerous provisions of the 1984 Act.

Secondly, Mr. Kies stated that Congress in now very sensitive to the time value of money and what deferral is. Again, those concerns are clearly reflected in the accounting changes in the Act which came largely from the Treasury as part of their recommendations.

The final policy area, according to Mr. Kies, is "a much greater emphasis on compliance. Whenever you go looking for revenue, it is much easier to explain that you are simply trying to collect what's owed rather than impose new taxes."

Sessions on Wednesday morning centered on new challenges real estate investing will face during the 1980s in light of proposed tax law revisions. David Silvers, senior vice president of Integrated Resources, stated that "there are two areas that are critical: the first is depreciation. There has been a heightened sen-

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PREA PENSION REAL ESTATE ASSOCIATION

October 17, 1984

Mr. John Weyer
Landauer Associates, Inc.
335 Madison Avenue
New York, NY 10017

Dear John:

I am sorry you were unable to attend the PREA Research Committee meeting last Tuesday, but I appreciate your getting together with me the next day to discuss what transpired. As I had discussed with you, I have enclosed a roster of all Research Committee members, short statements on the Committee's charter and goals, and material on the three subcommittees and their objectives.

You have been assigned to the Appraisal Standards Subcommittee headed by Jim Graaskamp of the University of Wisconsin. If you are not already familiar with him, I am sure you will enjoy getting to know him, and I hope it will be mutually beneficial. Dr. Graaskamp will be getting in touch with you in the next several weeks to let you know how you can help.

Sincerely,

Allen J. Anderson
Chairman
Research Committee

AJA:dek

Attachments

CC: Art Viner
Mike Dunbar
Jim Graaskamp

PENSION REAL ESTATE ASSOCIATION

Research Committee
Subcommittee: Appraisal Standards

Subcommittee Chairman:	James A. Graaskamp, Ph.D. University of Wisconsin-Madison The School of Business Madison, WI
Members:	Leonard F. Helbig, III Donald King Kathy Price David Snediker John Tuzzolino John Weyer
Mission:	Issue statement on uniformity of appraisal standards and valuation methods used in conjunction with appraisals for real estate investments made by tax-qualified retirements plans.
Target Report Dates:	A. Focus of Subcommittee 11-1-84 B. Issues to be Studied 1-1-85 C. Preliminary Findings 4-1-85 D. Final Report 7-1-85

PENSION REAL ESTATE ASSOCIATION

Research Committee
Subcommittee: Appraisal Standards

Potential Resources:

RERC
NACREIF
Appraisal Industry Organizations
European Counterparts
PREA Staff
ULI

Suggested Areas for Consideration:

Appropriate method of appraisal
Standardized engagement letter
Valuation of discounted, participating debt structures
Value of below-market financing (leverage)
Frequency of full appraisal
Interim valuation procedure
Establishment of regional capitalization rates
Sanctions
Discount of future rent reversion
Applications to various investment structures

PENSION REAL ESTATE ASSOCIATION

Research Committee
Subcommittee: Accounting Standards

Subcommittee Chairmen:	Harry Hutcherson Arthur Andersen & Co. Washington, DC Edward N. Constantino Arthur Andersen & Co. New York, NY
Members:	Steve Cunningham James Gorman R. Stephen Iler Glenn Whitmore
Mission:	Issue a recommendation to Research Committee for standardization of accounting practices with regard to real estate investments by tax-qualified retirement plans.
Target Reporting Dates:	A. Focus of Subcommittee 11-1-84 B. Issues to be Studied 1-1-85 C. Preliminary Findings 4-1-85 D. Final Report 7-1-85

PENSION REAL ESTATE ASSOCIATION

Research Committee
Subcommittee: Accounting Standards

Potential Resources:

- PREA Staff
- AICPA
- NACREIF
- Consultants
- National Accounting Firms
- Evaluation Associates

Suggested Areas for Consideration:

- Accrual treatment for operating expenses
- Capitalize or expense acquisition costs
- Recognition of accrued interest
- Recognition of future profit rights on participating debt
- Market value of participating debt
- Procedure for interim valuations
- Gain recognition on seller-financed sales
- Treatment of incentive fees as liability or net asset
- Valuation of below-market debt

PENSION REAL ESTATE ASSOCIATION

Research Committee
Subcommittee: Valuation Model

Subcommittee Chairman:	William Brueggeman, Ph.D. E. L. Cox School of Business Southern Methodist University Dallas, TX
Members:	Wayne Comer William W. Creighton Duncan Fuller John Kemble James McCandless Ray Walker
Mission:	Create a valuation model with specific standards for valuation of cash flow, recognition of appreciation and evaluation of participating debt formulae.
Target Report Dates:	A. Focus of Subcommittee 11-1-84 B. Issues to be Studied 1-1-85 C. Preliminary Findings 7-1-85 D. Final Report 10-1-85

PENSION REAL ESTATE ASSOCIATION

Research Committee
Subcommittee: Valuation Model

Potential Resources:

- PREA Staff and Members
- Consultants - FRC, Evaluation Associates, & Wilshire
- Fund Managers

Suggested Areas of Consideration:

- Regional capitalization rates for cash flow or NOI
- Participating debt formulae
  - Discount recognition
  - Future profits
  - Accured interest
- Treatment of incentive fee schemes
- Reporting value net of fee or gross
- Segmentation of returns cash vs. unrealized appreciation
- Tailor model to investment medium
- Risk-adjusted returns

The School of Business
University of Wisconsin–Madison
Graduate School of Business
1155 Observatory Drive
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November 20, 1984

MEMORANDUM

TO: PREA Research Committee

FROM: Prof. James A. Graaskamp

RE: Pension Real Estate Appraisal Procedure Study

Enclosed you will find an outline of a proposed appraisal procedural study prepared by doctoral candidate Robert Gibson and myself for your review. Rather than inflict a full Ph.D. dissertation proposal on you, I have sketched it in the briefest possible form. We would appreciate your written comments or a phone call, but anticipate pushing forward to detail questionnaires and procedures for your review at the January meetings. Note the schedule for research which should provide a final draft product for your fall meetings.

The budget for this project looks as follows:

PRO FORMA BUDGET

Spring semester research assistantship - Bob Gibson At 75% time (including University indirect charges)	$6500
Spring semester student hourly for extracting data from questionnaires and appraisals 500 hours x $5/hour =	2500
Summer semester - research assistantship - Bob Gibson	4000
Summer semester student hourly for data processing 200 hours x $5 =	1000
Summer semester research support - J. A. Graaskamp	6500
Travel for Bob Gibson for interviewing key individuals among asset managers and appraisers	3500
Miscellaneous expenses	1000
Total budget required	$25000

Prof. Maury Seldin has already committed $15,000 to the project, and we would hope that PREA could provide an additional $7500 to $10,000 by June 1 to fund the data organization and analysis phase. By incorporating this research into the dissertation process and administrating funds through the Univeristy Foundation we legitimately avoid heavy University overhead charges which apply to government research grants.

Both Bob Gibson and I plan to attend your January Research Committee meeting.

In the meantime, I have enclosed some additional reading on accounting and appraisal for a Sunday afternoon when you are tired of football.

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PREA
PENSION
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ESTATE
ASSOCIATION

November 29, 1984

Mr. Robert J. De Monte, Senior Vice President
Consolidated Capital Companies
1900 Powell Street
Suite 1000
Emeryville, California 94608

Dear Bob:

Pursuant to our telephone conversation of this date, I am pleased to enclose a copy of Professor James A. Graaskamp's memorandum report on the subject of establishing a standard letter of engagement for Real Estate Appraisal Services.

I am particularly pleased that you have found sufficient interest in the proposed research project to warrant the consideration of a matching grant of $15,000 to be contributed by the Consolidated Capital Companies.

As you noted during our conversations, such a contribution would ideally provide certain considerations whereby your representative would participate in the project design and report stages. While I am not authorized to confirm the acceptability of such conditions, I am hopeful that an accomodation will be found and that our mutual interests can be served in permitting Professor Graaskamp to proceed with this important work.

By copy of this letter and through discussions with the PREA Executive Committee and the Research Committee Chairman on Tuesday, December 4th, I will seek to gain an understanding which will permit us to proceed with final arrangements during our meeting on December 5th.

I look forward to seeing you on that occasion, and want to thank you again for this opportunity.

With kindest regards,

Mercer L. Jackson
Executive Vice President

MLJ:kdk

cc: Professor James A. Graaskamp
Mr. Allen Anderson

October 15, 1984

MEMORANDUM

TO: PREA Subcommittee for Appraisal Research

FROM: Professor James A. Graaskamp

RE: Minutes of First Meeting of Subcommittee, Grand Hyatt, October 9, 1984

The general task before the subcommittee is to define the role and content of a standard letter of engagement for appraisal services to be utilized by pension real estate asset managers. It was first thought that this might duplicate the work of NCREIF, but their discussions of appraisal matters have led only to the attached first draft comments, provided by Don King. NCREIF appears to have decided against development of a standard letter at this time.

The role of the standard letter seems to be primarily concerned with benchmarking values on selected anniversary dates rather than concern for the initial acquisition transaction. Opinion was divided as to whether the appraisal has a transactional role, but there seems to be a general concensus that the asset management function to value fund units and to measure performance of asset managers identified by the committee discussions were:

1. What is the purpose of obtaining the appraisal and therefore the constraints on the future that would be appropriate?

2. Which definitions of the asset to be appraised are appropriate for which questions for which the appraisal may be obtained?

    a. Is price of the total enterprise including land, buildings, and other profit centers less leasehold values and tenants the only number?

    b. Should the appraiser report land and real estate unencumbered and then report value added by financing, tax structuring, preferential cash distribution, etc., and deduct for leaseholds and purchase premiums to be amortized?

3. How should the appraiser relate to the need and sequence of engineering studies, structural integrity standards, and the discovery of latent defects?

4. What assumptions are legitimate relative to assigning rents to lease rollovers and collection of reimbursable operating expense?

   a. What assumptions are legitimate in extrapolating expenses, particularly to maintenance and refurbishment to maintain marketability?

   b. Should American appraisers follow the British tradition of taking the net present value of each lease minus the present value of anticipated expenses for a property using an equalizing rate which does not include an inflation factor? An equated value would provide a benchmark for providing the dependency of inflationary assumptions for yield.

5. Real estate accounting requires an accrual basis. What standards should be applied to appraisal, particularly tenant improvements and leasing commissions which may severely erode distributable cash in certain years?

6. Should values reflect distributable cash rather than total cash throwoff after debt service?

   a. Should resale value reflect cash to the seller in order to measure liquidating value of the pension fund?

   b. Should the appraiser report market value as though unencumbered and the leasehold values residing in tenants so that with a series of appraisals it would be possible to measure the recapture of leasehold values by the property manager?

7. What rule should control in-house appraisal review of valuations between anniversary dates for independent appraisal?

8. Should there be an appraisal valuation reserve for real estate just as there is a valuation reserve for stocks and bonds?

9. What qualifications should be required of the appraiser in terms of designations, continuing education, and experience with properties of the type he is appraising? Should he be required to read all leases?

10. If better appraisals are more expensive appraisals, how often should the independent appraiser be used? Should the investor be required to withdraw his funds over three or four reporting periods to dollar average against appraisal variance and reduce the frequency of in-house and out-house appraisal?

Enclosed with this letter is a copy of the NCREIF draft and a set of materials on appraisal standards for corporate real estate assets developed for use in Europe to standardize corporate real estate assets. These materials are the core of materials now being considered by FASB and the American Institute of Real Estate Appraisers. Finally, we have also enclosed evidence of an experiment for accounting research purposes on current value reporting for real estate assets.

I am pleased to report that the Homer Hoyt Foundation has promised matching funds assistance starting January 1, 1985, up to $15,000 to finance appraisal research for PREA here at the University of Wisconsin. Do the members of the Committee have any suggestions on how we might generate matching funds through and for PREA?

My leading Ph.D. student, Robert Gibson, has now completed his preliminary exam and is drafting his dissertation proposal with a view of completing research by August 1. Since his time table for completion parallels the tentative schedule provided by Allen Anderson, and since his research interest was to be real estate assets for pension investment, Robert Gibson will direct his dissertation efforts to some portion of the subcommittee task as seems appropriate.

Following completion of ULI meetings in Boston, we will draft a general research plan for your input and modification so that we can define our initial efforts and targets by mid-November and be under way by mid-December in the collection of letters of engagement as may be found in use throughout the country as well as discovery of other efforts to standardize appraisal for institutional use.

Hopefully by that time PREA will be able to define how expenses will be paid.

Enclosures

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PREA PENSION REAL ESTATE ASSOCIATION

1985 WINTER MEETING

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(January 7, 1985)

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550 Madison Ave., Rm. 1729
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100 Pine St., #1800
San Francisco CA 94111

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990 So. Fair Oaks
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Ted Stern
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Brian J. Strum
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Englewood Cliff NJ 07632

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San Francisco CA 94111

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Pacific Savings Bank
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Costa Mesa CA 92627

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PM Realty Advisors
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Newport Beach CA 92660

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San Francisco CA 94111

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Stamford CT 06904

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85 Broad St.
New York NY 10004

The School of Business
University of Wisconsin-Madison

Graduate School of Business
1155 Observatory Drive
Madison, WI 53706
608/262-1555

March 22, 1985

Donald A. King, Jr.
RREEF Funds
875 N. Michigan Ave., Suite 4114
Chicago, IL 60611

Dear Mr. King:

The Pension Real Estate Association (PREA) Research Committee has approved a study designed to develop a standardized appraisal policy manual for asset managers and a letter of engagement for appraisal services related to periodic valuation of pension fund real estate assets. The purpose of the study is to analyze the use of appraisals in the setting of unit values and to measure asset manager's performance; it is not the purpose of the study to define the relevance of appraisals to buy and sell decisions or operational problems like a real estate tax appeal.

The ability to accurately estimate asset values and measure asset performance relies largely on the ability to define income attributable to a specific asset at a specific point in time and to attribute a probable sales price attainable for the asset held at a specific point in time. The probable market price is generally determined quarterly to set investment unit values for new investors and repurchase of old shares, to inform investors of portfolio progress relative to earlier quarterly bench marks, and to measure performance of asset managers in both absolute and relative terms. Typically an independent appraisal provides a report of value on each anniversary following acquisition and an in-house committee reviews values each quarter.

To date there has been no standardization of the appraisal process to allow for consistent and objective reporting of fund values, except for such appraisal conventions which reflect the influence of the major appraisal organizations. These conventions are most often matters of form rather than substance. The study hopes to identify major causes of appraisal variation in substance and to suggest minimum provisions in a letter of engagement for appraisal services which PREA could advocate for standardization within its membership.

The study is designed to collect and analyze eight sets of data that PREA members are being asked to supply, including:

1. Any written policy on appraisal procedure specified by pension sponsors or generated by the asset managers used:

   a. in the direction and control of outside appraisal professionals engaged to appraise properties in the portfolio(s) managed by PREA members;

   b. when performing in-house appraisal for quarterly or other periodic asset valuation to set unit values.

