



Principles one should follow prior to preparing an appraisal or consulting report

By Don B. Swenson

Introduction

There is much controversy today about the usefulness and relevance of many appraisal reports prepared for clients in the marketplace. Personally, I have reviewed hundreds of reports over the past 30 years, primarily for mortgage loan purposes. What I have discovered is that most appraisals are prepared without much thought given to the decision-making issues that underlie the reasons for requesting the report in the first place. Why is it that so many reports turn out to be confusing and not very meaningful for the end user (client) of the report? Why are appraisers constantly under pressure to comply with governmental and institutional standards when writing their reports, i.e., USPAP, FNMA, etc.

I would like to propose that most writers and users of appraisal and valuation reports are not conditioned and educated to ask the most fundamental questions that would allow each party to understand the issues and decisions at hand. In other words, communication about the nature of the problem and the reasons for needing a report are usually not given sufficient focus. Following are the eight fundamental questions that usually are not explored consistently or thoroughly prior to writing an appraisal/valuation or consulting report.

1. What is the real problem(s) at hand?
 - (a) Why is a report needed? And what type of report options are applicable?
 - (b) What decisions must be made that require the expertise of an appraiser/consultant?

Whose perspective or viewpoint should be considered? The end user (client) has specific reasons for requesting the appraisal/consulting report in the first place.

A meaningful report will focus on the specific decisions and questions that the end user (client) must consider and contemplate prior to writing a report.

2. Given the above, what judgments seem to be appropriate to resolve the problem(s) at hand?
3. Is the resulting premise and scope of work realistic and applicable for this particular problem?
4. What meaningful assumptions should be adopted for this problem, considering the decisions that must be made?
5. What derivation process and/or methodology should be applied for this problem?
6. What are the conclusions that result from this process?
7. Are the conclusions meaningful? If not, what alternative assumptions and choices could be suggested.

Comments: It is this writer's philosophy that all appraisal and consulting reports need to focus on the specific decisions and core issues that underlie the need for a report in the first place. Many appraisers and also some consultants assume that the problem at hand is preparing a report which focuses on market value or some aspect of market value. And this may be valid in some situations, but in the vast majority of situations where financing is involved and where the end user is the lender, the real problem is not market value. The real problem is concerned with the issues of underwriting a prudent loan for a specific property. So to understand the relevance of the above questions as they apply to a particular problem, let's assume an example and then apply the above questions to this example.

Example: Let's assume that I represent a large financial institution and that I am employed as the CEO of the mortgage loan department. My responsibility is to underwrite prudent loans for my institution on large and complex income producing properties. To make decisions effectively in this position, I need current appraisals and/or appraisal consulting reports on the specific properties that I am reviewing and for which a loan is the objective. With this example in mind, let's now proceed with the above questions and consider the various implications.



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1. What is the problem at hand? Why is an appraisal or appraisal consulting report needed? And what decisions must be made that an appraiser or appraisal consultant can assist with resolving?

Comment: I would propose that a key reason for needing input from an expert and knowledgeable appraiser is because I have many issues to understand and focus upon prior to making my final decision about the nature and size of the loan to recommend to my Board. The most important and central issue has to do with the ability of the property under review to generate sufficient income to repay the annual debt service on the proposed loan. As a prudent lender, I desire to make loans, which avoid foreclosure and legal entrapments during the loan period.

Other important issues are:

- (1) the quality and growth of the net operating income (for the subject property) for the near term and the immediate future
- (2) the inherent risk of the annual income stream for this property (this risk will determine the degree of debt coverage required for this property) and
- (3) the quality of the real estate assets and the positive and negative location factors. This item is important primarily if difficulties arise in the future with respect to repayment of the loan.

I might also comment that lenders who only focus on the issue of current market value for a property are missing the essential reason for making prudent loans. The issue is not what the property might sell for today (date of appraisal), but rather how do I assure that my loan will be repaid without any interruption or future legal problems during the term of the loan. The issue of market value usually presupposes a legal and current transfer of ownership. A lender, however, is making a loan that will encumber the existing real estate. A transfer of ownership is not generally involved.

A better option would be to focus on the primary issue of a prudent debt coverage ratio and then create a value after this component is satisfied. If a value component is needed, I would suggest that any value conclusion derived from this process be called investment value, not market value. Once again, as a lender, I do not want to assume an immediate foreclosure of the property. Also, by eliminating the idea of deriving a market value number as the main issue, both appraiser and lender can communicate more clearly and precisely about the essential decisions that are involved in this problem situation, e.g., how to determine the maximum supportable loan for the near and longer term.

