

RERC[®]

REAL ESTATE REPORT

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Riding the Edge of Success



RERC Partner Profile



Del Kendall serves as managing director of Real Estate Research Corporation's (RERC's) southwest operations and co-director of RERC Hospitality. He has more than 20 years of high-level real estate analysis, valuation and consulting experience in nearly every major market in the U.S. and with all major property types.

Mr. Kendall has been active in the real estate profession for nearly 3 decades, and serves as 2010 and 2011 chair of the Valuation Committee for the National Council of Real Estate Investment Fiduciaries (NCREIF). He also plays a key role in monitoring RERC's appraisal management activities for the firm's pension fund clients.

Mr. Kendall's valuation experience includes managing a team responsible for valuing more than 900 single-tenant properties as part of a major acquisition for a global real estate client, reviewing and valuing real estate assets in Mexico, and valuing more than 500 hotels. He has appraised numerous properties of all types since 1981.

Mr. Kendall has conducted a variety of complex engagements, including the valuation and feasibility analysis of a 3,200-acre Austin multi-use development having a book value of \$100 million (the largest single-asset loss in the history of the Federal Deposit Insurance Corporation [FDIC] at that point) and undergoing bankruptcy proceedings. He also managed a team responsible for inspecting and performing a detailed market study on more than 8,000 multifamily units in 36 counties in East Texas in support of a federal housing program. In addition, he has participated in due diligence analysis and valuation of a multi-billion-dollar retail portfolio. Mr. Kendall also served as the sole real estate expert for the creditor's committee involved with the defaulted loan on the Enron headquarters building.

Mr. Kendall has served as a litigation consultant and expert witness in cases involving the FDIC and Resolution Trust Corporation. His work assisted their legal counsel in obtaining a judgment of \$200 million in favor of the client.

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Foreword

August 2010

Dear Readers,

What a difference a quarter makes! Just a few months ago we were encouraged by the growth and signs of stabilization in the economy, and this quarter we are discouraged by the loss of momentum we are seeing. Although we realize this slowdown is all part of the recovery process and that there will be many more ups and downs before we achieve stabilization, it does help us better understand the volatility that many investors more closely tied to stock and bond assets experience and to better appreciate the stability that the commercial real estate asset class offers investors.

As the second half of 2010 gets underway, we are at an inflection point in this investment cycle and are facing the harsh realities of a risky world. As the property markets continue to gain traction, some commercial real estate investors who have learned the lessons of the recent credit crisis will decide the price of playing is too high and will back away from the table. Others will take on the challenge of investing in a top-tier property at a record-high price, risking the possibility of losing it all, but also hoping for the chance to win it all. Real Estate Research Corporation's (RERC's) summer 2010 issue of the *RERC Real Estate Report*, "*Riding the Edge of Success*," offers investors some of the information they need to succeed in this investment environment.

In addition, we are pleased to share with you an article authored by Del Kendall, CRE, MAI, managing director of RERC's Houston office. "*Fighting the Battle of Appraisal Lag*," presented on Pages 33-35 of this issue of the *RERC Real Estate Report*, addresses how practitioners who lack sales comparables to use in determining the value of a property can rely on other methods, including the band of investment technique, to avoid the difficulties associated with appraisal lag. Del serves as 2010 and 2011 chair of the NCREIF Valuation Committee, and his credibility and knowledge of the commercial real estate valuation process is widely respected throughout the industry.

We would also like to extend our appreciation to the hundreds of professionals who willingly fill out RERC's surveys and share your responses each quarter. As we compile the raw data and analyze the results, read and take into account your insights, and recognize the time you have dedicated to completing your responses, we realize how important your individual contributions are in helping paint a more detailed picture of the investment world for commercial real estate. Thank you for your information, particularly during these risky investment times.