2. Current drafts of any letters of engagement required by PREA members for outside appraisal services, supplied by appraisal firms prior to supplying appraisal services to the PREA member and/or provided by pension sponsors as a requirement of securing an asset management contract.

3. Any real estate accounting classification manual used for the accounting of your owned real estate assets.

4. The most recent annual report on each of your funds for pension investors

5. Any spread sheet that your firm requires and provides to outside appraisers for analysis of individual leases.

6. Two sample outside appraisals received for each of two separate owned properties, preferably dated between January 1982 and December 1984, and the in-house review appraisals completed in the interim. (Appraisal materials will be kept confidential and immediately returned after data on appraisal methods is extracted.)

7. A list of firms presently approved by the PREA member for the appraisal of owned real estate assets to clearly define the number of firms engaged in pension fund real estate appraisal. (The list will remain confidential and only a count of firms and individual appraisers will be kept.)

8. Answers to the enclosed questionnaire.

The questionnaire was designed to cover both outside appraisal issues, and in-house appraisal review issues. It is intended to discover what policy is being followed by PREA members with regard to outside appraisal services and in-house reviews. It is designed so that short answers, yes/no, checks or numerical rankings are required. In some questions room has been left for comments. The research team encourages comments from PREA members on all questions.

The study is being conducted by Robert A. Gibson, a Doctoral Candidate under the direction of Dr. James A. Graaskamp of the Department of Real Estate and Urban Land Economics of the Graduate School of Business, University of Wisconsin, Madison, Wisconsin. All data and information supplied by PREA members will be held confidential by the research team. Findings will be reported in aggregate only; no mention of individual properties, asset managers, appraisal firms or individual appraisers will be released by the research team.

If you have any questions please feel free to contact either of us at our campus offices or at home.

Sincerely yours,

Dr. James A. Graaskamp
office--608-262-6378
home --608-238-8452

Sincerely yours,

Robert A. Gibson
608-263-2649
608-274-1217

JAG/RAG/rag

Enclosures

RREEF

The RREEF Funds

Donald A. King, Jr., Principal

March 22, 1985

Peter K. Maier
Maier & Siebel, Inc.
80 E. Sir Francis Drake Blvd.
Larkspur, CA 94939

Dear Mr. Maier:

In October of last year the PREA research committee approved a study designed to standardize appraisal policy and the letter of engagement to be used in contracting for outside professional appraisal services in the valuation of pension fund owned real estate assets. Professor James A. Graaskamp, the Chairman of the Real Estate and Urban Land Economics Department at the University of Wisconsin-Madison, an academic member of PREA, was selected to oversee the research that would be conducted by one of his doctoral candidates. Because of the need for the study the Homer Hoyt Institute and PREA have funded the research.

At our January meeting the research committee met with Professor Graaskamp and Robert Gibson, the doctoral candidate, concerning a draft of the questionnaire to be sent to each PREA member. The questionnaire was redrafted and resubmitted to the research committee for comment and testing.

The finished product of this process is enclosed. It is anticipated that the results will provide PREA members with the means to standardize the appraisal of owned real estate assets. The success of the research effort now rests with the PREA membership. Your cooperation in filling out the enclosed questionnaire and supplying the documents requested is essential to the eventual completion of the standardized appraisal policy and letter of engagement.

The research team has indicated that all materials will remain confidential and that the appraisals requested will be promptly returned. RREEF has completed the questionnaire and supplied the requested documents, as have other members of the research committee.

The RREEF Funds

If you have any questions please feel free to contact Professor Graaskamp or Bob Gibson in Madison, or myself. Thank you for your cooperation in the study.

Sincerely yours,

Donald A. King, Jr.

Donald A. King, Jr.
Principal

DAK/rag

Enclosures

1101 SEVENTEENTH ST., N.W.
STE. 700
WASHINGTON, DC 20036
202/296-4141

PREA PENSION REAL ESTATE ASSOCIATION

May 7, 1985

Dr. James A. Graaskamp
University of Wisconsin-Madison
The School of Business
1155 Observatory Drive, Room 118
Madison, WI 53706

Dear Jim:

The Pension Real Estate Association has a primary interest in prudent and protective investment practices for employee benefit funds participating in the real estate capital markets. In that regard PREA wishes to promote the exchange of ideas and sponsor research programs appropriate to its primary purpose. Your research project as defined and recently submitted is of interest to PREA.

The PREA Board of Directors proposes to offer sponsorship of this research project on the terms and conditions set forth in this letter:

<u>Research Project</u>

Pension Fund Independent Appraisal for Owned Real Estate Assets, agreed scope and definition of purpose attached.

<u>Conditions and Accountabilities</u>

A. The undersigned researcher shall:

1. Have complete and unhindered rights to conduct studies and reach conclusions within the defined and agreed scope for this project as attached.
2. Be responsible for the completion of the project on a timely basis, as agreed to herein and for a cost as budgeted and approved by PREA.
3. Identify all researchers and recipients of funds from this grant.
4. Give credit to PREA for funding the project in all publications, reprints, or other general media used in disseminating information obtained from the project.

5. Notify PREA 30 days in advance of each publication or other general media dissemination of the project results in order for PREA to issue or withdraw its permission to identify it as a funding source.
6. Publish results of the project with the endorsement of PREA only with PREA's prior written approval.
7. Have the right to publish results of the project at any time subject to 3, 4, and 5 above.

B. PREA shall:

1. Retain rights to withdraw unexpended financial support and/or its endorsement at any time during the course of this project if:
    a. the researcher fails to complete all phases of the project within the time frame agreed, or
    b. the researcher fails to conduct studies and research within the defined scope of the project, or
    c. the researcher spends any of the funds for any purpose other than for direct pursuit of the project.
2. Have the right to approve or disapprove the principal and researcher identified to be responsible for research and to receive funds from this grant.
3. Have the right to approve or disapprove any cosponsors of the project.
4. Choose to endorse or withhold its endorsement of the project at PREA's sole discretion.
5. Withdraw the right to mention sponsorship at any time.
6. Have rights to publish results of the project at any time, provided, however, appropriate credit is given to the researcher and/or author.

<u>Budget</u>

The budget shall be for those items and expenses as set forth in the attached budget proposal.

<u>Grant</u>

$15,000 to be paid in accordance with this agreement.

<u>Payments</u>

The grant will be funded to the University of Wisconsin Foundation on a semester basis in advance and in such amounts as are required to meet budgeted epxpenses for each subsequent semester subject to a 25% retainage. The retainage shall be withheld until completion of project and issuance of the final report, at which time it will be paid in full.

Progress Reports

Regular progress reports will be submitted to PREA (every 60 days or so) detailing all work, studies, preliminary conclusions, and grant expenditures for the project to date. PREA reserves the right to request more frequent reports and/or more detail at any time. Upon conclusion of the project, the researcher will deliver to PREA a final written report and conclusion of the research effort.

This letter shall serve as a letter of undertaking which generally sets forth our respective obligations. Please sign below indicating your agreement with the terms and conditions herein.

Sincerely,

Allen J. Anderson
Chairman
Research Committee

AGREED AND ACCEPTED:

Dr. James A. Graaskamp

5-10-85
Date

AJA:dek

A RESEARCH PROPOSAL

PENSION FUND INDEPENDENT APPRAISAL

FOR OWNED REAL ESTATE ASSETS

--PURPOSE OF STUDY--

In the last few years there has been an increasing competition by real estate asset managers for pension fund assets. The ability to measure performance relies largely on the income the asset manager produces and the value of the assets held. The value is generally determined by quarterly valuation to set unit values or inform investors of portfolio progress. Typically an independent appraisal provides a report of value on each anniversary following acquisition and an in-house committee reviews values each quarter. To date there has been no standardization of the appraisal process to allow for consistent and objective reporting of fund values.

To discover methods and limits of acceptability for standardization of the appraisal process the following research design is recommended.

--METHODOLOGY--

1. Literature and policy review will include but not be limited to:

   a. The International Assets Valuation Standards Committee, "The Valuation of Fixed Assets."

   b. Royal Institute of Chartered Surveyors, "Information Required of a Valuer by an Auditor."

   c. National Council of Real Estate Investment Fiduciaries, "NCREIF Exposure Draft #2: Appraisal Engagement Letters."

   d. Real Estate Accounting Committee, Accounting Standards Division, American Institute of Certified Public Accountants, "Guidance for an Experiment on Reporting Current Value Information for Real Estate" and works by FASB.

   e. Selected works from various journals.

f. Additional works from The Royal Institute of Chartered Surveyors and the International Assets Valuation Standards Committee.

g. Determine, through interview, what the regulators, such as ERISA, would like to see with regard to valuation of real estate assets.

h. Determine, through interview, what other governmental agencies are doing with regard to letters of engagement; such as FDIC/FSLIC, FHLBB and FNMA.

2. Basic empirical data will be solicited from PREA members under PREA letterhead that will request four sets of data including: (a) current drafts of appraisal policy concerning outside appraisals of owned real estate assets; (b) current drafts of letters of engagement for appraisal services of owned real estate assets (see #3 below); (c) five independent appraisals performed in the last year (see #4 below); and (d) a questionnaire addressing the related issues (see #5 below).

3. The collection of letters of engagement will be analyzed and a matrix developed that would show:

   a. Definition of value to be appraised;

   b. Appraisal methods to be used;

   c. What accounting standards are used;

   d. Who is responsible for reading leases;

   e. What access or requirements are there for engineering expertise;

   f. What is the wording of the limiting conditions; and

   g. Specifications of time adjustments for future renewals of leases and resale value.

4. From the set of independent appraisals develop a matrix covering appraisal techniques employed. In particular the following areas need to be explored:

   a. The method of accounting for operating income and expenses to arrive at net operating income;

   b. Method of converting income estimates to an estimation of resale value;

   c. How future increases in income and expenses are factored into the valuation process;

d. The method used in determining terminal value for the holding period;

e. The role of the sales comparison techniques in determining value;

f. How sales are adjusted for cash equivalency;

g. What details are included on comparable sales and what data sources are contained in the report; and

h. Can the reader track through the appraisal report and arrive at the same value conclusion;

(Note--There is a question as to how to generate a random selection of appraisals for state-of-the-art inference, avoiding the bias of PREA members selecting only the best outside appraisals.)

5. RELATED ISSUES--

a. Procedure for in-house appraisals; how do they bridge the gap between outside appraisals making sure that assumptions used in outside appraisal are followed through in in-house appraisal?

b. What are the procedures for in-house quarterly review; under what conditions can the value be raised or lowered and under whose authority?

c. Integration of appraised value to the unit share value.

d. Interface between appraisal and accounting for fund assets.

--RESULTS--

The study is designed to gather empirical data concerning appraisal policy, appraisal letters of engagement and the appraisals received. From the findings of the empirical research provide:

1. A draft of a proposed appraisal policy for pension fund owned real estate assets and circulate to the PREA Research Committee for input and amendment.

2. Generate a redraft of appraisal policy according to comments for a consensus of the PREA Research Committee.

3. From the final proposed appraisal policy develop a letter of engagement for outside appraisals of pension fund owned real estate assets for circulation to the PREA Research Committee for input and amendment.

4. Redraft the letter of engagement according to comments for a consensus of the PREA Research Committee.

5. Prepare a catalog of appraisal procedures and examples of nonstandardization leading to misinformation, disinformation and noncomparability of results.

(Note the importance of interacting with PREA members in steps 1 through 2)

The engagement letter will be used to instruct the appraiser to appraise the investment value of the asset under existing use and not the market value of the unencumbered fee. The faster the asset manager can move from investment value to market value is a measure of management ability.

By standardization of the letter of engagement the appraisal process could be specified and multiple assumptions permitted to allow several value conclusions to permit:

1. Measurement of the adequacy of fund assets to meet fund liabilities;

2. Establishment of a unit value of the fund, i.e., a buy/sell value; and

3. Comparison of the effectiveness of funds asset manager(s) and the relationship of that to fund policy including:

    a. The rate managers recapture leasehold value;

    b. The percentage of their collection of reimbursables; and

    c. Allocation of yield to income, equity appreciation, loan amortization, etc.

--TIMING--

1. Prepare the letter of introduction requesting the four data sources and questionnaire for review by PREA at their January meeting in San Francisco.

2. February and March conduct mailing to PREA members and develop the literature and policy review.

3. April and May gather and analyze the data and develop the first draft of the appraisal policy for comment by PREA members.

4. June complete the second draft of appraisal policy and circulate to members.

5. July complete final draft of appraisal policy and the resulting first draft of the letter of engagement and submit to the PREA Research Committee.

6. August complete the final draft of the letter of engagement and the catalog of appraisal procedures for disbursement to PREA members.

The School of Business
University of Wisconsin-Madison

Graduate School of Business
1155 Observatory Drive
Madison, WI 53706
608/262-0391

November 20, 1984

MEMORANDUM

TO: PREA Research Committee

FROM: Prof. James A. Graaskamp

RE: Pension Real Estate Appraisal Procedure Study

Enclose you will find an outline of a proposed appraisal procedure study prepared by doctoral candidate Robert Gibson and myself for your review. Rather than inflict a full Ph. D. dissertation proposal on you, I have sketched it in the briefest possible form. We would appreciate your written comments or a phone call, but anticipate pushing forward to detail questionnaires and procedures for your review at the January meetings. Note the schedule for research which should provide a final draft product for your fall meetings.

The budget for this project looks as follows:

PRO FORMA BUDGET

Spring semester research assistantship--Robert Gibson at 75% time (including University indirect charges)	\$6,500
Spring semester student hourly for extracting data from questionnaires and appraisals 500 hours @ \$7.00/hour	3,500
Summer Semester research assistantship - Robert Gibson	4,000
Summer semester student hourly for data processing 300 hours @ \$7.00/hour	2,100
Summer semester research support - J. A. Graaskamp	7,900
Travel for Robert Gibson for interviewing key individuals among asset managers and appraisers	3,500
Miscellaneous expenses	2,500
Total budget required	\$30,000

Prof. Maury Seldin has already committed $15,000 to the project, and we would hope that PREA could provide an additional $15,000 by June 1 to fund the data organization and analysis phase. By incorporating this research into the dissertation process and administrating funds through the University Foundation we legitimately avoid heavy University overhead charges which apply to government research grants.

Both Bob Gibson and I plan to attend your January Research Committee meeting.

In the meantime, I have enclosed some additional reading on accounting and appraisal for a Sunday afternoon when you are tired of football.

PREA

STEPHEN ROULAC
& COMPANY

100 California Street
San Francisco, California 94111
(415) 433-0300

July 16, 1985

Dr. James A. Graaskamp
Landmark Research, Inc.
202-A Breese Terrace
Madison, WI 53705

Re: Standard Appraisal Specifications

Dear Dr. Graaskamp:

Enclosed herewith is the latest iteration of the standard appraisal specifications which we discussed over the telephone last week. As I mentioned at that time, Stephen Roulac & Company would appreciate whatever contributions or criticisms you have.

The specifications consist of instructions to the appraiser and examples of sections of appraisals, which are distinguishable by being printed in a smaller typeface than the instructions. Not all sections are accompanied by examples because we have not located satisfactory ones in our files.

