Working the Appraisal

-and Playing the Numbers

Submitted by Ann Scott, April 4, 2016

If loan underwriting and cash flow analysis are the main course of a loan, appraisals are typically considered a part of the appetizer. Actually, they're the burgundy to the beef, the Alfredo to the fettucine, the mint to the julep.

It's up to the appraisal reviewer to take a close look at the numbers. Do the rents used by the appraiser match the most recent Tax Return or FYE numbers? What about the expenses? Did the appraiser use a "market percentage" or the actual expenses indicated by the financial information?

And what about all of those numbers? One expert appraiser estimates that over 50% of all appraisals have mathematical errors. Most of those will be minor, but some will be critical. Given that, the reviewer needs to review not only the narrative, but examine and test numbers contained within the appraisal. Checklists are not sufficient.

Given the volume of information contained within an appraisal, errors are not surprising. In one income producing property with a wide variety of retail and medical tenants, a $3 million error was made due to an over estimation of expenses. The appraiser "assumed" all of the leases had identical expense terms after reading a couple of the leases where all expenses were paid by the landlord. As it turned out, only a few "minor" tenants did not pay expenses. The other leases were all NNN and those leases represented nearly 80% of the total square footage. The error resulted in a 30% markdown of the property. The reviewer read all of the leases, found the error, and the appraisal was corrected.

The appraiser preparing the report should read and examine all leases and lease terms and compare those to market. If the appraisal indicates income or expenses that differ from the actual numbers in tax returns or financials, a complete explanation should be part of the appraisal. If rents are indicated as higher than actual, it should not be based on what rents the appraiser *thinks* the property should achieve. If there is a new lease pending to replace a current tenant and the new lease is above the current lease, then that is reasonable and the information should be placed in the appraisal. If the leases in place are nearing maturity and will soon be available for negotiation AND the local economy is heating up that, too, is reasonable and should be described within the appraisal.

If the property has had a 15% vacancy the past three years, but the appraiser indicates the market shows a 3% vacancy and collection rate, there should be a complete, reasonable, and logical explanation. If a new and aggressive management company has been hired and there is demand within the area that should be explained. (Then the management fee expense should also be examined for any change.) Or if nearby residential growth creates an increase in demand for retail space that would be logical and should also be stated within the appraisal.

If the appraiser indicates market percentage operating expenses are 30%, but the subject property consistently runs 35% to 45% of the income, the appraiser should describe the reasoning behind the lower operating expense estimated. It may be there is ongoing maintenance that the appraiser did not account for or the client is reporting expenses in that tax return that may not relate to the subject property.

Another problem that can occur is treatment of Common Area Maintenance Expense or CAM. The appraisal reviewer needs to review the leases and understand the lease per SF and the CAM per SF. If the CAM is included in the lease amount, then the income should reflect this and the full expense amount should be deducted.

What can happen in these situations is that an appraiser and/or a reviewer knows there is a lease and a CAM but fails to understand that the CAM is included in the lease. The appraisal will show the gross rent amount but not indicate expenses and the NOI will be overstated, resulting an over valuation of collateral.

Different income producing properties have different issues. Multi-family properties may have more turnover or collection problems. Sometimes, the problem is the owners and the information provided.

There's the story of the two partners, one old and one young, who owned a multi-family income producing property together. The young partner was managing the property and the old partner wanted to sell out and retire to a warmer clime. Based upon the tax return and the cash flow it evidenced, they had agreed upon a sale price for the young partner to buy out the old partner. The young partner went to the lender with the older partner. They provided the tax returns to demonstrate the property's performance. And the younger partner told the lender he would provide the same to the appraiser. Being multi-family, no leases were required, and the rent roll that was provided indicated a higher cash flow. The young partner explained the vacancy issue was recently corrected. And he was the borrower, so only one extra copy of the appraisal would be needed for him.

Fast forward to the appraisal review. The appraisal report is received and the review begins. In the income approach, the reviewer took out the borrower supplied tax returns and noted that appraisal rents are nearly 15% HIGHER than the tax return indicated for the same timeframe and 10% higher than indicated by the rent roll. The reviewer also noted that the appraiser states that the owners provided INHOUSE income statements. A call to the appraiser confirmed that the young partner brought inhouse statements to the appraiser. No tax returns were provided to the appraiser. The reviewer alerted the loan officer. The loan officer called the young partner who initiated the loan request to inquire as to the difference in rents. The response was mostly stammering. The loan request was denied. The two most likely explanations were not good; one being the younger partner was defrauding the older partner or they were both defrauding the IRS. Either avenue opened up the lender to potential litigation.

The appraisal review is critical in the loan process. The numbers should be reviewed. Income and expense differential from the actual should be carefully examined. The appraisal should explain why the numbers used were selected, especially if those numbers vary from a property's performance. The more "blue sky" in the numbers, the higher the lender's risk.

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