Sincerely,



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Fighting the Battle of Appraisal Lag



By RERC Managing Director, Del Kendall, CRE, MAI

Since the credit crisis took hold in Fall 2008, determining market value of commercial property has been a major challenge for appraisers. Although this is due, in part, to a dearth of sales comparables during the past 2 years. However, it may surprise some appraisal practitioners that *appraised* values have also consistently lagged *actual* values in periods when the transactional markets have been active. As more tools become available to compare actual transactions to appraisals within the same databases, the more appraisers should work toward eliminating this lag by providing more accurate appraisals.

Accurate Appraisals Are Needed

Before expanding on the issue of appraisal lag, it is important to understand the importance of timely and accurate values. Although every appraiser seeks to provide an accurate valuation when performing an appraisal, there are repercussions if the valuation fails to meet the test of accuracy.

Some appraisals performed for pension fund advisors are for properties owned by comingled funds. Typically, appraisers hired by the fund perform annual valuations, while internal staff perform valuations the other three quarters of the year. In these funds, buyers and sellers can trade in and out of the fund, with the pricing based in large part upon the appraisal-based market value of the properties contained in the fund. It is obvious that if appraisals are lagging market value in a rising market, sellers would be under-compensated and buyers would experience an arbitrage by acquiring below market priced shares. This outcome would present fiduciary issues for the fund (and indirectly for the appraiser) by failing to meet the mark-to-market requirements of the fund.

Lending institutions likewise consider market value as a major benchmark in underwriting loans. Banks and insurance companies depend on external appraisers to determine market values for new loans, which determine the loan amount through a concluded loan-to-value ratio. Appraisal values that lag in a rising market may prevent a borrower from receiving adequate loan proceeds by undervaluing the property. A reduced loan on an undervalued property could make a new development unfeasible to their borrower. In the opposite situation, where an appraisal lags market value in a declining market, too high a market value will lead lenders to over-leverage a property, adding unwarranted risk to the lender. It is prudent for banks to be

conservative in underwriting real estate loans; however, this process should involve a market value appraisal that is objective and not influenced by any considerations other than those obtained by the appraiser in their research of the market.

Other uses of appraisals, such as litigation, tax appeals, and corporate valuations also have obvious repercussions of failing to produce accurate appraisals. In adversarial litigation proceedings, the appraiser that fails to accurately recognize market conditions as of the date of value opens his/her client to taking an indefensible position if the adversary does a better job of recognizing prevailing market conditions as of the valuation date.

The Case For Appraisal Lag

The National Council of Real Estate Investment Fiduciaries (NCREIF) provides several indices of interest to commercial real estate investors and practitioners. The NCREIF Property Index (NPI), the organization's flagship index, includes over \$230 billion in property value. Property information is submitted quarterly by all asset holding members as a requirement of their membership. Values for assets in the fund are based on appraised values. Typically, exter-



nal appraisers are hired annually, while internal valuations are performed by the fund holding (or advising the fund holding) the asset in the other three quarters. Analysis of the NPI has revealed appraisal lag, as well as its associated nemesis, appraisal smoothing.