The specifications will be accompanied by a cover letter which will explain the uses to which Merrill Lynch will put the acquisition appraisal and annual appraisal updates. These include:

- acquisition support
- due diligence documentation
- property management decisions
- asset management decisions (including disposition strategy)

The appraiser should ultimately become an outside member of the acquisition and asset management teams; therefore the quality of the information he or she provides in written reports and ongoing informal reports is of paramount importance. (For our purposes, quality is defined in two contexts: accuracy of information and conclusions, and responsiveness to the needs of the client organization).

I hope you find this document interesting and I look forward to receiving your comments.

Steve sends his regards and hopes that your paths cross soon.

Cordially,

Rick May

Richard D. May

RDM:rl/4220B

Standard Specifications for Full Narrative Appraisals

Merrill Lynch Hubbard, Inc.

Effective July 1, 1985

Prepared by: Stephen Roulac & Company
One Post Street, 24th Floor
San Francisco, CA 94104
(415) 433-0300

Table of Contents

APPRAISAL SPECIFICATIONS

I. LETTER OF TRANSMITTAL AND REPORT ORGANIZATION

The Letter of Transmittal should be of standard format, including identification of the property being appraised, the rights appraised, the type of value appraised and the final value estimate. Any information which ought to be brought to the reader's attention should be included in the Letter of Transmittal. Such information would include anything that is unusual about the property or about the appraisal techniques used. Any unusual circumstances applying to the appraisal should be mentioned, since the value to be provided is presumed to reflect a cash transaction and full market terms for all property elements, recognizing the particular contractual commitments and specialized interests that are associated with the property and can (or must) be assumed by the purchaser. For instance, a value estimate based on existing financing or existing leases should be explained as such.

A detailed table of contents and list of exhibits, including page numbers, should follow the letter of transmittal. The report is to be organized in a manner consistent with what is stipulated in these appraisal specifications.

II. SUMMARY OF SALIENT FACTS

The Summary of Salient Facts should be one to two pages long, and include brief descriptions of important information contained within the body of the appraisal report. Such information should be appropriate to the property type and includes, but is not limited to:

A. Name and Address of Property

B. Rights appraised

C. Property Description

1. Type of property

2. Size of property

    a. gross and net rentable square feet

    b. number of rooms

    c. number of units

    d. land size and shape

3. Type of construction

4. Age of buildings

5. Zoning

6. Any unusual characteristics of the building, such as solar or other energy efficient systems

C. Financing (including ground lease, if applicable)

D. Leasing status at the appraisal date, including major tenants, if appropriate

E. Special property interests (options, management contracts, partial interests, seller guarantees)

F. Value derived by each of the approaches used

G. Final Value Conclusion

III. PURPOSE OF APPRAISAL

This section of the appraisal should contain, at a minimum, the following items:

A. Purpose of the appraisal

B. Rights appraised

C. Definition of value

D. Statement of all conditions to which the value estimate is subject

An example of a Purpose of Appraisal section is provided on the following page

IV. SOCIOECONOMIC ANALYSIS

A strong socioeconomic analysis is essential to understand the factors that influence demand for real estate in any market. Accordingly, a detailed and accurate description of economic and demographic conditions and trends is required. Specific information to be included is detailed below.

A. Economic Base Analysis

A healthy, growing economy stimulates demand for real estate. Conversely, a weak economy is likely to produce conditions contributing to high vacancy rates and declining rents and property values. Often, however, a strong and growing economy will contribute to overbuilding, which leads to a soft rental market. This effect is similar to that of a weak economy, but with a very different cause. Any existing or contemplated overbuilding should be discussed in Section V, the Market Analysis. The appraisal report must include an analysis of the economic base of the market area, which answers such questions as:

- o How does the local economy affect demand for this property type?
- o What factors would cause space users to relocate or expand in this market?
- o What economic/demographic trends can be discerned?

The items listed below are typical of the kinds of information that are useful in addressing those questions. They are most useful when viewed in a historical context with projections of the future, and compared with regional or national statistics, particularly when both absolute and relative changes or differences are highlighted.

1. employment and unemployment statistics
2. employment by industry (SIC Codes)
3. major employers and the number of people they employ
4. per capita income
5. business formations and failures

6. property-specific information, as appropriate such as:
   a. number of conventions and attendees
   b. tourism
   c. passengers boarded at airport
   d. tonnage shipped by rail, water, road or air
   e. retail sales

B. Demographic Analysis

Demographic information is also useful in understanding the dynamics of the local market as related to the property being appraised. A good demographic analysis is particularly important if the subject property is residential. As in the case of the economic base analysis, trend analyses and comparisons with regional and national statistics are necessary. The following list includes examples of the types of information desired. The relative importance of each statistic will vary according to the type of property being appraised.

1. population
2. age profile of the population
3. household size
4. household income
5. rate of household formation
6. numbers of owners and renters

An example of a socio-economic analysis prepared for the appraisal of a rental apartment property follows on pages 6-23.

V. Market Analysis (Office, Apartment etc.)

This section should include sufficient information to acquaint the reader with current, historic and forecast market information affecting the property. Information contained herein will form the basis for appraisal assumptions concerning occupancy rates, leasing period, rent increases, etc. Information should include:

A. Competitive supply

   1. existing
   2. under construction
   3. planned

B. Occupancy rates

C. Rent levels

D. Historic annual net and gross absorption

E. The appraiser's conclusions about future market trends, particularly as they affect appraisal assumptions.

Exhibits, such as the one shown on the following page, are very helpful and their use is encouraged.

VI. SUBJECT LOCATION AND SITE DESCRIPTION

This section should consist of a detailed discussion of the merits and demerits of the subject location, both specifically and in the context of the relevant neighborhood. Items which should be included are:

A. The Appraiser's Definition and Description of the Relevant Neighborhood

1. The reasons for defining the boundaries of the neighborhood--If it is a submarket, how is it defined? Surrounding competition or compatible use? Trade area?

2. Surrounding land uses--are they supportive of the subject? Competitive?

3. Traffic patterns--Is there easy access to the neighborhood for commuters or shoppers?

4. Shopping patterns--In the case of retail properties, where do consumers go for certain goods or services? What could cause the patterns to change?

5. Neighborhood amenities--Do neighborhood amenities support the subject property? Is the neighborhood more or less desirable than others? Why? What would cause a user to locate in this neighborhood?

6. Best locations and/or best examples of the property type within the neighborhood--How does the subject stack up to the competition?

7. Past and future trends of neighborhood land use--What are the long-term prospects for the property? Is the neighborhood in transition? What are active factors affecting land use?

B. Site Description

1. Physical characteristics--Topography, geology, soil conditions, drainage, etc. Are there any unusually good or bad site characteristics which affect its value?

2. Highest and best use--Identify highest and best use. Is highest and best use limited by current zoning? If the subject property is improved, do the improvements constitute highest and best use? Are there possibilities for future conversion to another use? Does that increase value?

3. Visibility--Does an identity exist which increases its attractiveness to tenants? Who? Is a necessary visual identity lacking?

4. Ingress, egress, access--Is there easy access to the site? Are left turns into the property permitted? Is it easier to see than get to? How does that affect rentability?

5. Site identity - Advantages and disadvantages of the location relative to the competition.

6. Zoning and permitted uses on the subject site--Is the property in compliance? If raw land or if a change or addition is contemplated, what uses are permitted? Will the planned use require a variance? What is the planning and development environment of the community? What are the relevant agencies of jurisdiction?

7. Availability of utilities/infrastructure--Are all necessary utilities available and extended to the site? Are hookups available? Will the property be assessed for public improvement bonds? If so, what is the exposure?

8. Title status--Is the title marketable and insurable? Are there onerous restrictions?

9. Other encumbrances--Is there a ground lease, etc.?

An example of a property description from an appraisal of vacant land is presented on pages ______ through ____. It is followed by a ground lease description on page ____.

VII. DESCRIPTION OF IMPROVEMENTS

The description of the improvements should be sufficiently detailed to give the reader 1) a good idea of the quality and condition of the property, and 2) a basis for comparing the subject property with the rent and sale comparables. Examples of items to be covered in this section are as follows:

A. Description of the Improvements

1. Construction type

    a. frame

    b. curtain wall

    c. roof

2. Types of mechanical systems

3. Building standard tenant improvements

4. Appliances and furnishings included, if applicable

5. Amenities provided

B. Quality, Age and Condition of Improvements

C. Quality/Image of Subject Compared to Competition

D. Unit sizes, building efficiency, etc. as appropriate

It is anticipated that an inspecting engineer will be hired by the client to inspect the subject property prior to or during the course of the appraisal assignment and that the engineer's report will be provided to the appraiser. For that reason, the appraiser's inspection of the property need not include an estimate of deferred maintenance unless the appraiser has reason to disagree with the engineer. The appraiser will, however, be responsible for estimating the replacement cost of the building.

An example of a description of improvements is provided on the next two pages.

VIII. COST APPROACH TO VALUE

The cost approach to value is used by the client for tax allocation purposes as well as for insurance purposes. Replacement cost, rather than reproduction cost, will be the relevant figure in most cases. Methods used to develop the replacement cost will be determined by the appraiser, provided that a full description is provided of the particular techniques employed and comprehensive bibliographical notations are made to direct the reader to source materials where appropriate: i.e., Marshall Valuation Service, Sec. 15, p. 2, etc.

Explanation of the derivation of land value is of major importance. The narrative about land value derivation should be sufficiently detailed to provide the reader with a thorough understanding of land values in the pertinent market area and should also provide a good basis for allocation of the purchase price or value for tax purposes. Accordingly, the following types of information should be provided in the appraisal report. Some of this information may be included in an appendix, rather than the body of a report, if the appraiser so chooses.

A. Locations of the subject property and land sale comparables must be shown on a map.

B. Adjustments to land sale prices should be thoroughly explained, and any relevant calculations that have been made should be provided in the report. Such adjustments may include the following:

1. Location adjustments

   Explanations should agree with information provided in the neighborhood and location descriptions above.

2. Time

   Time adjustments should be justified by use of empirical data, which show property appreciating over time, not influenced by other factors, such as subsequent improvements or more favorable financing.

3. Degree of development

Comparable sale prices should be adjusted according to a relative degree of development, as appropriate, on the basis of cost. Such adjustments include grading, streets, utilities and assessment bonds.

4. Topography, soil conditions, water rights

Appropriate adjustments should be explained.

5. Size, shape, plottage value

C. A land sale comparable grid sheet should be provided, showing the following:

1. address

2. parcel size

3. zoning

4. allowed density or FAR

5. sale date

6. sale terms

7. sale price

8. adjustments to each land comparable, as described in narrative.

9. the adjusted sales price of each comparable on a per acre, per square foot, per buildable square foot, or per unit, as appropriate.

D. Methods by which the adjusted comparable land sale prices were correlated to estimate the value of the subject site should be explained in narrative.

IX. MARKET APPROACH TO VALUE

This section of the report is very important, even if far greater reliance is placed on the income approaches in deriving the final value estimate. Information on sales activity in the market place is crucial to an adequate understanding of the market as well as to the derivation of the relevant capitalization rate for use in the income approach. Accordingly, the reader should be provided with the following information:

A. Improved Sale Comparables

1. Each improved property sales comparable should be presented by means of a one-page summary sheet, including a picture of the property, property description, and complete sale information, including:

   a. property name and address

   b. sale date

c. grantor and grantee

d. sale price

e. financing terms

f. property description, including
   1. size (gross and net rentable or number of units)
   2. number of stories
   3. special features

g. leasing status of property at the time of sale, including:
   1. square feet or number of units occupied
   2. number of tenants
   3. list of major or anchor tenants

2. Locations of improved property sales comparable should be shown on a map.

3. Explanations of adjustments to comparable sales prices should be provided, including the following information:

   a. location

   b. age, quality, construction type, condition and amenities

   c. leasing status, including occupancy rates, number of tenants, list of major tenants, types of users.

   d. time

   e. financing terms associated with sale: i.e., assumed or new financing, seller carryback financing, ground lease

   f. special conditions, such as earnouts or seller guarantees.

The rationale by which adjustments were made should be explained and all relevant calculations should be shown.

4. A one-page improved property sales comparable grid sheet should be provided, providing the following information:

   a. Name and address of property

   b. Date of sale

   c. Building size (net rentable)

   d. Number of units or rooms, if applicable

e. average unit size, if applicable

f. Actual or pro forma gross and net income at date of sale

g. Sale price

h. Adjustments to sale price

i. Adjusted gross sale price, price per sq.ft., per unit (as appropriate) gross income multiple and overall capitalization rate.

Relevant comparisons to be used are up to the appraiser, as is the relative importance of sale price per square foot, per unit, per room, or gross rent multiplier.

5. The correlation of adjusted comparable sales prices and derivation of value by the market approach should be explained in detail in narrative format.

X. INCOME APPROACHES TO VALUE

The income approaches consist of the capitalization approach and the discounted cash flow approach, both of which are required in each appraisal. Items A and B apply to both income approaches.

A. Rent Comparables

Rent comparables should be presented in the same manner as improved property sales comparables, including the following:

1. A one or two page information sheet on each comparable, including the following information, as appropriate to the property type and market:

    a. picture

    b. name and location of comparable

    c. property owner or manager and building contact

    d. contract rents

    e. rent concessions

    f. effective rents

    g. expense pass-throughs

h. leasing status, including:
   1. square feet or number of units and percentage occupied
   2. number of tenants
   3. list of major or anchor tenants

i. measurement of rentable area

j. rent comparatives on the basis of rent per square foot, per unit, per room, as appropriate

k. rent escalations, such as CPI, adjustments to market, percentage rents, etc.

l. building operating expenses and taxes if available

m. property description, including:
   1. quality and condition of the building
   2. construction type
   3. number of stories
   4. special features

2. Locations of rent comparables should be shown on a map.

3. Rent comparables which are also sale comparables should be used, if at all possible. Otherwise, an explanation of comparability between rent and sales comparables is required, in order to reconcile the market and income approaches.

4. Adjustments to comparable rents should be explained in narrative and presented on a grid sheet similar to the grid sheet for improved sale comparables.

B. Expenses

Projected or stabilized expenses should be well documented. Primary reliance should be placed on actual expenses or on expense and tax comparables, as appropriate. Any projected expenses which are materially different from actual expenses should be justified.

C. Capitalization Approach

The overall rate utilized in the capitalization approach should be derived from the market sale comparables. Appropriate overall rates should be shown for each of the sales comparables and adjusted for the relevant differences in the sales terms, particularly financing terms. Relevant calculations should be shown.

D. Discounted Cash Flow Approach

A discounted cash flow investment analysis model should be developed, over a presumed 10-year holding period, or such other holding period as is justified, given the remaining terms of existing financing or major leases. Reversionary value should be determined by using a reasonable rate, applied to the final year's cash flow. The capitalization rate should be supported by a full rationale for its selection, including consideration of possible sale terms and leasing status (rollover schedule) at the time of sale. All inputs to the model should be justified and explained, such as:

1. Rental income

2. Other income

3. Vacancy rate

4. Operating expenses

5. Taxes

6. Debt service

7. Selling expenses

8. Rollover assumptions (leasing commissions, vacancy period, tenant improvement costs)

9. Value of reversion

10. Rates of appreciation or inflation applicable to the variables.

Reference to information included earlier in the report is appropriate, in order to avoid redundancy. A discount rate may be adjusted for greater or less than average risk, but only if fully justified.

