CRE's VIEWPOINT

Appraisal Thoughts From A Non-Appraiser

by Bruce P. Hayden, CRE

Many years of reviewing appraisals for a major financial institution and of conducting appraisals inhouse from time to time, have led this non-qualified appraiser—at least in the MAI sense—to a number of conclusions:

- Too many users of real estate appraisals are unwilling to pay appraisal fees commensurate with the time and skills needed by the appraiser to do a thorough, professional job.
- Too many appraisal users insist, as a condition of engagement, that the resulting appraisal be "usable." This term usually means that the appraisal should support the mortgage loan the users are seeking or the results of negotiation, arbitration, assessment appeal, etc. (Such engagements may take the form of a stipulation to "do your numbers and discuss your results with us. We will tell you then if we want you to finish your report. If not, we will pay you for your work to date.")
- Too many financial institutions want appraisals to fit their purposes—such as to meet a "loan to value" test.
- Too many appraisers, facing these pressures, work backwards from the assessment of value to the accumulation of supporting data or otherwise compromise their professional skills or integrity.
- Too many appraisers do not have the slightest idea of how to evaluate the separate interests in commercial real estate—such as lessors' interests, lessees' interests, mortgagees' interests, "sandwich positions," remainder interests and the like.
- Too many well-qualified appraisers, who know how to value fractional interests, nonetheless do not insist on starting where every appraisal should start: with the value of the land and its improvements—as if it were held in fee simple, unencumbered by a mortgage or other lien or leases of any sort but subject to natural or regulatory conditions affecting value.
- Too many appraisers assume that the value of both a mortgagee's and a mortgagor's interests are the same as the unpaid balance due on the mortgage. Often, this assumption is correct; however, equally often the value of the two interests differ, and neither is equal to the unpaid balance.

For example, consider the values to the mortgagor and to the mortgagee of a 7% mortgage in a 10% market with 11 years to maturity. The value of the mortgagor's position in this example is substantially *greater* than the unpaid mortgage balance, while the value of the mortgagee's position is substantially *less* than the unpaid balance. Likewise, an option to prepay the mortgage at 101 is substantially more valuable to the mortgagor than an option to prepay at 110 or no option to prepay.

While these generalities apply to appraisals of all real estate, this treatise looks only at appraisals of income property—apartments, shopping centers, office buildings, etc.—and leaves the condominium, single family home, industrial and special use property fields to other papers.

Appraisal Scenarios

Let us look at the appraisal of an office building, erected on a site owned by a Catholic diocese, which has entered into a long-term ground lease with the developer/owner of the building. Who are the parties at interest? What are their relative priorities of claim on the building's net operating income?

In one situation, the diocese's interest is *superior* to the mortgagee's interest as follows: The diocese's interest ranks first; the mortgagee's is second; the developer/owner's is third; and the tenants' is fourth.[1] In another situation, the diocese's interest is *subordinate* to the mortgagee's interest. In this case, the mortgagee's interests come first; the diocese's second; the developer/owner's third; and the tenants' fourth.

Now let us move to a more complex, more typical office building situation that involves multiple interests: ground lessor and lessee; a first mortgage loan on the lessor's interest in the ground; another first mortgage loan on the lessee's interest in the ground and on the improvements; a ten-year lease on half the office space to a major corporate tenant; short-term leases on the remainder of the office space with a number of other tenants.

What Is The Appraiser's Task?

First of all, the appraiser must identify the various legal entities involved and the priority of the claim of each interest. Priority should be determined both in terms of each interest's legal

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position and claim on cash after operating expenses and taxes. (Usually, these two factors are the same, but occasionally they are not.)

Second, the appraiser must clarify which interest or interests he is engaged to appraise.

Third, the appraiser must appraise the whole property, including the site, all current improvements and the right to make further improvements, as if the property were held in single ownership and in fee simple. *This value becomes the total of the values of each fractional interest in the appraised premises.*

Fourth, the appraiser must determine the priority of the claim of each interest that is superior to the interest he is valuing.

Fifth, the appraiser must successively value each interest that is superior to the interest he has been engaged to appraise. The appraiser then subtracts the value of each senior interest from the value of the whole property less the values that have been already subtracted.

Sixth, the appraiser must consider as immaterial the value (as a group) of all interests that are junior to the interest he is appraising. (In litigation involving the property, the appraiser may consider junior interests for their nuisance value).

As to the determination of the value of each of these interests, the appraiser must decide which approach is most significant—both to the value that is sought and to the purposes for which the appraisal is being made. For example, the manager of a pooled investing group of corporate pension funds may instruct his appraisers to rely primarily on the economic approach to valuation rather than either the comparable sales approach, or the replacement value less depreciation and obsolescence approach. Why? Most pension funds are net present value oriented; therefore, the fund must rely most heavily on net present value calculations. The basics for such calculations, of course, must be substantiated by comparables.

Summary

Assume the value of a particular parcel of real estate, as if it were held in fee simple and was unencumbered, is represented by W. Assume the limited interests in W are in the following order of priority: A, B, C, D, E, F. The appraiser's assignment is to value the limited interest C.