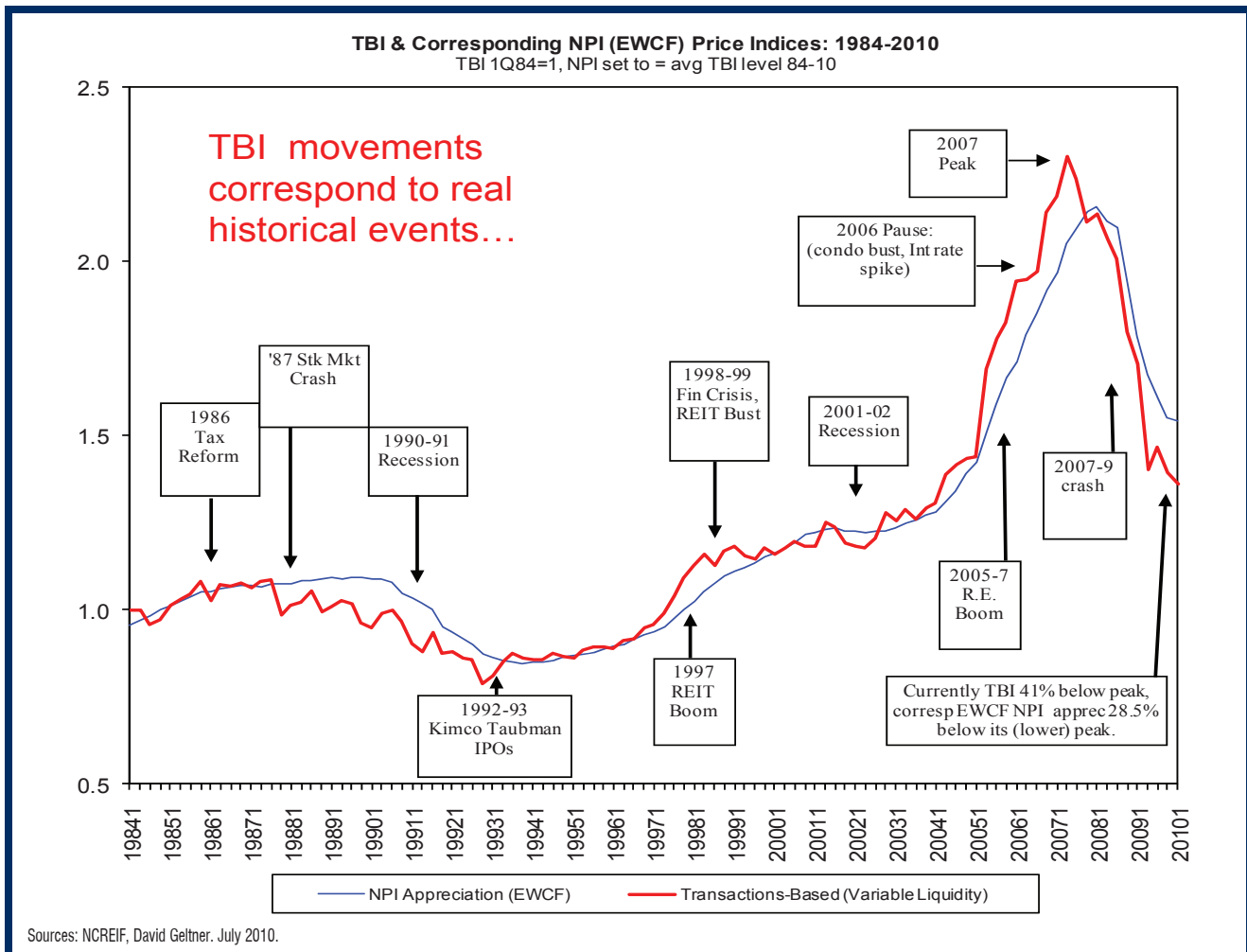
In 1989, Dr. David Geltner, Director of Research, Center for Real Estate at MIT, provided a precise definition of appraisal smoothing as the ratio of the standard deviation of true portfolio property values to the standard deviation of appraised portfolio property values. That is to say that actual transactions tend to show broader dispersions from the mean price trend, while appraisals tend to vary less from the mean of appraised values within a given index.

As long ago as 1984, Roger G. Ibbotson and Laurence B. Siegel identified appraisal smoothing as a weakness in the process of real estate valuation. The basis for their conclusion was the appraiser's reliance on historic cost and transaction information. In 1988, Rebel Cole showed that the

valuation-based series (such as NPI) possessed less variability than actual transaction-based indices. He attributed appraisal smoothing to three major causes: 1) factoring past value estimates into current appraisal judgments; 2) annual rather than quarterly appraisal cycles; and 3) the influence of desired client outcome. Daniel W. C. Quan and John M. Quigley argued in a 1991 paper that smoothing is the consequence of an updating strategy employed by appraisers, that appraisal smoothing does not result from flawed methodology, incompetence, or inappropriate influences, but rather from the appraiser's rational choice to rely increasingly on previous value estimates in the face of greater market uncertainty.