With the exception of seller guarantees, such items as financing terms of the sale, or existing financing which is below market rate, may be used in the discounted cash flow approach unless, in the appraiser's judgment, such items should be handled separately. Seller guarantees should not be used in deriving gross or net income estimates. They should be separately analyzed and valued.

Stephen Roulac & Company should be provided with sufficient information about the software used to run the discounted cash flow model to check its logic and accuracy. Only those models whose logic and accuracy have been validated by Stephen Roulac & Company are to be used, and the appraiser should make reference to such confirmation.

Computer printouts of the discounted cash flow models used in the appraisal should be shown; however, if sensitivity analyses that generate numerous printouts are used, they may be included in an appendix.

XI. RECONCILIATION AND FINAL VALUE CONCLUSION

The logic used in the reconciliation of values derived in the various approaches should be disclosed and explained in detail. A range of value in addition to a most likely single point estimate of value may be appropriate in certain circumstances, according to the appraiser's judgment. If a range of value is used, however, the reasons for the selection of the upper and lower ends of the range, as well as any relevant points in between, must be explained.

XII. APPENDICES

The legal description of the property is appropriately included in an appendix, as well as any other information which, in the appraiser's judgment, it is necessary to provide to the reader in order to enhance his understanding of the property and the appraisal. Such information may include, assessors' parcel maps, assessment information, and zoning codes.

JAG Copy

Richard D. May
Stephen Roulac & Company
100 California Street
San Francisco, CA 94111

Re: Standard Appraisal Specifications Comment

Dear Rick:

Following previous conversations, I would like to add a few written comments on your very thorough set of appraisal specifications.

Relative to structure of the appraisal report it is more logical and efficient to begin with a thorough analysis of the property and probable occupancies before analyzing the local economy and effective demand and supply. Supply will be much better defined as a subset of the property class once the specific location and structure characteristics of the subject property are known. Further, if the building is occupied by a specific set of S I C codes, those are the primary codes that are relevant to demand analysis. The balance of general economic trends for the commnuunity is primarily relevent to assumptions about resale value in the five-year or ten-year future. In short, the best use of the subject property is an editorial control on how far-ranging the analyist should be in terms of general economics. The more you can prove that the subject property has monopolistic attributes, the more you can reduce the boiler-plate on the economics of the region, etc.

The second major issue in terms of logic has to do with the order in which you present the three approaches to value. Theory and common sense agree that the preferred method is to infer price from market transactions; the second best approach is to simulate future productivity, i.e. the income approach. Failing that, a normative method like the cost approach may serve as a benchmark, but only for new buildings which represent the best use of the site. Thus, the cost approach can be ignored much of the time, and if it is used should be deemphasized. On the other hand normalized income and a cap rate has become a market comparison rather than a true income approach, which should use discounted cash flows before or after taxes and with and without leverage, as appropriate.

The market comparison approach should emphasize the necessity that the appraiser research each transaction to discover if there is any significant engineering of the sales price in the form of seller financing, assignment of management contracts, renegotiation of leases with tenants related to the seller, inventory transfers, or equipment allocations or going concern values such as working capital, hotel booking, etc. involved in the price. Secondly, the appraiser should demonstrate how he selected the relative unit of comparison, such as gross leaseable, net useable, net building area, or what-have-you. The unit of comparison is a critical choice in reducing dispersion of adjusted sales prices per unit.

The discounted cash flow approach of the interest as encumbered by existing leases, etc. is often the most meaningful method, but it is necessary for the client to define the accounting rules to be followed by the appraiser. As we discussed by phone, the operating statements will probably be prepared by a CPA on an accrual basis, while discounted cash flow logically must be applied to a hard-dollar cash basis. Therefore, we recommend a new set of items on the spread sheet below net economic income on an accrual basis. These items should be called unrecognized assets and represent the difference between either booked income and cash ~~recei-~~ income receipt (such as a concession rent deferral) or a cash expenditure not amortized in that year (such as $100,000 of tenant improvements on a five-year lease , resulting in a $20,000 expense and an $80,000 unrecognized asset). When these items are deducted from accrual income, the result is a more-meaningful cash available for debt service and distribution. Before debt service would be discounted at the targeted equity rate; the after-debt service cash available for distribution would be discounted at the equity rate and added to the face amount of the debt; cash not available for distribution but allocated to a reserve should be added to the estimated resale price in any given year. As in FHA projects, reserves for replacement go to the new owner and are included in the purchase price. In short, your specifications need to be more explicit relative to the accounting standards for discounted cash flow.

One final area of confusion today. Many clients believe that the independent appraiser must be left entirely alone to discover for himself the potentials and problems of a specific property while others try to use the appraiser as a puppet to arrive at a preconceived conclusion. Neither is true, however. The client should share the property management records and investment strategy for the property with the appraiser. Who knows more about the property than the owner/managers and who will have more to say about where that property will be at the end of the forecast period? Some clients go so far as to provide pro forma budgets for the appraiser to critique or lease documents already programmed for FINSIM II. As long as the source of lease data is explicitly recognized, I think it is legitimate for the client to provide this kind of data bank assistance.

Enclosed is a Letter of Engagement we have been using at FARA. It intimidates the appraiser or provides an excuse for a higher fee. The biggest sore point is the need to document sales and leases since that is a time-consuming project.

Relative to annual appraisal updates, there would seem to be a need for very close cooperation between the property manager and the appraiser. Capital improvements to alter energy costs or maintenance may be buried in the expense ledger and the significance of renegotiated leases in terms of future income also may not be apparent, say where a major tenant is consolidating and taking over responsibility for tenant improvements in exchange for extending the average term of occupancy, etc.

Thanks for the opportunity to comment.

JAG

RREEF
The RREEF Funds

RICHARD A. RAYBIN
Treasurer

January 23, 1986

Mr. Charles Raper
Travelers Insurance
One Tower Square
Hartford, CT 06183

Mr. Glen Emig
JMB Realty - Suite 3900
875 N. Michigan Ave.
Chicago, IL 60611

Mr. Norman Cardinali
Prudential Realty Group
20 Prudential Plaza
Newark, NJ 07101

Mr. Edward Daly
Aetna Life Insurance
CityPlace
Hartford, CT 06156

Dear Charlie, Norm, Glen, and Ed:

You will find enclosed an update to the previous version of the engagement letter guideline. Most of the changes to the previous version are additional text: example engagement letter and listing of appraisal procedures (copy of what Grayson Moss sent to us).

The other changes are for better grammar, incorporating some ideas presented by Jim Graaskamp about the future direction of the appraisal process and how to improve the perception of the accuracy of the appraisal.

Please review these materials and let me know what further revisions should be made before we circulate it among the other members of the committee and the Directors.

I look forward to seeing you on Thursday, January 30, in RREEF's office in New York City. (55 E 52 ST, 31st FLOOR; 212-688-3900).

Thank you for helping on this important project.

Sincerely,

Rik

RAR:asm
Enclosures

CC: Jim Graaskamp

I. INTRODUCTION

Since ERISA was enacted in 1974, pension funds have invested in real estate, many up to 10 to 15% of their entire fund. The common goals of investment in real estate are:

Diversification -	values and current returns do not rise and fall on the same cycle as stock or bonds.
Stability -	price movements in property market values are less volatile than prices of equity or fixed income securities; since leases are written over a number of years, current income also changes more slowly.
Current Income -	real estate can generally provide current income at a rate in excess of stock dividends and comparable to interest on bonds.
Inflation Protection -	with its space being (re)leased periodically, real estate will adjust to current market conditions and can provide inflation protection for both value of the principal invested and the current income.

The appraisal is a key part of establishing periodic updates to the values that are integral to the investment goals of diversification, stability, and inflation protection. The pension fund investor requires this periodic update so that it can determine the value of beneficiaries' holdings, annual corporate contributions, and can project future funding and investment requirements. The investment manager needs the periodic update to provide his market values to his pension fund investors and to determine the performance of his investment management.

Since the appraisal is so important in determining how well the investment goals are being met, future investment decisions are greatly influenced by the perception of the appraisal's validity. Our industry and the professionals providing appraisal services are working to enhance that perception, taking steps necessary to insure that qualified appraisers use appropriate "state-of-the-art" techniques.

As part of our work, we have developed this document to assist the appraisers and their clients in developing engagement letters which identify the nature, scope, terms, and responsibilities of the appraisal engagement. The engagement letter should be prepared with the care exercised in entering into other contracts. This document has addressed only initial appraisals or their annual updates that are either full narratives or form narratives.

This document sets forth only minimum standards that are to be considered in the appraisal process and the appraiser or the client must exercise professional judgment to perform other necessary procedures.

Beyond the standards set forth in this document, the appraisers and their clients need to consider further steps to improve the appraisal process. If the appraisal can be prepared more efficiently, the appraiser can operate within current fee constraints while providing a more comprehensive service, thus enhancing its credibility.

One way to provide the appraisal more efficiently is having the client prepare more, if not all, of the valuation model. Similar to the independent auditor's review of financial statements, the appraiser can test the data and model used by the client in determining the value and "attest" to its reasonableness. Instead of focusing so much of the appraisal effort on gathering the client's rent roll and expense data and extrapolating future cash flows, the appraiser can concentrate on the assumptions affecting future market rents, leasing costs, operating expenses, competitive market yields, and eventual reversion values. This approach is already being used successfully by large institutional managers.

Jim Graaskamp of the University of Wisconsin Graduate School of Real Estate has suggested another way to enhance the credibility of the appraisal. Instead of showing the value as one number, break it down into components. Show how much value is the result of the current economics of the property, how much this is affected by current market rents, and how much it will change from anticipated future market rents and other property and market economics. Thus, instead of viewing it as something dependent solely on future events, the reader can better understand the intrinsic value of these investments.

Enhancing the perception of the appraisal process is an on-going process, something of benefit to all members of the institutional investment community. As we refine existing ideas and develop new ones, this process will continue to evolve. By responsibly participating in this process, we can help millions of pensioners, the ultimate beneficiaries.

II. ADMINISTRATION OF ENGAGEMENT

ENGAGEMENT LETTER

In October, 1985, the American Institute of Real Estate Appraisers issued a new set of professional ethics and standards. As described in S-R 2.4, the engagement letter should explicitly:

identify the definition of market value;

> DEFINITION OF VALUE (GROSS OF CLOSING COSTS)
> "fair market value shall be defined as the most probable price at which the property would sell to a knowledgeable buyer on a given date if placed on the market for a reasonable length of time by a well informed seller assuming cash to seller or financial arrangements equivalent to cash. Since institutional owners have been able to sell properties directly, the value should not be reduced for assumed closing costs."

identify the real property interests and rights being appraised;

identify and describe the physical real estate being appraised;

set forth the date of the property inspection, the effective date of the appraisal, and the date of the report;

identify and describe the purpose and use of the appraisal;

Also, the engagement letter should specify that the report comply with S-R 2.4.

APPRAISAL REPORT

The engagement letter should require that the appraiser describe the methods and procedures used in the appraisal process in sufficient detail for the client to determine that the appropriate and necessary professional standards were employed.

As described in S-R 2.5, the engagement letter should require that the appraiser, in his report, certify that, ... "to the best of my knowledge and belief, ...

- the statements of fact contained in this report are true and correct.
- the reported analyses, opinions, and conclusions are limited only by the reported assumptions and limiting conditions, and are my personal, unbiased professional analyses, opinions, and conclusions.
- I have no present or prospective interest in the property that is the subject of this report, and I have no personal interest or bias with respect to the parties involved.

- my compensation is not contingent on an action or event resulting from the analyses, opinions, or conclusions in, or the use of, this report.
- my analyses, opinions, and conclusions were developed, and this report has been prepared, in conformity with the requirements of the Code of Professional Ethics and the Standards of Professional Practice of the American Institute of Real Estate Appraisers or comparable professional organization".

ENGAGEMENT MEETINGS

The engagement letter should also include the dates of meetings with the client and when responsibilities are to be fulfilled (milestones).

FEE

Since the engagement letter is a contract, it needs to identify what the appraiser will be paid for his services. In expressing the fee structure, a payment schedule should be specified. This schedule may be relative to completion of certain tasks or may be based on specified dates.

A portion of the fee may be contingent upon these dates being met. But as the fee cannot be based upon the appraiser reaching a value sought by the client, the client should avoid language describing the fee as not being paid until the appraisal is "reviewed" or "reviewed and accepted".

III. ATTACHMENTS

To help the client and appraiser develop their engagement letter, we have attached an example (Exhibit A) that incorporates the matters described above.

To help the appraiser develop his/her set of procedures, we have attached an example (Exhibit B) used by one appraiser.

To help the appraiser develop his/her appraisal report, we have attached a "template for full narrative appraisal" (Exhibit C).

These are just examples and are not offered as standards to which compliance will be measured. These examples may include language or procedures that are not applicable to each assignment and/or may omit other language or procedures that are applicable. Each appraisal assignment is unique. The engagement letter should accurately describe that assignment. The procedures performed should be applicable to the conditions of that assignment. The report should provide a meaningful description of the appraisal performed in sufficient detail.

EXHIBIT A
EXAMPLE ENGAGEMENT LETTER

September 1, 1985

XYZ Fund
100 San Francisco Street
San Francisco, CA

Gentlemen:

As a follow-up to our recent meeting, Real Estate Valuation Incorporated is pleased to submit the following proposal for appraisal services relative to the subject property.

It is understood that the purpose of the appraisal is to establish the Fair Market Value of the leased fee simple interest in the subject property office building located at 500 University Avenue, San Francisco, California, as of December 31, 1985. The appraisal report will set forth the date(s) the property was inspected. It is further understood that the appraisal will be utilized in reporting the unrealized appreciation in this property since acquistion.

Market value is defined as 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 a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.

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 based 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.

The leased fee simple interest is defined as the right to receive rent for a period of years under a lease with the ultimate reposition of the fee simple interest in the property upon lease termination. It is also identified as the owners or lessors interest.

With this preface in mind, we propse to appraise the subject property by way of the three most commonly utilized methods of analysis: cost, market, and income. The appraisal will be narrative in nature and include the following sections: letter of transmittal, summary of salient facts, purpose of appraisal, property identification, legal description, value definition, definition of rights appraised, effective date of appraisal, date of inspection, regional/city/neighborhood data, site analysis, description of improvements, highest and best use, valuation process, cost approach, market approach, income approach, reconciliation and final value estimate, statement of limiting conditions, certification of appraiser, qualifications of appraiser, addendum/exhibits.

Within the cost approach, we propose to analyze at least three comparable land sales in determining the underlying land value of the subject property. Replacement cost will be estimated and depreciation taken based on the current edition of Builders Estimating Service, combined with observed conditions at the subject property.

The market data approach will utilize at least three market comparable properties which will be analyzed by applicable units of comparison and adjusted to the subject property.