The appraiser's basis determination should be:

$$C = W - A - B^2$$

Different approaches may be needed to determine the value of each subinterest. For example, if A has a first mortgage on W, the appraiser may reason: "A's unpaid balance is less than 50% of W; the interest rate and other terms approximate present market levels. Therefore, I can safely value the subinterest at the unpaid balance." Or the appraiser may find that the unpaid balance of A is 85% of W and that B (who leases the property as a whole and is responsible for making the mortgage payments) has had a tax lien filed on the premises by the Internal Revenue Service. The value of A under these circumstances may be speculative and range between 20% and 50% of the unpaid balance. The value of all other interests, of course, also are highly speculative.

Conclusion

It should be recognized that real estate appraisal is at least as much an art form as it is a matter of science. The appraiser, accordingly, must be a person of judgment, integrity and experience. The appraiser consequently should be well paid for his services, not bought at any price.

NOTES

1. Non-disturbance agreements, etc., would alter tenant position in the pecking order.
2. (D + E + F) may have nuisance value.

How Long Is a Long-Term Lease?

by Roy P. Drachman, CRE

If a man doesn't learn anything during nearly 50 years of experience in the real estate business, he was either extremely knowledgeable at the beginning or too dumb to recognize the important facts he encountered along his lengthy journey.

I fall into the latter group. I have learned many, many things as I wended my way through a melange of real estate deals that included shopping centers of all sizes, office buildings, residential developments and industrial projects.

One thing I learned early on was that if you had no capital but a good idea, for a shopping center, for example, about the only way to put the package together was to find a property that could be leased with the right of first mortgage to provide funds for construction.

Another thing I learned was that it was not difficult to find such properties and owners who would permit that kind of arrangement for financing a project. I will not bore you with the techniques used to make such deals. That story has been told many times by many people.

The most important thing I have learned about leasing the land on which a development will be placed concerns the length of the lease term. I, and many other developers, have long believed that a 50- or 60-year lease was long enough to accomplish almost any kind of development.

"Why not?," the thinking has been. "I'll be 85 or 90 years old by the time the lease runs out, and I won't care after that. Furthermore, all the buildings will be worn out by then anyway," the dialogue continued.

Well, let me tell you how wrong we who have thought and acted that way were. I am one of those 85-year-old guys who is now aware of having made a gross error.

A partner and I leased a parcel of land on which we built a neighborhood strip center of 100,000 square feet. We had the right to encumber the land on a first mortgage which provided all the money needed to cover development costs.

The length of the land lease was 60 years, which certainly seemed long enough to us at the time. The length of the mortgage was 20 years. The shopping center opened in March of 1957. My age at that time was 50. I believe that almost anyone consulted at that time would have agreed that my partner and I had made a good deal.

The shopping center was a success from the time it opened. We paid off the mortgage in 20 years and held the property free and clear. The income from the development has been acceptable and steady. We remodeled the center a few years ago and have been attentive regarding the maintenance of the property. As a result, it has been quite productive.

Competition has emerged in the form of other shopping centers in the trading area, but it has not seriously affected the volumes that our tenants enjoy, and there has been practically no decrease in the amount of rent we collect.

So, one might say: "What problem do you have? What is wrong with what has happened to that property?" Obviously, the answer is: "Nothing seriously is wrong with the property; but the problem is with the ground lease that was negotiated in 1956 and will terminate in 2016." We have only 24 years left on the ground lease. At that time, the ownership of the buildings will revert to the owner of the land.

Our key tenant, one of the large food chains, occupies a store of approximately 25,000 square feet in our shopping center and wants us to increase the size of the store to 40,000 or 50,000 square feet to make it more competitive with the other new supermarkets in this area that have 40,000 to 50,000 square feet.

We can either ignore the request of our present tenant, whose lease has just a few years before it expires, or face the prospect of increasing the size of the store to suit the tenant for the relatively short period of 24 years.

Financing today, under the best of conditions, is not easy to obtain. Even under what might be called normal conditions, would it be wise to build a new building knowing that we will have to give it away in 24 years? Furthermore, our tenant may not accept a lease with such a short term.

I have had some experience with other ground leases that ran 50 or 60 years. While I sold my position in these properties, I continue to think about what must be happening to the present owners. I must come to the conclusion that a 50- or even 60-year lease is hardly long enough; the lessee must have some option to extend the lease to somewhere around 90 to 100 years.

The years slip by very quickly, and when you reach my age, you can look back and see very clearly that a long-term investment that pays good returns is a very valuable asset. It is one that you do not wish to give up but may be forced

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to because the title of the buildings will flow to another owner when the lease term for the ground is not long enough.

As for the buildings wearing out, that can happen, of course. But, on the other hand, a going business can operate in a very old building for a very long time, as many of us can attest.

So, a bit of free advice from someone who has made the journey over the hills and through the valleys: If you must make a lease that has no more than 50 or 60 years for its term, be sure to have the option to extend the actual term of control of the land to 90 or 100 years.

I have been told that in England it is not unusual for lease terms to be for 1000 years; I heard of one lease for 2000 years. I do not think anyone would have the temerity to project a value for property that many years ahead. But at least the developer of the property will own something he can pass on to his grandchildren, and they to theirs.