2. Whose perspective or viewpoint should be the main focus during the data gathering process?

Comment: I would suggest that reports written for lenders with the purpose of securing a maximum loan, be viewed from the lender's perspective. Most appraisals today do not focus on this important issue. Rather, they are written from the perspective of a hypothetical seller/buyer under the misleading premise of a market value definition, which assumes a transfer of ownership as its core item in the definition.

It was this premise (in my view) that led to the 1980's Savings and Loan crisis and the later restructuring of all appraisal standards (USPAP). The idea of incorporating the appraiser into the decision-making issues of the lender/underwriter was rejected by the authorities and educators after this crisis period. Did we accomplish any meaningful reform after this serious crisis? Why didn't we focus on making the appraisal/consulting profession a problem solving profession with a focus on decision-making issues?

Again, in my view, the appraisal and real estate consulting professions may yet be entrapped with many of the same core problems that led to the 1980's crisis. Could a repeat crisis be looming on the horizon? Time will enlighten us all. You can be the judge!

3. What judgments seem appropriate to resolve the problem at hand?



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Comment: All decisions in life require degrees of judgment. Judgment can be defined as the appraiser/consultants accumulated past experiences and his/her skill at discernment and understanding. We live today in an information society. We have more information than needed in most situations. But information is meaningless and useless without good judgment. Judgment, consequently, describes an acquired quality, which involves a high level of discernment, understanding, and wisdom. An appraiser/consultant, therefore, needs judgment to derive meaningful assumptions for the problem at hand.

Hopefully, we can all learn from the experiences of the past and improve our individual and collective judgment. I would suggest that judgment would also improve with an appraiser/consultant's increased understanding of the underlying questions, which led to the need for an appraisal/consulting report in the first place.

4-5. What assumptions should be adopted? Are they realistic and relevant?

Comment: The fourth and fifth step concerns the many assumptions which all appraisers/consultants must make when writing their reports. There are very few certainties during this process. Assumptions describe the potential facts, or events, which are possible and realistic for the problem at hand (but uncertain). I use the word "assumption" for all potential events that are less than 100% certain on the date of writing a report.

Examples of assumptions for our current situation include: (a) accurate projections of income, vacancies, expenses, interest rates, loan terms, debt service ratios, legal ramifications, management capabilities, market trends, etc. The reality of today's marketplace allows appraisers/consultants to acquire tons of information (say via the internet) but all this information must be "sifted and strained" so that meaningful and relevant assumptions can be ascertained for the problem at hand.

It is important that we use the term "assumption" when we are not 100% certain about a particular fact or event. I have noticed in my review of appraisals that many appraisers/consultants tend to use the word "fact" when referring to current data in their reports. If we think about these items, however, I think we might agree that most current information can be interpreted in many different ways.

If this is true, then a more appropriate concept for these current items, when we use them as data in our reports, might be the label "assumption". I think this would convey a more realistic scenario to the reader of our reports.

I might add this additional comment. My personal experience has been that many appraisers/consultants tend to make assumptions that are not always relevant or meaningful for the problem at hand. For example, many appraisers will use a DCF model with a 10-11 year projection period when writing a report for a lender client. This type of analysis may be very relevant for investors acquiring properties for their real estate portfolio, but it is not really relevant for most financing/underwriting decisions. The DCF model requires numerous hypothetical assumptions that tend to mislead and confuse the underwriting issues applicable for financing situations. Once again, a lender is rarely interested in hypothetical assumptions that transcend the funding of a loan. Also, a lender is not usually going to acquire the property that is being considered for a loan.

Rather, the existing property will serve as the security for the loan being funded. A key reason why appraisers/lenders tend to apply this analysis may be because of their focus on the concept of "market value" (a misleading concept for underwriting purposes), whereas, their focus should be centered upon debt service coverage and, secondarily, the concept of "investment value" (in my opinion). If appraisers/consultants are incorporated into the decision-making process, which underlies the problem at hand, then a different view of value may emerge.

6-7. What derivation process and/or methodology should be applied and what conclusions result from this process?

Comment: These steps should follow naturally from the application of the above principles. Appraisals done for mortgage loan purposes need to focus upon methodologies that are relevant and meaningful from the lender's perspective. Methodologies that may be meaningful from other perspectives (again we can mention the DCF model) should not be used for lender's that may not view this model as appropriate for underwriting purposes. Most lenders



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just want to make a loan that is prudent and proper for the longer-term period (often 10 to 30 years).