The income approach will discuss market rent, competitive occupancy rates, historical, current, and market expenses, and establish net operating income. Net operating income will be converted to value by the two most acceptable methods: direct overall rate capitalization and discounted cash flow. The applicable overall capitalization rate will be extracted and justified by extraction for at least three comparable market sales. The 10 year discounted cash flow analysis will outline, discuss, and justify all inherent assumptions.

The reconcilation and final value estimate will consider all relevant approaches to value, however, given the nature of the subject property as an income generating asset the discount cash flow analysis will be given most consideration.

The preceding appraisal report will be prepared in accordance with the standards established by the American Institute of Real Estate Appraisers of the National Association of Realtors. The report will be reviewed and approved by a member of said organization with the professional designation M.A.I.

This proposal shall also stipulate a number of meetings necessary for the operational management of the assignment. Said meetings shall be set as follows: pre-engagement meeting October 15, 1985, report delivery meeting February 1, 1986, and post appraisal meeting February 10, 1986.

The fee for the proposed appraisal is established at ($25,000) Twenty Five Thousand Dollars. The entire fee is due and payable within 30 days of the delivery date. A penalty of 5% shall be enforced for every week of delay beyond the delivery date.

If you are in agreement with the terms of this proposal please execute the attached copy and return it at your earliest convenience. We are prepared to begin work on this assignment immediately upon your approval of the proposal. We look forward to working with you on this important appraisal assignment.

Sincerely,

Pension Valuation Incorporated

____
Agreed and accepted

____
Date

:asm

EXHIBIT B
EXAMPLE APPRAISAL PROCEDURES

In preparation of my estimate of the market value of this property I have taken the following steps:

1. Reviewed the lease briefs of major tenants.
2. Reviewed existing mortgage notes.
3. Considered the current office rental market.
4. Analyzed the financial statements.
5. Analyzed 11-year income and expense pro forma.
6. Reviewed rates of return based on sales of office buildings.
7. Considered the mortgage payable to Insurance Company with a balance of around $ amortizing through 9/1/2011 with the right of to declare the entire unpaid balance due as of 10/1/98 with 12 months prior written notice.

Comments on the above items are as follows:

C-1. Lease briefs - prepared by the management offices of reviewed by me and the original lease of Company was reviewed by me.

C-2. Mortgage notes and amortization schedules were reviewed.

C-3. Office Rental Market: Market rates have been estimated for those spaces which will be rolling over at market and the present market rates are grown as shown under general assumptions below. (See C-5 below).

Reports on the occupancies of office buildings by Property Research and Investment Consultants, Inc. have been studied for the past four years for the area, the Area and other buildings in the surrounding neighborhood which were considered significant competition. Significant portions of this data are attached.

The introduction and overview of the October 1984 report by Property Research and Investment Consultants, Inc. states the following:

> "Although the bottom of the current market cycle was reached during early 1984, it will be several years before the overall market can inch its way back to normal."

C-4. Balance Sheets for December 31, 1984 and 1983 together with Statements of Income (Loss) for the years ended December 31, 1984 and 1983, together with notes have been reviewed and analyzed for historical reference and verification of basis for the pro forma projection.

C-5. An 11-year pro forma income and expense analysis was created by me in cooperation with Interests management, wherein I set our parameters for general assumptions, including the following:

a) Unless otherwise stipulated in the lease, major tenant renewals have generally been "given" discounts of 15% to 25% below market (as grown in the projection).

b) The projected rates for other tenants were based on anticipated 1985 rates, before expenses with base expenses equal to the 1984 amounts. Rental rates are based on an analysis of the general market, together with actual leases signed during 1984 among the various similar buildings together with anticipated changes due to influences in the market such as building quality, location, absorption, competition, etc. Rates were then grown at 6% per annum.

c) It was believed that the maximum occupancy would not exceed 95% for this building which was completed about seven years ago.

d) Free rent: generally for new tenants, first 12 months free through 1985; six months through 1986; 3 months thereafter. Free rent for 1985 is to be split with 50% granted in 1985 and 50% earned in 1986.

e) Operating expenses including utilities and taxes are projected to grow at 6% per annum from the 1985 budget. The amounts were checked for reasonableness.

f) Buildout: new tenant space buildout cost above building standard is estimated to equal $5/sf in 1985; $3/sf in 1986; none thereafter.

g) Standard Buildout: Space which is considerd acceptable for re-renting with its existing partitioning is generally considered to require an expenditure of $2.50 to $3/sf for painting and replacement of carpeting only. Other second generation space that does not require complete demolition will cost generally between $10 and $15/sf while some spaces requiring total demolition and rebuilding may cost between $15 and $20/sf. The subject Building was based on $10/sf.

h) No other costs associated with re-leasing (such as tenant lease buyouts or moving allowances) were assumed since any such cost would usually be offset by reducing free rent and/or buildout allowances.

i) Capital Improvements: $0.25/sf of rentable area was estimated as the base of 1984 and was increased at 6% per annum in the 11-year pro forma.

j) Commissions: generally 4%, net of free rent granted and buildout costs above building standard unless otherwise stipulated. Usually paid up front (50% upon signing of lease and the balance upon move-in).

k) Lost Rent Due to Turnover: generally 20% of space occupied by non-major tenants was assumed would be vacated. This space is estimated to remain vacant six months before a new lease can be secured through 1986 and three months thereafter with new leases also having the free rent inducement set out previously.

l) General Contingency: generally estimated at one-half of one percent of total revenues for bad debts, etc.

Supporting data is attached herewith comprising the significant ingredients for this "limited" assignment, the purpose of which is to estimate the present market value of the property herein described, including all rights of ownership and having no restrictions which do not apply to other property in the immediate area.

I certify that I have no present nor contemplated future interest in the real estate that is the subject of this appraisal report nor personal interest or bias with respect to the subject matter herein.

To the best of my knowledge and belief, the statements of fact contained in this appraisal report, upon which the analyses, opinions and conclusions expressed herein are based, are true and correct. This appraisal report sets forth all of the limiting conditions (imposed by the terms of my assignment or by the undersigned) affecting the analyses, opinions and conclusions contained in this report. This appraisal report has been made in conformity with and is subject to the requirements of the Code of Professional Ethics and Standards of Professional Conduct of the American Institute of Real Estate Appraisers of the National Association of Realtors.

In the preparation of this report no one other than the undersigned prepared the analyses, conclusions and opinions concerning real estate that are set forth in this appraisal report and I have personally inspected the subject property.

The American Institute of Real Estate Appraisers conducts a voluntary program of continuing education for its designated members. MAIS and RMs who meet the minimum standards of this program are awarded periodic educational certification. is certified under this program through December 31, 1986.

Disclosure of the contents of this report is governed by the bylaws and regulations of the American Institute of Real Estate Appraisers of the National Association of Realtors. Neither all nor any part of the contents of this report (especially any conclusions as to value, the identity of the appraiser or the firm with which the appraisers are connected, or any reference to the American Institute of Real Estate Appraisers or the MAI designation) shall be disseminated to the public through advertising media, public relations media, news media, sales media or any other public means of communication, without my prior written consent and approval.

Respectfully submitted,

Attachments:

- Summary of Cash Flow Analysis
- 11-year Pro Forma of Operating Revenues, Operating Expenses and other Expenditures
- Cash Flow Projection Supporting Schedule
- Rent Roll: Office Towers Lease Expirations
- Summary of Available Space
- Location Plat
- Legal Description
- Limiting Conditions-Definitions-Market Value
- Qualifications of the Appraiser

EXHIBIT C
TEMPLATE FOR FULL NARRATIVE APPRAISAL

LETTER OF TRANSMITTAL
SUMMARY OF SALIENT FACTS
PURPOSE OF APPRAISAL
PROPERTY IDENTIFICATION
LEGAL DESCRIPTION OF PROPERTY RIGHTS APPRAISED
VALUE DEFINITION
EFFECTIVE DATE OF APPRAISAL/DATE OF INSPECTION
REGIONAL/CITY ANALYSIS
NEIGHBORHOOD ANALYSIS
SITE ANALYSIS
ZONING/LAND USE CONTROLS
DESCRIPTION OF IMPROVEMENTS
HIGHEST AND BEST USE
VALUATION PROCESS
- COST APPROACH
  - DESCRIPTION OF APPROACH AND ITS APPLICABILITY
  - MINIMUM OF 3 LAND COMPARABLES TO ESTABLISH LAND VALUES. ADJUSTMENTS FOR COMPARABILITY SHOULD BE EXPLAINED.
  - COST OF IMPROVEMENTS SHOULD REFLECT DEPRECIATED REPLACEMENT COST.
  - SOURCE OF COST AND BASIS OF DEPRECIATION INFORMATION SHOULD BE IDENTIFIED AND EXPLAINED.
- MARKET DATA/COMPARABLE SALES APPROACH
  - DESCRIPTION OF APPROACH AND ITS APPLICABILITY
  - DISCUSSION OF APPLICABLE UNITS OF COMPARISON FOR THIS TYPE OF PROPERTY
  - SELECTION RATIONALE AND ADEQUATE DESCRIPTION OF PROPERTIES USED FOR COMPARISON
  - JUSTIFICATION AND EXPLANATION OF ADJUSTMENTS FOR COMPARABILITY
- INCOME APPROACH
  - DESCRIPTION OF APPROACH AND ITS APPLICABILITY
  - SELECTION RATIONALE AND ADEQUATE DESCRIPTION OF APPROACH USED, I.E. 10 YEAR DISCOUNTED CASH FLOW
  - INCOME ANALYSIS
    - REVIEW OF EXISTING LEASES (SCOPE TO BE DETERMINED BY APPRAISER)
    - REVIEW OF MARKET CONDITIONS FOR FAIR MARKET RENT AND TERMS
    - REVIEW OF EXPECTED OCCUPANCY LEVELS
  - OPERATING EXPENSE ANALYSIS
    - REVIEW OF HISTORICAL EXPENSES
    - REVIEW OF MARKET EXPENSES
    - RECONCILIATION AND ESTABLISHMENT OF FIRST YEAR BUDGET (NOTE: SAVINGS AVAILABLE ONLY TO CURRENT OWNER, E.G. PURCHASING POWER, FAVORABLE INSURANCE PREMIUMS, CALIF TAX BASE, DO NOT CARRY FORWARD)
  - CAPITAL IMPROVEMENTS AND RESERVES
    - REVIEW PLANNED CAPITAL IMPROVEMENTS AND RESERVES FOR REPLACEMENT OF SHORT-LIVED ITEMS OVER

PROJECTED HOLDING PERIOD
NET OPERATING INCOME BEFORE DEBT
IMPACT OF FAVORABLE FINANCING
CAPITALIZATION PROCESS
DESCRIPTION OF APPROACH AND ITS APPLICABILITY
DIRECT CAPITALIZATION
REVIEW OF SELECTED MARKET TRANSACTIONS, EXTRACTION OF PERTINENT FIRST YEAR OVER-ALL CAPITALIZATION RATES, AND APPLICATION OF CAPITALIZATION RATE TO NET INCOME OF PROPERTY
DISCOUNTED CASH FLOW
REVIEW OF OUTLINE OF ASSUMPTIONS: DISCOUNT RATES, LENGTH OF HOLDING PERIOD, GROWTH OF INCOME AND EXPENSES, RENEWAL PROBABILITIES, MARKET RENT, LEASING CONCESSIONS, BROKERAGE COMMISSIONS, TIMING AND COST OF CAPITAL IMPROVEMENT PROGRAMS, REVERSIONARY CAPITALIZATION RATE, AND COST OF SALE.
RECONCILIATION OF FINAL VALUE ESTIMATE
LIMITING CONDITIONS
CERTIFICATION OF APPRAISAL
ADDENDUM
EXHIBITS - TITLE REPORT
LEASE ABSTRACTS
ZONING ORDINANCE
PHOTOGRAPHS OF PROPERTY
QUALIFICATIONS OF APPRAISER
TEMPLATE FOR UPDATE APPRAISAL

PROVIDE CREDIBLE DATA SUPPORTING ASSUMPTIONS & DETAIL ASSUMPTIONS
FOR UPDATES INCORPORATE ASSUMPTIONS USED IN PRIOR APPRAISAL AND NOTE MAIN ASSUMPTIONS AND ANY CHANGES THAT AFFECT VALUE

The School of Business
University of Wisconsin-Madison

Graduate School of Business
1155 Observatory Drive
Madison, WI 53706
608/262-0391

March 3, 1986

Richard A. Raybin
The RREEF Funds
650 California Street
San Francisco, CA 94108

Dear Rick:

Thanks for keeping me up to date on your progress toward a letter of engagement. In your preamble I think it would be useful to identify three areas of communication where PREA/NCREIF could standardize communication format to build investor confidence in the management of real estate capital pools:

1. 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 single individual, and unqualified by self-serving or convenient assumptions which avoid empirical research (see Exhibit A).

2. A standard set of appraisal protocols defining the relationship between the appraiser and his client in order to identify those sensitive areas 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).

3. 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).

This hierarchy of policy, protocol and practice controlled by contract needs to develop in that order or the opportunities, purposes, and proper content of the letter of engagement are not well defined. Therefore, I believe your preamble should expressly indicate the necessity of providing some minimum policy statements as well as negotiation of some contemporary protocols with the appraisal professional societies. Given the momentum now created for the topic of appraisal standards, I think discussion should be focused on three preliminary documents, the outline of which are provided in appendix of A., B., and C. and correspond to the earlier outline we discussed and agreed on for the most part in your office.

Relative to your specific draft there are several ambiguities and omissions on which I might comment before reaching Tuscon:

A. The most recent definition of market value indicated that the final conclusion is "gross of closing costs" because insitutional owners have been able to sell properties directly. The common understanding of fair market value has always been that of a price without discount for sales costs generally paid by the seller. However, now that there is explicit mention of sales cost does that mean that when using discounted cash flow, that the reversion is not discounted for sales costs either? Even if sold directly, the cash cost of sale will exceed 1% of the sales price for the seller in terms of legal costs, title insurance, and closing process. It would seem more reasonable to explain to investors that current market value assumes holding to the end of a forecast period so that sales costs are charged to the reversion because the objective of the appraisal is not to determine liquidation value. Pension fund managers can apply their own discount if they wish to the current gross market value to represent the cost of instant liquidation. S-R 2.4 is ambiguous as to whether the appraiser should charge the future reversion value for resale costs.

B. In your Exhibit A you make the usual fundamental assumptions that property may be valued subject to specified financing but that the effect shall be clearly and precisely revealed in the appraisal report. Experience has shown that the increment in value attributable to financing or other special arrangements should immediately follow the statement of value conclusions in the letter of transmittal and the certificate of value or it will be lost to public view and never be reported or understood by those not inclined to ferret out the information from the report. Syndicators fudge on reporting cash value, which may explain the ambiguity of "in the report", a concession to appraisers serving the syndication market.

C. Your use of a template in your Exhibit C is a good way to organize discussion but the critical issues to be addressed in either the letter of engagement or a statement of protocol are the kinds of things that you brought out in the format of Exhibit B - a set of comments on what is expected in the way of appraisal procedure. There should be a counterpart like Exhibit B for an appraisal procedure detailed for each of the three approaches to value. Exhibit B is where we should be going - it's good stuff as the parenthetical notes in Exhibit C are incomplete.

