RE26C20 - The Commercial Appraisal Process for Non-Appraisers

Added June 2020

1. **What is the Objective of an Appraisal?**
    a. Understanding the process of a commercial appraisal and appraisal report for financing, establishing current market value and other purposes
    b. Impacts lending and transaction negotiations
    c. Price is not value and value is not necessarily the price
    d. There are many objectives to an appraisal determined by the client (probate, divorce, sale of property, refinancing, tax abatement, insurance, etc.)
    e. Each objective can employ a different appraisal method. There are many methods and over 30 types of value
    f. Not all commercial appraisals are about determining current market value

2. **What is an appraisal? Court definitions and Appraisal Institute definitions**
    a. Appraisal is the act or process of estimating value
    b. One person's opinion is based on research in the appropriate market and applying appropriate analytical techniques
    c. An appraisal can contain descriptions of any positive and negative influence affecting the value of the real property. Any appraiser on any given day can reach a different conclusion: Part art and part science.
    d. There are global appraisal standard differences and standardization through Royal Institute of Chartered Surveyors (RICS). Associations outside of U.S. include: Union of Pan American Valuation's Association (UPAV) and RICS.
    e. A BOV (broker opinion of value) or BPO (Broker Price Opinion) is NOT an appraisal but often confusing to clients
    f. A real estate agent cannot mislead a client that a BOV is an appraisal

    g. **Definition:** An appraisal is an unbiased estimate of the nature, quality, value or utility of an interest in, or aspect of, identified real estate.
    h. Appraisal is a valuation and an evaluation.
    i. **Definition** Valuation is the process of estimating market value, investment value, insurable value, or other property defined value of an identified interest in a specific parcel at a given date.
    j. **Definition:** Evaluation is a study of the nature, quality, or utility of a parcel of real estate without reference to a value estimate
3. **Appraisal License Process**
    - **The different levels and requirements of a licensed appraiser and recommending the appropriate level to your client:**
        a. Licensed trainee
        b. Licensed appraiser
        c. Certified Residential
        d. Certified General
        e. Is there a Commercial Appraisal License?
        f. Trade designations: MAI (Member, Appraisal Institute), RICS (Royal Institute of Chartered Surveyors)
4. **What are the federal regulations for an appraisal? How is an appraisal different from a broker's CMA?**
    a. Comparative Market Analysis (CMA) are now being regulated in some states: it is not a valuation but a "suggested listing price" so that the client understands the differences.
    b. Uniform Standards of Professional Appraisal Practices (USPAP). What is it and how does it regulate appraisal reports?

c. Background on the Appraisal Foundation, the Appraisal Standards Board and why it was formed. Review of 1989 Savings and Loan Crisis and FIRREA (Financial Institution's Reform, Recovery and Enforcement Act)
d. Summary discussion about the Federal Yellowbook

5. THE APPRAISAL PROCESS

- **Definition:**
- Definition of Market Value: most probable price in a competitive and open market

a. Buyer and Seller are typically motivated, well-informed or well-advised, property has reasonable exposure to the market, parties are unaffected by special or creative financing and its arms-length transaction.
b. Fair Market Value: What is "fair"? How does "fair" differ from "current market value?"
c. It's an estimated value at "this point in time." The value can change the next day.
d. Law of Supply & Demand is the basis for the 3 appraisal approaches.

6. THE LAW OF SUPPLY AND DEMAND

a. Assumes that the market is "perfect"
b. Assumes perfect knowledge of the product
c. Assumes An Active market with no monopolies of buyers/sellers or large enough to affect prices
d. Assumes homogeneous product: that all comparables are the same
e. Assumes all cash transactions, no financing
f. Assumes Easy Entry into the Market by All Interested Buyers
g. How is the market performing in your area? How does the market impact values?
h. Supply and demand impacts value

7. APPRAISAL INSTITUTE'S DEFINITION OF APPRAISAL PROCESS STEPS

a. Concepts of Land
   i. Geographic
   ii. Legal
   iii. Social
   iv. Economic
b. Appraisal
   i. Discipline of Appraisal
   ii. Real Estate, Real Property and Personal Property
   iii. Definition of Appraisal
c. Valuation Process
   . Definition of the Problem
   i. There are over 32 types of value and a number of methodologies. Each value dictates a different appraisal methodology and approach.
   ii. Preliminary Analysis and Data Selection and Collection
      - General
      - Specific
   iii. **Highest and Best Use Analysis**: How is this analysis to the foundation of valuation? What is legally permitted?
   iv. Land Value Estimate
   v. Application of the 3 Approaches
      - Sales
      - Income
      - Cost
   vi. Reconciliation of Value Indications and Final Value Cost
   vii. Report of Defined Value

viii. Review any updates necessary due to new Federal, USPAP or Congressional changes