Irrespective of the potential causes of appraisal smoothing, studies confirm that it exists. Dr. Geltner's recent presentation to NCREIF¹ further outlined the case for appraisal lag by analyzing actual sales of properties in the NPI in his Transaction Based Index (TBI). The chart below illustrates the trends in values obtained from the TBI and the NPI.

¹ Presentation to the NCREIF Research Committee, July 1, 2010, Chicago, Ill.





The graphs show the smoother trend line for the appraisal-based NPI data, which illustrates a standard deviation of 2.3 percent, compared to a 4.3-percent standard deviation for the actual sales in the TBI. The most recent downturn in the market resulted in a 41-percent decline from peak values in the TBI. Coming down from a lower peak, the NPI declined 28.5 percent, though it is still 11 percent above where the TBI suggests that first quarter 2010 prices lie. Observing the downward trend lines of both indices since early 2008 shows that appraisers for the NPI properties responded much more accurately to declining prices than during the last major downturn in the late 1980s.

Steps to Avoid Appraisal Lag

The four quarters following the September 2008 crash of the credit markets revealed few sales of improved properties. This led appraisers to rely on more anecdotal evidence, including interviews with brokers, investors, and other real estate sources. Brokers, many of whom did not close a deal for 6 to 12 months, tended to provide information as to what prices would stimulate the sale of a property and corresponded with the buyer's view of pricing. Sellers contributed to the wide bid-ask spread, as they were unwilling to accept what they considered distressed prices, and withdrew most of their listed properties from the market. Consequently, those few transactions that did occur included motivated sellers. In spite of this conundrum of appraising without sales, appraisers improved their communication skills by talking to more market participants, rather than focusing on older sales as they had in the past, with the result being more accurate valuations.

A second area of consideration in valuing in a down market was from a more technical perspective. One of the main issues causing declining values was the absence of credit. This was an instance where the band-of-investment meth-

od all appraisers learn in their coursework came in handy. Before the crisis, higher loan-to-value ratios were readily available in the market. By mid-2009, lending ratios had declined—if you could find a lender that would lend! A strong argument could be made for assuming there would be no mortgage, with the capitalization rate equaling the equity rate. The following example shows the impact on capitalization rates by increasing mortgage rates from 5.5 percent to 7 percent (30 year amortization) and increasing equity returns from 6 percent to 10 percent.

Band of Investment Technique

	M	Rate M	
Pre-Credit Crisis			
Mortgage	75%	6.8134680%	5.1101%
Equity	25%	6.00%	1.50%
			6.61%
Mid 2009			
Mortgage	50%	7.9836299%	3.9918%
Equity	50%	10.00%	5.00%
			8.99%

Although there are a number of complexities that could be imputed into the preceding calculations, such as consideration of the amount of appreciation built into the equity return, the primary point is that methods of quantifying the price decline exist and should be considered by the appraiser. In addition, the discounted cash flow includes a number of assumptions that could be modified based on the appraiser's analysis.

In the recent market that has shown a strong price recovery in certain segments, many of the same procedures used in a down market can be followed. The one difference is that transactions within these recovering market segments are available, although it is incumbent on the appraiser to contact brokers and investors to obtain the latest pending or offered transactions to obtain real time data. Over the past 30 to 60 days, RERC has worked in markets that have experienced capitalization declines of 75 to 100 basis points during that time; however, these price trends are only available in pending sales and would not be evident by observing 30- to 60-day old closings.

While appraisal has often been compared to looking in a rear view mirror based on its reliance on past sales activity, it is time appraisers begin looking to the left and to right in their proverbial drive down the valuation highway.