D. Given our discussions in your office there should also be an additional statement on procedure that would better integrate the appraisal process into the need for evaluation of the investment and measurement of asset manager performance. The major increments in growth will be the result of the following three elements in some combination:

1. Recapture of the leasehold advantage of specific tenants through aggressive management which brings these spaces back to market rent on schedule or ahead of schedule. Management is not doing well simply because net income is rising if income is not rising to the maximum possible in the market. Perhaps the appraiser should report both the value of the leased fee as currently encumbered by existing leases and market value of fee simple.

2. Inflationary increases in market rent structures which are reflected in assumptions about rents to be realized at the time of the rollover of existing leases. Perhaps the discounted cash flow model should be run twice. The first time would use the English method of bringing leases to <u>current</u> market value without anticipating inflation, and the second run would provide the discounted value if market rents were inflated as is the American practice so that the investor could see the increment in value attributed to the inflation assumption as distinct from recapture from leasehold value.

3. Resale value appreciation is the result of capitalizing both the market rents presumed at the time of sale and leasehold values recaptured from tenants so that the total reversion multiplies any distortion in the assumption about growth. Some appraisers deduct for costs of sale and others don't. A few appraisers apply a higher discount rate to the reversion than to the income, recognizing the higher risks in realizing a hypothetical future resale price. As a part of the no-inflation growth run recommended in item 2 above, the increase in future resale price should be the result of bringing rents to current market value in order to compare zero inflation growth value to the actual inflated growth value. As a result investors would be able to perceive the approximate contribution of inflation to asset value presumed by the appraiser and compare portfolios on the proportionate values dependent on the ability to achieve current market value rents and the presumption of also achieving parity with some index of inflation.

E. A few comparative statistics which reduce investment yield to certain components such as cash available for distribution, expected changes in cash available for distribution with and without an inflation component, and the present value of the resale reversion with and without an inflation component would provide significant insight to a specific real estate portfolio or property within that portfolio. In this way the appraiser would contribute toward investment understanding as well as unit value of the share. A unit value without a statement of the risk element or degree of dependence on future risks and duration to recapture of leasehold interest is a rather sterile number.

F. The other matter that your procedure must discuss is the current state of misinformation from the market approach. Robert Gibson can show that of 39 original appraisals only 20 identified the terms of sale. Of the 20 only 8 adjusted and 2 claimed all sales were for cash. 10 did nothing. 3 out of 34 made adjustments for market differences on an explicit basis and 31 did it by assertion only without reviewing any computation for the adjustment! Here it would seem the pension funds must make their appraiser do his job, i.e. research market transactions and since the market may not be generous with informtaion, market value must be stated as a range of values per unit of comparison. 21 appraisers out of 28 did not document where the capitalization rate for the future resale price was determined nor did he have any checks to indicate the compound rate of growth required or implied by that value judgement. R 41 (b) shows the exasperation of other regulatory agencies with the laxity of appraisers in documenting their comparables, and pension fund people must be sensitive to the growing dependency on discounted cash flow rather than reliable market data. Indeed, PREA or NCREIF might wish to address the ethical question as to whether they should continue to suppress market data on their own purchases and sales so that this pool of transactions would be available to pension fund appraisers.

The three elements being prepared for PREA by Bob Gibson and myself are only in outline form but we share these with you and some annotations on these outlines to indicate where we are relative to your process at NCREIF. Hope these materials will be useful for discussion purposes in Tuscon as we will bring along two dozen copies for comment and criticism to perhaps enrich the contents of your initial efforts.

Sincerely,

James A. Graaskamp, Ph. D., CRE
Chairman, Real Estate & Urban Land Economics

JAG:gg

EXHIBIT A

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

A. Specific questions to be addressed by appraisal value determination:

1. Unit price of investment shares assuming real estate interests are priced at most probable market value on specified quarterly valuation dates as a benchmark for buy or sell transactions of investment shares.

2. Asset value of a specific interest in a specific property given income and resale prospects for the underlying collateral.

3. Allocation of market value to specific components of expected real estate return including distributable cash available from existing contracts and leases, distributable cash which could be realized by recapture of leasehold interest at current market value, distributable cash to be realized from systematic inflation of rental structures, and distributable cash to be realized from resale with or without systematic inflationary increases.

4. Periodic financial indicators of operating expense ratios, cash break-even points, ratio of income reinvested in leasing, tenant improvements, capital improvements, and annual variance in revenue and expense realizations versus budget proformas.

B. Definition of real estate investment categories and appraisal values relevant to each:

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

C. Definition of in-house appraisal standards:

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 addresed in the next scheduled independent appraisal. Fund management must limit the deviation of annual independent values from in-house values to no more than ___ percent from the lower value.

2. The in-house review committee will consist of no less than three persons, two of whom may have appraisal backgrounds 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. The in-house appraisal committee must be linked to a maximum adjustment per property of ____ percent, not including capital investment or partial sale between annual revaluation dates. Capital improvements or partial sales can adjust previous values at the face value of the transaction. And finally, fund managers must define accounting rules for booking capital investment or amortized investments in leases, tenant improvements and general refurbishment to be observed by independent and in-house appraisals.

EXHIBIT A (Continued)

D. 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

E. Control of accidental or systematic bias in the independent appraisal process:

1. Professional designation and code of conduct

2. Experience with property type

3. Accountability of a specific individual within the appraisal enterprise

4. Preservation of independence defined by aggregate fees collected, relationships with subsidiaries, and protection of appraiser from intimidation through conditional fee collection.

5. Maximum number of up-dates prior to reassignment to alternative appraisal firm

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

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

2. Asbestos removal or other building code internal hazards

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

G. Specification of the discounted cash flow as methodology as a primary appraisal tool while permitting the appraiser to:

1. Utilize lease abstract reviews by other independent professionals without having to read the leases themselves

2. Specify assumptions and empirical support for lease renewals based on projections of supply and demand for space

3. Unbundle total value attributable to cash flow, change in cash flow, equity build-up from amoritized debt and resale components

4. Provide key financial ratios such as expense ratios, cash break-even, collection ratios on pass throughs

5. Accept a standard accounting convention to place appraisal on cash basis accounting standard

H. Optional policies of fund managing board would include:

1. Decision to spot-check appraisals on a random audit basis directly by pension fund managers by-passing asset managers

2. Determination by pension fund trustees for random audit inspections of properties owned or contained within unit shares of co-mingled fund investors

3. 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

EXHIBIT B

SUBJECT MATTER FOR REVISION OF APPRAISAL
PROFESSIONAL PROTOCOLS
WHICH CARRY POTENTIAL FOR ENCROACHING
ON INDEPENDENCE OF THE
APPRAISER, TRADITIONAL APPRAISAL WHOLE-HARMLESS
CONVENTIONS, AND EXTENSIONS OF CORPORATE FIDUCIARY
STANDARD TO THE APPRAISER AS
AGENT FOR PENSION FUND MANAGER

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 purveyours 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 managment responsibilty of on-site data. The appraiser as auditor of external market data should not be expected to serve as auditor of internally-generated 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 contingent fee but also maximum number of dollars of professional fees of all types received by appraisal firm or parent company

EXHIBIT C

SUBJECT MATTER FOR LETTER OF ENGAGEMENT
TO PROCURE APPRAISAL SERVICES TO ENCOURAGE A
HIGHER LEVEL OF STANDARDIZED APPRAISAL
QUALITY FOR DETERMINING PENSION ASSET
VALUES AND INVESTMENT PERFORMANCE

A. Specification of assignment:

   1. Purposes of appraisal assignment

      a. Basis for investment share unit value
      b. Basis for evaluation management
      c. Basis for monitoring buy-sell transactions
      d. Inspection of property and independent review of leases

   2. Definition of real estate interest 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)

      a. Discussion of approach and its applicability

b. Selection of comparable property rules and full description of property and transaction including terms of sale must be included in report
c. Discussion of choice of units of comparison must be provided
d. Justification and explanation for each adjustment for comparability must be documented to be replicated by the reader
e. Value conclusions should be reported as a range to reflect potential error in available information or interpretation

2. Discounted cash flow using cash accounting before tax

a. Agreed format for cash flow pro forma (see note 1)*
b. Agreed format for capital outlays (see note 2)*
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 amoritzation and from increased resale price estimate (see note 3)*

3. Capitalized income approach

a. Actual NOI of last previous fiscal year
b. Cap rate from at least 3 comparables where actual NOI for fiscal year prior to purchase is known and sale price can be reliably adjusted to cash equivalency
c. Weighted average cap rate of 3 comparables can be used or capitalized value reported as a range
d. As an alternate to item c, a sensitivity analysis comparing present value without inflationary growth above current market and alternative yields given a reasonable range of resale prices based on capitalized income using alternative cap rates (see note 4)*
e. Key financial ratios including distributable cash as a percentage of original cash equity, and as a percentage of current net worth, expense ratio trends, vacancy trends and compunded annual growth rate implied by project resale price as compared to inflation rate, real rates of return, or other indices of investment performance to demonstrate reasonableness of discounted cash flow assumption (see note 5)*

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

* notes or procedural manual under development

EXHIBIT C (Continued)

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 report

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 interest

11. Need for relevant zoning ordinances, building codes or code violations or nonconforming 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 standrds 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

18. Format of future update appraisals to be anticipated by original report summary of salient facts

PRELIMINARY REPORT

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)

Chicago, Illinois

May 20 and 21, 1986

Prepared by Professors James A. Graaskamp and Robert Gibson

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

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RESPONSE TO PRELIMINARY REPORT BY PROFESSORS GRAASKAMP/GIBSON

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

COMMENTS BY J. B. FEATHERSTON, MAI, CRE

EXHIBIT II-1:

A.3. Several times in the document you recommend the unbundling of the components of value into such categories as:

(1) Cash flow from current leases
(2) Cash flow from renewals, inflation, etc.
(3) Equity buildup through loan amortization
(4) Distributable cash realizable from resale of asset

I believe the unbundling idea is good. I recommend that more precise language be employed in describing the components, particularly as to category (1). In this section it is called "distributable cash available from existing contracts and leases." In section G.3. it is called "cash flow." In the proposed engagement letter, on page 81, it is described differently and in more detail. Until I read the latter, I wasn't sure what you really meant.

On the other hand, is it really possible to fix the present value of the cash flow from current leases over the projection period? What assumptions does that call for on leases which expire prior to the end of the period? Wouldn't the client be served just as well by combining the first two categories into value attributable to the ever-changing income stream?

B. The division of investment real estate into three categories is interesting and can be useful. I think it could be emphasized that the dividing lines are somewhat arbitrary and each asset manager could set them where he or she chose. The important thing, in my judgment, is to insist on documented market analysis to support the rent-up projections of properties less than (say) 80% occupied.

C.1. I think the emphasis in the last sentence is upside down. Shouldn't it read,"Fund management must limit the deviation of in-house values from annual independent values..."? Obviously, if fund management limits the deviation of independent values from in-house, then the independent values are not independent.

C.2. How about requiring that at least one of the in-house committee MUST (not 'may') have appraisal backgrounds?

E.3. Again, make it emphatic: The appraisal MUST be signed by an individual, not by a corporate or association name.

E.4. Suggest specific guidelines be recommended to preserve inference of independence of appraiser. Examples: No more than 25% of portfolio to be assigned to same appraisal firm. No more than 10% of appraisal firm's gross income to consist of fees generated by one pension fund. Fees to be due and payable upon receipt of the report, not upon "review" or "acceptance." If review uncovers errors or deficiencies, the appraiser would not neglect corrections because he or she had been paid if additional assignments were expected.

E.5. How about minimum number of up-dates? After an asset manager has received the first appraisal assignment, he or she should not move to another appraiser until at least three updates have been received. In other words, the asset manager should not have the freedom to shop for another appraiser if the original appraiser cuts the value in an up-date. That is wasteful of the contract holder's money as well as a breach of the manager's fiduciary duty and of the appraiser's independence.

H.1. The idea of spot-checking appraisals is good, but how do we know the fund manager is qualified to review an appraisal? We might suggest that the fund manager may wish to contract with a separate real estate appraisal or consulting firm, or pension fund consultant with competent staff, to review on a random basis appraisals procured by the asset manager.

CHAPTER IV.

A. I like your phrase, "subtle distortion of the future by extrapolation of the past..." It reminds me of what a minister said during the Watergate hearings, concerning President Nixon's staff: "These young men who so casually dismantle the truth..."

B. In first sentence, I believe "direct capitalization with a single overall rate" would be more descriptive than "overall capitalization." In last sentence on page 13, suggest inserting "sometimes" before "based on an economic accrual method with reserves for replacement..." Not all of us use R/R with all direct capitalization problems.

Another key statement is found at top of p. 14, "The method of building a capitalization rate conceals implicit assumptions about a trend line of future property income." The Fisher formulation, for example (R=(1+d) x (1+r)), implicitly builds into the overall rate an assumption concering inflation. The model comes from the financial world where its aim was to account for the erosion of purchasing power in the currency. Applying it to real estate begs the question: "Does d represent the general rate of inflation, the rate at which NOI will increase, or the rate at which the property will appreciate?"

As you point out, appraisers may be very well informed in the field of valuation, but not well informed about the nuances of portfolio work. Perhaps the appraisal standards should point out that assumptions used in estimating net income for direct capitalization purposes should conform with the accounting method used by the fund manager. If overall rates taken from the market cannot be verified to be similarly based, they should not be used. Any bias built into the capitalization rate should be fully explained and related to the subject property.

D.4. I see the practicality of permitting the appraiser to accept abstracts of leases, engineering studies, and electronic data in preference to repeatedly and arduously re-creating the same information. Perhaps the standards should permit such practices if the asset manager guarantees the authenticity of the data, the adequacy of the abstracts, and the quality of the studies, specifically exempting the appraiser from any liability for basing his value on such criteria. The appraiser could then be held accountable only for gross negligence in not spotting obvious errors. The appraiser would also have the option of refusing the proferred material and conducting his or her own studies, subject to the client's willingness to pay the costs. In the alternative, the appraiser could decline the assignment.

I'm not sure how AIREA will view this kind of problem in the light of the high degree of accountability to which it presently holds its members. Also the FHLBB continues to hold the appraiser on the hook. Perhaps a way out would be to permit exceptions such as that suggested above, provided the appraiser believes that it is reasonable to accept such a waiver, provided reasonable persons would agree that it is reasonable, and provided the appraisal could not be used to mislead the public.

D.4. Shall the appraiser accept the development program put forward by the property manager and the asset manager? Here, I don't believe the appraiser should cop a plea in the manner suggested above. I believe the highest and best use analysis should thoroughly explore all reasonably possible and practical development programs and, by process of testing and elimination, affirm that the manager's program is as good as any or that it could be improved upon. The fund manager has a right to know that the asset manager's plans have been weighed in the balance by an independent expert and found prudent.

EXHIBIT IV-1.

This is an excellent allocation of responsibilities. It certainly dramatizes the complexity of the appraiser's assignment. One could pick at it, but I find little to quarrel about. As to logic of cap rate, it should be clear that the asset manager and CPA are involved only to the extent of insuring consistency, not in the selection of the rate.