8. There are 3 Approaches in Basic Appraisal Theory

A. SALES MARKET APPROACH

- **Definition:** Price that equates the supply of real estate to the demand for real estate

- Comps to be used should be closer to the subject commercial property; comps up to 12 months and required adjustments for location, market and physical characteristics

. **Close Comps**: Want within one mile of subject property. **Current:** Sold within the past 3 months. **Clone:** Similar Features

a. How does an appraiser find commercial market information? Discussion
b. Discuss how a commercial broker can help an appraiser with data and market information.
c. Appraiser should be researching the market through discussions with market area commercial brokers.
d. When comps are difficult to find: **Dissimilar**: Do not share the same dominant features**. Dated**: Up to 12 months. **Distance**: Competing markets to the subject commercial property.
e. Then the appraiser makes adjustments by using: Matched Pairs or Bracketing
f. **Match Paring**: Determining a value for a specific feature by comparing two properties that are alike in all features except for the feature in question. No "set" adjustment for a feature, you have to know and read your market. Even in the same market, adjustments change.
g. **Bracketing**: A technique of selecting some comparables that are slightly superior to the building and others that are slightly inferior regarding significant characteristics. Bracketing every minor characteristic of a building is virtually impossible.
h. This approach is most applicable for owner-occupied commercial properties selling to owner-occupied end-users

B. INCOME APPROACH

a) **Definition:** Price that equates the supply of income streams to the demand for income streams
b) This approach works better for investment property rather than owner-occupied
c) Calculate net income
d) Impose any variations in operating expenses with vacancy rate and reserves
e) Impose a capitalization rate
f) Determines potential value to investor
g) Research information from sales comparables, talking to investors, researching alternative investments, talking to investment brokers, etc.
h) This approach is most applicable for commercial and investment properties

C. COST APPROACH

a) **Definition:** Price that equates the supply of material and labor to the demand for material and labor
b) Strictly "bricks and mortar" approach
c) Cost to rebuild the same structure on the same site
d) Estimates from commercial brokers, construction firms, architects, trade journals

9. INDUSTRY STANDARDS FOR REPORTING

- The Appraisal Institute sets minimum requirements for its own members on content, facts, descriptions and statements of work and purpose in all types of appraisal reports.

- **The report should include the following:**

a) Complete description of the appraised real estate.
b) Who is the Intended User, Purpose and Distribution? Scope of Work
c) Explanation of assumptions, limitations and disclaimers.
d) Competency of Appraiser for the assignment. How can an out-of-state appraiser be engaged? What is the definition of competent and how does the appraiser disclose competency?

e) All significant facts used.
f) Reasonable complete summary
g) Statement of the Interest Appraised.
h) Disclaimer Statements and why they are important to the reader and appraiser
i) Clear Statement of any smaller parcels of larger parcels.
j) That the appraiser has no interest or personal bias to the parties involved.
k) Certified statement that the appraiser did or did not inspect the property and the facts reported are true.
l) Statement of report distribution and intended use.
m) Date of valuation and report

10. REPORT WRITING in GENERAL

a) Function of a report is to lead a reader from the definition of an appraisal problem to a specific conclusion through reasoning and relevant descriptive data.
b) Appraiser's facts, reasoning, and conclusions must be presented clearly and succinctly.
c) Length of report is not as relevant
d) Can be oral or written but usually decided by client
e) If oral, still must have detailed documentation.
f) Must be meaningful to a client and not misleading in the market.

11. FINDING IMPORTANT INFORMATION IN AN APPRAISAL

a) Read the beginning pages defining the client. What is the purpose of the report and objectives?
b) Is the subject commercial property on the market for sale or contemplated to be on the market?
c) Read the commercial neighborhood description
d) What are the sample commercial market conditions at the time of the appraisal?
e) What is the zoning, utilities, lot size and external issues?
f) Read the improvement section for physical deficiencies and conformity
g) Read the Disclaimers, Hypothetical and General Assumptions
h) Read the appraiser's noted process, market area reviewed and comps
i) Read the adjustments and reconciliation
j) What is the date of the appraisal, not the appraisal report?

12. **RED FLAGS IN COMMERCIAL APPRAISALS**

a) Above predominant value for commercial neighborhood?
b) What is the zoning? Commercial I, II, Industrial, Residential, Mixed-Use, Gen. Business?
c) Comps outside the commercial market area?
d) Dated sales?
e) Across the board adjustments?
f) Many adjustments to comps?
g) Condition?
h) Large Lot Size? Public or private utilities?
i) Dissimilar comps (Year built, design, size)?
j) Need to check prior sale date and price
k) Comps adjusted in one direction (adjusted/unadjusted range)?
l) An appraiser that did a "drive-by" or "desktop" appraisal. It is allowed but appraiser is required to disclose, and the client would need to be notified and understand that the value could change with an actual inspection.

13. **Example of Commercial Appraisal Report. Use examples of commercial real estate valuation throughout the module**