A most important factor for lenders is the current NOI (generated by the property) and the appropriate debt coverage ratio (for the risk and loan to be funded). Factors such as property reversion and resale (after a 10 year holding period) are really not an immediate concern to most lenders when determining the appropriate loan to fund at closing. This type of analysis is much more relevant for investors (say a REIT) who desires to acquire properties for investment and later resale – not for lender’s who must focus on making a prudent loan today on an existing or proposed property.

If a value component is desired or needed for a report prepared for a lender client, then the more relevant methodology would be the Band of Investment methodology using data specific to the loan being contemplated and an equity dividend rate typical for underwriting this type of risk. The appraiser/consultant needs to remind himself/herself that the perspective of the end decision-maker(s) must be constantly kept in the forefront. After all, appraisal/consulting reports are requested because specific decisions must be made to accomplish a specific set of objectives and the appraiser/consultant is part of this decision-making process.

8. Are the conclusions meaningful for the intended use? Are there other alternatives? Comment: If all the above principles and questions were incorporated into a written report, and if the appraiser/consultant focused upon the end users questions and perspective, then the final report should be a meaningful document that the lender/client can use for decision-making purposes. But even with all these principles applied, there certainly is room for other alternatives. For example: maybe the appraiser/consultant will want to recommend a creative approach to funding a particular loan. If the property under review has the potential for sizeable growth in NOI in future years, maybe the concept of a growth in the loan amount, as NOI increases, could be suggested. Since a lender may desire to make a prudent loan today (an initial funding) and then also accommodate the need for future financing, a step-up loan amount as NOI increases could be one additional alternative.

Other alternatives may also be appropriate. Creativity should never be stifled by bureaucratic rules and restrictions. As things stand today, this writer could not write a meaningful report on most types of commercial properties for lending purposes. The current mindset in the industry would not allow for my degree of creativity.

I think this situation is lamentable and detrimental for our profession and industry in the longer term. Maybe this article will help to create an environment where new questions can be asked and explored.

Conclusion: All the above principles need to be taken collectively and comprehensively if a report is going to be meaningful and useful to the end decision-maker (in our example the lender/client). Currently, most decision-makers working with commercial properties in the United States require some type of appraisal or consulting report as the key document for making a financing/underwriting decision. I have reviewed hundreds of these reports over the past 30 years as a loan underwriter, review appraiser, mortgage banker, and MAI appraiser. I have also prepared many reports in the past, which really were an embarrassment to me upon later reflection.

Why did I use terminology and methodologies as I did? Upon reflection, I would suggest that much of my work as an appraiser was done to meet the legalities and institutional requirements of the parties I was dealing with. A sample request from a typical lender would proceed as follows: I need you to prepare a “market value” appraisal on “x” property because the borrowers are requesting a maximum loan on this property. Can you provide me this document as soon as possible? I also need an MAI report for this property to meet my institutional requirements. I would then receive a call from the borrowers stating that they need an appraisal for “x” amount so they can accomplish their needs in financing this property. And many would advise me that the fee being paid to the lender on my behalf is a substantial fee, implying that if I write this report I had better derive a value that supports their objectives.



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After all, why would I take this assignment and collect the substantial fee without doing my utmost to derive a “market value” that justifies their needs? I am sure that many appraisers/consultants can identify with this scenario. After many years of reflection on this “game” that is being played, I sincerely suggest that major changes are needed in the appraisal/consulting profession. New questions need to be asked. Educational organizations need to rethink the whole process of appraising/valuation so that all appraisers and consultants focus on the decision-making issues underlying report writing. The Appraisal Foundation needs to rethink their strategies for improving the appraisal profession. I am convinced that appraisers/consultants desire to be professionals.

But there are many forces and factors hindering this from becoming a reality. If appraiser/consultants were educated to think about the underlying decisions that initiated the need for a report in the first place, then the current mindset would change and all parties would benefit. A new relationship between lenders and appraiser/consultants could emerge. In our example above, the key decision-making issues were related to underwriting a prudent loan and funding that loan on a specific property.

The concept of “market value” needs to be de-emphasized in writing reports. All values are derived from a subjective basis (e.g., human judgment). There is no single objective “market value” for any property. This means that all properties can be viewed as having many different “values” depending on the viewpoint of the person deriving the value conclusion.

Finally, appraisers will only improve, as they become real professionals who assist and help decision-makers solve their real and immediate problems. Currently, appraisers and lenders are NOT on the same “page” in this endeavor. When it comes to communicating all the essentials that make for good problem solving skills, the above eight principles can serve as a beginning.

P.S. I welcome comments, suggestions, and constructive criticism on this article. God knows, I don’t have all the answers.

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