EXHIBIT VII-1 (Letter of Engagement)

P. 78 - I'm glad to see the AIREA definition of market value specified. However, since AIREA has sponsored publication of numerous value definitions over the years, I believe the source document should be specified (8th Edition of The Appraisal of Real Estate, The Dictionary of Real Estate Appraisal, etc.) or the definition attached as an exhibit.

I always react negatively to the redundant "fair" before market value and note that it is omitted in two of three references on the page. Why not altogether?

I was puzzled at first by the dichotomy between market value as unencumbered and net investment value. I am not aware of any published definitions of net investment value except those which interpret investment value to be value to a specific purchaser. Isn't the distinction actually between market value as unencumbered, assuming a cash sale, versus market value as encumbered and/or enhanced by leases, financing, management contracts, etc.? Any interest in real estate has a market value (in theory, at least). The descriptive and restrictive phrases which make market value what it is should also apply to the valuation of the interest being appraised. Otherwise, it seems, we open the door to appraisers applying tortured or biased interpretations of what they think the value is, or ought, to be.

APPRAISAL METHODOLOGY:

Para. 1.- Cost Approach. Suggest that part d. be added, requiring any intangible value premiums or penalties (such as favorable financing or onerous leases) be combined into the final value conclusion, if the three approaches are to be comparable. If the cost approach is to be for insurance purposes only, this would not be necessary; in that case, the cost approach should be given no weight in the final (market) value estimate.

Para. 3 - Income Approach. Sub-paragraph d.4) is a little muddy. Apparently you are saying: Compute the present value of the equity in the normal way (present value of income stream and the reversion). Then recompute the present value of the reversion, substituting the present value of the equity for the calculated future value. Step #5, then, takes the difference between the present value of the two reversions for an unbundled calculation of the value added to the equity by appreciation. I hope that's correct...it took me about six readings to come to that conclusion. (You should take into consideration that I am not very bright when it comes to numbers.)

APPRAISAL BUSINESS ARRANGEMENTS:

Page 83 - Instead of a reference to "ethical standards" of an organization to be specified, I would suggest "Code of Ethics and Standards of Professional Practice." The former applies to questions of fundamental honesty and confidentiality, the latter to appropriate methods and criteria for adequate, supported appraising and reporting. Both apply. Of course, as an old AIREA warhorse, I hope most employers would specify, regardless of the appraiser's affiliation, the C/E and SPP of AIREA, adding "as supplemented from time to time by Guidenotes." As a neutral option, the employers could universally specify the SPP recently adopted and ratified by nine of the leading North American appraisal organizations. Regardless, the requirement could be added that the appraiser would conform with the C/E and SPP of the organization to which he or she belongs, so that there is certainty of accountability, insofar as that is possible.

Incidentally, footnote /8 is in error (substitute Institute for Society).

The Karsten Companies

1212I Wilshire Boulevard, Suite 900
Los Angeles, California 90025
(213) 826-0035

Herbert L. Roth, Executive Vice President & Legal Counsel

October 28, 1986

Mr. Robert Gibson
1012 Commodore Drive
Virginia, VA. 23454

Re: PREA Appraisal Study

Dear Mr. Gibson:

I am a member of PREA and I have the following comments on the Appraisal Study submitted at the recent PREA meeting in Washington:

1. Appraisals assume a willing buyer, but for some property types, such as raw land, there are few willing buyers. People who read and rely on appraisals frequently are not familiar with the difficulties and the long-time frame that may be required to market particular types of property and, accordingly, may be misled by the value conclusion. A $5 million office building that can be readily marketed in 3 months and a $5 million parcel of land that could be sold in 3 months, but may take as long as 3 years to market, are not truly of equal value. I think the appraisal of a difficult to market property should include a caveat near the value conclusion warning the reader that the number of potential buyers is small and the holding period for the property may be long without any assured offsetting increase in value over time.

2. I found the Appraisal Protocols Matrix difficult to follow. The graphic design of the Matrix should be improved to more readily enable the reader to determine the column and row where each "x" belongs. The meaning of some of the column headings was not clear. For example, I don't know what "Asset Management Standards" means. Are they written standards established by the owner's asset manager? Whatever they are should be clarified in a footnote or by some other means.

3. Most important, the appraiser must be clearly instructed to determine the value of the property based on an all cash sale. I think this should be required for all appraisals, not just pension fund appraisals. Appraisals all too frequently are based on unstated financing assumptions. A statement in the appraisal that the appraiser assumes that financing at market rates is

available hardly helps. Frequently the appraiser assumes, but doesn't say, that the seller will take back a mortgage for most of the purchase price at an interest rate lower than that obtainable from a third party, assuming that third party financing is obtainable at all. The appraiser, in my opinion, should assume a cash sale, even if sales are not typically for cash. If sales are not typically for cash the appraiser should state the typical sale terms and the amount by which the price will increase as a result of the financing.

To make it clear that a cash market value is called for a sentence should be added to the next to last paragraph on the first page of the Standard Letter of Engagement stating that the appraiser should assume an all cash sale of the property.

The last paragraph on the first page implies but does not say this. The portion of the last paragraph which mentions cash describes the property interests to be valued not the assumptions regarding the term of sale.

4. I don't understand how the enumeration of the purposes of the appraisal on the first page of the Standard Letter affect the appraisal. The purpose of the appraisal is to determine the market value of the property, using it to determine unit share value should be a simple mathematical process. How will the appraiser's work change as a result of knowing it will be used to determine unit share value? Will it change as a result of the appraiser knowing it will be used for the other enumerated purposes?

5. The Standard Letter could be written in plainer English . Although it addresses an appraisal professional the persons using the letter may not be appraisal professionals. The Standard Letter should enable them to understand in clear, simple terms, if possible, what to expect from the appraisal. For example, the last paragraph on the first pages deals in one sentence with two separate subjects: the property rights to be valued and the increases or decreases in value caused by such matters as assumable financing and existing leases. The two separate subjects should have been more clearly separated in the sentence, or two sentences should have been used. The phrase "adjusted for enhancement and encumbrances of other

legal interests" seems overly heavy to me. I think the same thought could have been expressed by simply referring to increases or decreases in value caused by assumable financing, existing leases and the like.

These comments aside, I thought the report was excellent. Congratulations to the Research Committee on their efforts.

Sincerely,

Herbert L. Roth

HLR:rs

Heitman Advisory

Richard S. Cohen, M.A.I.
Vice President

October 28, 1986

Dr. Robert Gibson
1012 Commodore Drive
Virginia Beach, Virginia

Dear Dr. Gibson:

We have reviewed, with great interest, the appraisal study prepared by Dr. James Graaskamp and yourself for the Pension Real Estate Association. We found it to be a well drafted document which highlights the necessity for standardized policies and procedures regarding appraisals of pension fund real estate assets. In particular, we found the prototype engagement letter to be an excellent example of an appraisal contract which will help to ensure that the appraisal product will follow certain minimum guidelines and will provide a measure of consistency in the appraisal process.

The need for a standardized appraisal policy statement which will provide industry wide consistency in terms of relevant definitions and procedures in appraisal administration and report content is critical. Your proposed policy statement provides an excellent framework from which to build such a standardized policy. The one component of the proposed policy statement with which we tend to disagree involves Section C, the definition of the frequency of appraisals by independent appraisers. We find the proposed frequency to be overly stringent when a qualified in-house appraisal staff exists. The independent appraisal frequency is particularly stringent when the in-house staff consists of professional appraisers who are members of and subscribe to the code of ethics and standards of professional practice of the leading appraisal organizations. Such appraisers, we feel, can provide accurate and unbiased valuation opinions which should reduce the required frequency of independent valuations.

We fully agree with the necessity for consistent industry wide standards regarding the valuation process. However, we feel that a qualified, in-house appraisal staff can provide objective valuations, thus reducing the required frequency for independent appraisals.

Sincerely,

Richard S. Cohen
Vice President

RSC/kd

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Suite 930
San Francisco, CA 94105
(415) 421-4000

November 4, 1986

Mr. Robert Gibson
1012 Commodore Drive
Virginia Beach, VA 23454

RE: PREA Appraisal Study

Dear Bob:

Here are some questions, criticisms and miscellaneous musing concerning your immensely valuable study for PREA.

1. What happened to part B of Chapter II? Was something missing from my copy?

2. Exhibit II-1, B, 2, a. Terrific idea. I would extend the list to include all lines of the cash flow with the exception of sporadic items such as leasing commissions and tenant improvement costs. The compound annual rate of change from year 1 to year 10 could dramatize wild or erroneous assumptions, e.g., net operating income growth rates of 8%/year.

3. Exhibit II-1, B, 2, b. I would compute these ratios yearly and would add the operating ratio. The operating ratio for particular property types tends to be a very stable statistic.

4. Exhibit II-1, B, 2, c. My problem with this item revolves around the proper method of computation of "potential rent." Is potential rent the month-to-month change in market rent? Year-to-year change? Rent held constant for typical lease term? With or without pass-through or other extra revenue provisions? In short, the problems are monumental and difficult to solve without the heavy hand of a dictator.

5. Exhibit II-1, B, 2, d. Sensitivity of what? Value, I presume. Would you vary each variable individually or just give optismistic, pessimistic, and likely case outcomes? The number of separate runs could range from 2 or 3 to 2 to the n^{th} power.

6. Exhibit II-1, B, 3. As you know, this is the subject about which I have the greatest reservations. You say "where appropriate" without providing any guidance. You say "to facilitate understanding" where there is no body of thought or method of practice or testable hypothesis upon which we can bounce our conclusions. I sense, perhaps somewhat erroneously here, that you have some preconceived notion about what relative quantities characterize sound or unsound investments. I cannot make statements of merit or demerit about these relative measures. This whole exercise seems more academic than practical, a problem in search of a solution, deceiving with statistics. I will have other thoughts on this subject later.

7. Exhibit II-1, C, 5. Many advisors have properties appraised as of the annual anniversary date of acquisition which invariably throws many (most) appraisals into the fourth quarter of the year.

8. Chapter III, D. While I generally agree with your ideas here, I would add the opportunity to alter the management plan where such alteration is clearly warranted. For example, the appraiser may note that some retail tenants are or will in the future pay more total rent than their sales can justify. Those tenants may fail prior to lease expiration. The flip side of the same problem relates to tenants which are clearly paying less than they are able or which are clearly underperforming. An intelligent manager would temper future revenue estimates in the first case and seek lease buyouts, replacement tenants or lease renegotiation in the second case.

9. Exhibit IV-1, 3. Cash accounting is extremely difficult to program for operating expense pass-thrus and percentage rents. In many instances, managers collect all or some amounts in advance and settle accounts later. In my experience, managers report extreme difficulty in collecting amounts due after a tenant has vacated so strict adherence to cash accounting may cause appraisers to have to make additional judgments about the probability of collection of items which do not have a significant impact upon the total value estimate.

10. Exhibit IV-1, 3. Somewhere in here I would add a requirement for explicit assumptions about costs of turnover including leasing commissions and tenant improvements.

11. Exhibit IV-1, 3. Where there is debt involved, the present value should be the cumulative present value of pre-tax cash flow (cash flow after debt service, commissions, tenant improvements and capital additions) and the reversion after repayment of mortgage debt and any other credits including costs of sale and credits for commissions and tenant improvements according to common practice plus the current debt balance.

12. Exhibit IV-1, 3. The reversion is generally calculated by capitalizing the NOI in the year following the sale. If it is done any other way, this should be made clear.

13. Exhibit IV-1, 3. If the appraiser utilizes any commercially-available analytical software (models), he should say which product was used and the current release number. If a spreadsheet or other customized model is used, it should be given to the advisor so that an audit can be conducted on the model's logic and accuracy. This is especially important for spreadsheet models which are notoriously weak and subject to erroneous formulas or cross-references.

14. Exhibit IV-1, 3, e. I have found that expressing the present value at various discount rates is a good test of sensitivity. In fact, my computer software, microREAM, has a PV matrix across both discount rate and holding period for NOI and PTCF.

15. Exhibit IV-1, 3, f. All present valuing must be at the same discount rate for each component or you invite chaos.

16. Exhibit IV-1, 3, f, 1 and 2. I would welcome an example of how you propose to calculate these items. It seems to me that you would have difficulty attributing specific expenses to specific tenants whether existing or prospective. Then what do you do with the expenses which are not attributable to any tenant or cannot be split? How about expenses when space is unoccupied? Would increases in revenue from speculative sources such as CPI clauses, percentage rents and operating expense pass-thrus be considered part of tenants under contract or thrown into a speculative basket? What about options? About the only approach I can think of would be universal adoption of Gordon Blackadar's "Dynamic Capitalization" model. Good luck trying to get appraisers to accept actuarial notation and reasoning.

17. Exhibit IV-1, 3, f, 4, a. This seems silly at best. If net rents have changed, values are sure to change so why compute this fictitious number.

18. Exhibit IV-1, 1, 4, a. As I said earlier, you might consider adding the operating ratio here.

Thanks for sticking with me this long. If there is any way that I can be of further assistance, please do not hesitate to call. I have a keen interest in this subject and hope that your efforts will add new rigor and discipline to the appraisal process.

Your report has prompted me to consider some changes in our software which we immodestly believe is already the best available for multi-tenanted commercial property appraisal by the income approach. In case you have not seen microREAM, I am enclosing a copy of the annual cash flow report for your information. (Please excuse the column misalignments. This is not a normal printout but a dump of an ASCII file.)

Sincerely,

Michael S. Young
Manager

MSY:cp

Enclosure

cc: James A. Graaskamp

PAGE 1: OPERATING STATEMENT

Annual Cash Flow Forecast

Port No: 025 Portfolio: SAMPLE PORTFOLIO Reporting Date: Oct 31 86
Prop No: 001 Property: LAKESIDE PLAZA Manager: M.S. YOUNG

Year ending	10/1987	10/1988	10/1989	10/1990	10/1991	10/1992	10/1993	10/1994	10/1995	10/1996
Revenue:										
Contract Rent	2247582	2438071	2569580	2578231	2495195	2775280	2916962	2872810	3052274	3165724
C.P.I. Adjustment	55849	101228	137225	193809	159619	141199	157969	133117	126647	187536
Percentage Rent	69816	99225	131351	165970	205706	254454	301048	376842	435552	495599
Expense Escalation	92501	95542	137823	215532	201214	184599	246708	257306	215585	329161
Common Area Maint.	4340	4340	4340	4340	4160	3620	3620	0	0	0
Porter's Wage	66551	74609	113999	164837	181684	183668	239321	70617	60241	121464
Real Estate Tax	3603	3586	4179	4978	5833	6748	7727	0	0	0
Parking	12772	13390	14060	14762	15501	16276	17089	17944	18841	19783
Other Income	28303	27256	24136	25551	26917	28183	29789	31576	33471	35479
Gross Revenue	2581317	2857246	3136693	3368011	3295828	3593947	3920234	3760212	3942611	4354746
Less: Vacancy	12907	14286	15683	16840	16479	17970	19601	18801	19713	21774
Effective Gross Rev.	2568410	2842959	3121009	3351171	3279349	3575977	3900633	3741411	3922898	4332972
Operating Expenses:										
Management Fee	82189	90975	99872	107237	104939	114431	124820	119725	125533	138655
Administrative	42131	44659	47339	50179	53190	56381	59764	63350	67151	71180
Payroll & Fringes	188320	201797	217623	235032	253835	274142	296073	319759	345340	372967
Utilities	197505	193482	210979	234297	264652	296411	331980	371817	414436	464408
Cleaning	32813	35004	37455	40077	42882	45884	49095	52532	56209	60144
Common Area Maint.	118243	126332	135176	144638	154763	165596	177188	189591	202862	217063
Repairs & Maint.	98438	105013	112364	120230	128646	137651	147286	157596	168628	180432
Real Estate Tax	247104	246724	260231	278447	297938	318794	341110	364987	390536	417874
Insurance	40541	43988	48162	52978	58276	64104	70514	77566	85322	93854
Other Expenses	5000	5000	5000	5000	5000	5000	5000	5000	5000	5000
Total Oper Expense	1052283	1092895	1174200	1270115	1364121	1478393	1602831	1721924	1863017	2023577
Net Operating Income:	1516127	1750065	1946809	2081056	1915228	2097584	2297802	2019487	2059880	2309395
Debt Service:										
Mtg. Amortization	159670	174865	191506	209731	229670	251548	275487	301703	330415	5353390
Mtg. Interest	675800	660605	643964	625739	605780	583922	559983	533767	505055	319414
Participation	76302	84539	92880	99785	97630	106529	116269	111492	116937	0
Ground Rent	42000	42000	42000	42000	42000	42000	42000	42000	42000	42000
Total Debt Service	953772	962009	970350	977255	975100	983999	993739	988962	994407	5714803
Leasing Commissions:	27083	37607	47521	47676	45994	51563	54361	52356	55909	58537
Tenant Improvements:	262560	112478	114719	61252	482006	175207	30015	160899	499167	74641
Capital Additions:	0	100000	0	0	0	0	0	0	0	0
Pre-Tax Cash Flow:	272713	537971	814219	994872	412128	886815	1219688	817270	510397	-3538587
Operating Ratio:	40.97%	38.44%	37.62%	37.90%	41.60%	41.34%	41.09%	46.02%	47.49%	46.70%
Breakeven Ratio:	89.38%	81.08%	73.91%	70.31%	87.43%	75.20%	68.73%	78.16%	86.99%	181.67%
Debt Service Coverage:	1.815	2.095	2.330	2.491	2.292	2.511	2.750	2.417	2.466	0.407

PAGE 2: CALCULATIONS OF PRESENT VALUE

Port No: 025 Portfolio: SAMPLE PORTFOLIO Reporting Date: Oct 31 8

Prop No: 001 Property: LAKESIDE PLAZA

NOI Cap Rates: Curr 7.500% Futr 9.000%

Discount Rates: NOI 14.000% PTCF 12.000%

Year ending		10/1987	10/1988	10/1989	10/1990	10/1991	10/1992	10/1993	10/1994	10/1995	10/199
Present Value Calculations											
Yearly Present Value:											
Net Operating Income		1329936	1346618	1314040	1232151	994709	955631	910287	707949	633429	62294
Total in 11/1986	10055699										
Reversion at yr end	19696815	18873054	17377190	13775056	12994792	12261386	9282075	8154981	7875103	7102356	
Cap rate at yr end		7.638%	7.779%	7.922%	8.067%	8.216%	8.367%	8.521%	8.678%	8.837%	9.000%
Pre-Tax Cash Flow		243493	428867	579544	632259	233852	449288	551724	338081	184054	-113933
Total in 11/1986	2493836										
Reversion at yr end	13514317	13858380	13376564	10500848	10501834	10463155	7798835	7099857	7304531	8477557	
Cumulative Present Value:											
N.O.I. & Reversion		21026751	21549608	21367785	18997802	19212248	19434474	17373450	16954306	17307857	1715805
Pre-Tax & Reversion		13757810	14530740	14628469	12385013	12619851	13030460	10917865	10548969	10937697	1097139

Cumulative Present Values @ Various Discount Rates for 10 Holding Periods

	10/1987	10/1988	10/1989	10/1990	10/1991	10/1992	10/1993	10/1994	10/1995	10/199
Net Operating Income & Reversion:										
10%	21791360	23095228	23629952	21599351	22433569	23273842	21179798	21055429	21937655	2211848
12%	21402229	22301936	22459360	20242733	20741051	21241698	19152311	18857024	19439404	1942550
14%	21026751	21549608	21367785	18997802	19212248	19434474	17373450	16954306	17307857	1715805
16%	20664221	20835459	20348605	17853516	17828561	17823378	15808140	15381746	15481731	1523973
18%	20313980	20156935	19395856	16800093	16573791	16383746	14426809	13861559	13910983	1360915
20%	19975413	19511693	18504156	15828852	15433792	15094393	13204441	12602271	12554587	1221673
Pre-Tax Cash Flow & Reversion:										
10%	14007952	15059427	15423800	13269399	13731569	14398002	12213372	11948135	12554405	1275094
12%	13757810	14530740	14628469	12385013	12619851	13030460	10917865	10548969	10937697	1097139
14%	13516445	14029559	13887560	11574985	11618219	11818820	9787335	9346265	9569637	948858
16%	13283403	13554005	13196482	10831657	10714025	10742820	8798042	8309885	8407644	824769
18%	13058260	13102358	12551100	10148706	9896261	9785132	7930017	7411823	7417061	720484
20%	12840623	12673040	11947684	9520230	9155325	8930892	7166407	6633214	6569579	632476

Each year's reversion is the result of capitalizing the following year's N.O.I.

PAGE 3: RESTATEMENT OF ASSUMPTIONS

Port No: 025 *Portfolio* SAMPLE PORTFOLIO Reporting Date: Oct 31 86
Prop No: 001 Property: LAKESIDE PLAZA

Statement of Assumptions and User Inputs

Use Global Assumpt No
Use Zone Rents No

NOI Cap Rates: Curr 7.500 % Futr 9.000 %
Discount Rates: NOI 14.000 % PTCF 12.000 %

Annual Market Rents	$/sf	Management Fee Computation Method	Eff Gross
Annual Increase	3.0 %		
Future Terms	years	Lease Commissions	2.00 %
Months Vacant	2 months	Frequency	Annually
Escalation Code			
C.P.I.		Tenant Improvements	4.00 $/sf
		Annual Growth Rate	7.0 %
Annual Retail Sales	$/sf	Frequency	One-time
Annual Growth Rate	%		
Annual C.P.I.	3.0 %		
Vacancy & Losses	0.5 %		
Annual Incr in Other Revenue	%		
Annual Incr in Operating Exp	%		

Capital Additions:

year 1	0	year 6	0
year 2	100000	year 7	0
year 3	0	year 8	0
year 4	0	year 9	0
year 5	0	year 10	0

Reversion, Sales Cost & Mortgage Balance

	Adjusted Reversion	Sales Cost	Mortgage Balance
Year 1	22912621	458252	7318334
Year 2	25027980	500559	7143468
Year 3	26270481	525409	6951962
Year 4	23740327	474806	6742232
Year 5	25530981	510619	6512542
Year 6	27462661	549253	6260994
Year 7	23700252	474005	5985507
Year 8	23737540	474750	5683804
Year 9	26132072	522641	5353389
Year 10	26867353	537347	0

Sales Cost @ 2.00%
Adjustments: Lease Comm -- No
Tenant Impr -- No
Capital Add -- No

Summary of Year Ending 10/1997

Effective Gross Revenue	4611293
Total Operating Expenses	2193231

Net Operating Income	2418061
Total Debt Service	42000
Leasing Commissions	58384
Tenant Improvements	39343
Capital Additions	0

Pre-Tax Cash Flow	2278334

Custom Escalation Codes

Operating Expenses:	R	S	T	U	V	W	X	Y	Z
Management Fee	*								
Administrative		*	*						
Payroll & Fringes		*	*						
Utilities									
Cleaning			*						
Common Area Maint.	*								
Repairs & Maint.									
Real Estate Tax		*							
Insurance		*							
Other Expenses									

Report cites appraisal flaws

By Steve Hemmerick

BOSTON — The appraised value of properties could be significantly under- or overpriced in some small commingled real estate funds, which are becoming increasingly popular with pension plan executives.

According to a recent study, real estate appraisals generally are inconsistent and frequently don't provide necessary information, resulting in the incorrect valuations.

The 18-month study was led by James A. Graaskamp, chairman of the Department of Real Estate and Urban Land Economics at the University of Wisconsin-Madison and a member of the Salomon Brothers Inc. Real Estate Advisory Board. It was underwritten by the Pension Real Estate Association, an organization of real estate managers, and the Homer Hoyt Institute, a non-profit organization devoted to real estate research.

Mr. Graaskamp didn't say how far off appraisals could be in valuing properties, but he did say failing grades were given to most of the more than 50 appraisals that were studied.

The findings come at a time when plan executives increasingly are selecting smaller, specialized real estate funds to boost their returns and also are questioning the reliability of appraisals.

Mr. Graaskamp pointed out the appraisals' lack of needed information should make it difficult to determine the skills of real estate asset managers in adding value to a portfolio. It also makes it difficult, if not impossible, he said, to make performance comparisons of real estate managers.

In his study, Mr. Graaskamp said part of the blame for the situation rests with plan executives who don't know what to ask for when seeking an appraisal.

That view might shock some executives, but not Wm. Irwin Arbuckle II, vice president and treasurer for The Board of Pensions of the Presbyterian Church (U.S.A.).

"If the appraisals are inconsistent, it's because the plan sponsors haven't known enough to draw appraisal specifications," said Mr. Arbuckle.

Letting appraisers pick their own specifications frequently won't do the job, he said. In getting the right type of appraisal, "I should tell him the purpose of the appraisal; I should tell him the information I need," and so on, said Mr. Arbuckle, who as a certified review appraiser can examine appraisals to determine their aptness.

The Presbyterian board, which oversees $1.75 billion in assets, does get adequate appraisals from its real estate adviser, CIGNA Asset Advisers Inc., Hartford, Conn., said Mr. Arbuckle, "because I specify what I want."

Even when it is the money manager — and not the pension executive — asking for the specifications, pension officials should be asking to see the money manager's appraisal policy and standard letter of contract with the appraiser.

If an executive can't or doesn't want to get the basics on real estate, then, Mr. Arbuckle suggested, "He shouldn't be in real estate."

In any case, Mr. Arbuckle said an appraisal is really an opinion, and the property owner will never be sure of the value until the property is sold, probably after a long holding period.

Yet, appraisals are a crucial component of the real estate investment process because they help determine the value shifts in properties, especially in commingled funds. And in most commingled funds, the value of the properties determines the fees paid to the investment managers.

Also, the appraisals help set the unit values of commingled funds and determine an investor's share of ownership in an open-end commingled fund and the money to be received should the investor pull out of that fund.

Because the appraisals are used to determine the value of properties in open- and closed-end funds, the plan executive is, in part, determining the value of the pension fund's portfolio and its total return based on appraisals.

The appraisals are more of a problem for small funds, which might have only 10 or 20 properties, Mr. Graaskamp said, because in large commingled funds, the mistaken appraisals tend to cancel each other.

In fact, he said, another study of property sales in the aggregate showed real estate properties tend to be slightly undervalued. However, he noted that because of this undervaluation of large funds, investors that withdraw from those

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funds early may be getting less value than they would if they waited.

In a very small sample, however, there could be a bias in one direction or the other, he said. He did not cite any specific instances of small funds that experienced significant over- or undervaluation.

Generally, on a quarterly basis, real estate managers send plan executives return on investment reports stating the return from the property in terms of income and appreciation.

Not only can the appraisal valuations be of lower quality than they should be in Mr. Graaskamp's view, but frequently the appraisals don't alert the investor to serious financial risks, or risks in assumptions used in the appraisal that the investors could be facing, he said in remarks delivered at the fifth annual PREA conference in Boston last month.

In underscoring the importance of appraisals, Mr. Graaskamp said, "Most of the losses of real estate may be attributed to failure to have acquired data that could have been available had one been willing to invest in data collection of properties."

According to Mr. Graaskamp, a good appraisal should state the purpose, for example, whether it is an appraisal to measure shifts in value or for a tax assessment.

It should be specific on what is to be appraised, provide a procedure for exchanging information with other professionals, define a minimum methodology for the appraiser, such as in the establishment of market comparisons, and set the fee and other business arrangements.

Specificity is important, he said, such as in establishing a market comparison or defining what market a building is in. That is helpful in determining a number of factors, including how quickly space is being filled and what buildings are selling for in a particular market.

But, he said, some appraisers are basing assumptions on a market as wide as a major city's entire downtown area, while in fact, he said, there might be three distinct downtown markets.

In helping to establish the value of a building, appraisers also include information on transactions for similar buildings within the market area. But it is increasingly important to provide specific details on any transaction used in a comparison, he said, because many of today's transactions are "engineered" or include conditions that affect the price but are unknown to those not involved in the transaction.

Some of Mr. Graaskamp's remarks were challenged at a panel discussion during the conference. Charles B. Akerson, chief appraiser for Laventhol & Horwath, Boston, said, "The notion nothing has been done (to improve appraisals) along these lines is unfair and incorrect." He said the National Council of Real Estate Investment Fiduciaries, Washington, is holding seminars in several major cities on the subject of appraisals for pension portfolios.

In addition, he said, NCREIF has prepared guidelines for the preparation of an appraisal engagement letter.

Another panelist, Norman J. Cardinali, a vice president with the portfolio management unit of The Prudential Realty Group, Newark, N.J., and valuation manager for the group's seven managed accounts with nearly $6 billion in assets, supported many of Mr. Graaskamp's suggestions, but said many of the faults found in the appraisal process were not true of Prudential Realty.

In the study, 39 original appraisals and 17 second-year update appraisals were collected from asset managers and graded in 12 areas, such as quality of regional analysis, quality of market approach to value, how they derive the discount rate on income and supply and demand analysis.

The average score for the appraisals was 58%, the highest was 89% and the lowest, 31%.

> *"Most of the losses of real estate may be attributed to failure to have acquired data that could have been available."*
>
> — James A. Graaskamp, chairman, real estate department, University of Wisconsin

Among other findings:

- In the standard appraisal contract, there is generally no statement of what the appraisal product should be like, but there are copious instructions on obligations of payment to the appraiser.
- There are several different kinds of appraisals, but clients most often don't tell the appraiser what kind is wanted. Consequently, the definition and value of the assets can change, depending on what is included in the appraisal.
- Money managers have independent appraisals done on properties, in addition to the usually more frequent in-house appraisals, but frequently reserve the right to veto the independent appraiser's conclusion.
- Appraisals frequently don't explain that conclusions reached are predicated on key assumptions that could change significantly.
- Building owners or managers sometimes don't tell appraisers about investigations they have made on properties, sometimes concerning such important topics as toxic pollutants or asbestos, on the grounds they don't want to bias the appraisal. ▪