

Telling The Story – A Solutions Approach to Appraisal

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Communication is the name of the game in today's world of commercial mortgage finance. In this ever-evolving environment, the role of the real estate appraiser goes well beyond just providing "an opinion of value". As transactions become more complex and clients become more demanding, appraisers need to be able to "tell the story" behind the opinion of value, since frequently there is a real story to tell.

Here are a few examples of real life situations where "telling the story" is key to making or breaking the deal.

1. "Mark to Market" – CMBS lenders are required to "mark to market" any contract rents that are above the appraiser's opinion of market rent. This can dramatically impact the loan proceeds and terms for the borrower. In the appraisal of a neighborhood shopping center for example, it is reasonable for an appraiser to develop a point opinion of market rent for each type of space in the center. Suppose the actual in-line rents range from \$1.50 to \$2.00 psf, depending on the location in the center (e.g.- elbow vs. end-cap). The appraiser may be correct in concluding to an overall market rent for the in-line space at \$1.75 psf. This reflects the average of the actual activity, and the opinion of value may be right in line with the loan underwriting.

So what's the problem? Under this scenario, the CMBS lender would be required to write down all in-line rents over \$1.75 psf as being "above-market". In reality the end-cap space may be at-market at \$2.00 psf, but the loan funds will be reduced nonetheless.

Solution – The savvy appraiser should "tell the story" by concluding to a *range* of market rent which reflects the nuances of the spaces within the center. In addition, for any individual leases that are above the indicated market range, the appraiser should discuss whether the contract rent is truly above market, or if there are specific mitigating circumstances for that individual space (e.g.- extra tenant improvements that would have value in the marketplace).

2. What is the Property? – The client orders an appraisal of an industrial building. The appraiser begins his due-diligence by developing sale and rent comps for an industrial building. Unfortunately, the site inspection reveals that this "industrial" building has been illegally converted to a *residential loft* use with 50 tenants currently living there. Worse yet, the property is not zoned for residential use.

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So what does the client want to be appraised? ... an industrial building less the cost to relocate the tenants and convert the building back to industrial use? a residential loft building subject to the Extraordinary Assumption that a conditional use permit could be obtained? Just what is the scope of work?

Solution – Since this situation is news to the client, it may take going through several layers of command to get a clear answer. Rather than assuming an approach, the appraiser and the client should communicate early and often regarding the nature of the property and the scope of the engagement.

3. Below-Market Rent – An underperforming neighborhood office building is in escrow to be purchased in a turnaround play. The prior management did not pay much attention to the fact that existing rents were 20% below market. As long as the building was full, they were happy. The purchaser is planning on putting some money into the building and bumping rents to market as they roll over in the next 3 years.

So how much is the building worth, and more importantly how do we get there? There are a number of *technically* correct approaches to dealing with a below market rent, turnaround situation.

- Capitalizing contract rent (below market) would require use of a cap rate that accounts for the significant upside potential. The challenge with this approach is that it is hard to account for the varied remaining lease terms with just a cap rate.
- Another approach is to capitalize market rents (stabilized) at a market cap rate, and then do a lease-by-lease analysis to determine the leased fee disadvantage, or capitalized rent loss. The problem here is that this may not reflect the real considerations of market participants.
- A discounted cash flow analysis (using Argus or another DCF program) can accurately measure the impact of the below market rents and the costs associated with rolling the spaces over (TI's, leasing commissions, etc.). Again, this may or may not reflect the considerations of market participants, depending on the type of property, and the dynamics of the local market.

Solution – Communication is clearly the order of the day. Since there is no *right* answer, this is another situation where some dialogue with the client can lead to a solution that all parties can buy into. Proactive dialogue throughout the appraisal process can save substantial time, frustration and pain down the road.

4. How Big is the Property? – Public records show that the building has 46,500 sq.ft. of building area. The client provides a rent roll that shows total building area of 48,350 sq.ft. The property is in escrow and the listing flyer shows the building area as 52,400 sq.ft.

So, just how big is the building...and does it really matter? Of course it matters. The value of the building is directly tied to its size. Well, how do we reconcile the differences?

Solution - The smart appraiser has a variety of options available to get to the root of the problems. He can review building plans or confer with the original architect. He can measure the building himself. He can ask questions: Have there been any recent additions that the public record might not have picked up? Were they permitted? Was there a storage mezzanine that was finished out as office space? There is a story to tell, and after enough research and discussions, the appraiser should be able to tell that story, so that the answer is clear to everyone involved.

5. Owner-User vs. Investor Value – The property is an industrial building in a marketplace that is dominated by owner-users. There is very little rental activity in the area, and virtually no investor sales. Owner-users are so prevalent because business owners are able to qualify for SBA financing which helps them to purchase a building where the mortgage payment is less than competitive market rent. As a result, users bid up prices above what a pure investor can afford to pay. The owner-user sales in the marketplace support a value of \$3,300,000. An income analysis using market rents and a market cap rate only results in a value of \$2,800,000.

So, how much is the building worth? How do we reconcile the difference between the two analyses? The answer is...it depends. Is the property vacant and available for use by an owner user, or is it leased. If it is leased, is it leased on a short-term basis or a long-term basis? If the building is vacant, it is probably worth \$3,300,000. If it is leased at a market rate on a long-term basis, it is probably worth \$2,800,000. If it is leased on a medium term basis it is probably worth something in-between. It also depends what analysis the client wants to see. They may want to see the property on an investment basis only, or they may want to see several scenarios analyzed.

Solution – Once again, pro-active communication early and often will keep all players on the same page. If there is clear dialogue throughout the process, then the result should be something that works for all parties.

The examples go on and on.... Above-Market Rents, Large Tenant-Early Rollover, Ground Leases, CTL-NNN Lease – Cost vs. Market Value, Unique Property – No Good Comps, Basement Space, et. al.

In each situation the answer lies in a clear and healthy dialogue between the appraiser and the client. Communicating...discussing problems early...working out solutions together...telling the story...these are the keys to a successful appraisal practice. They are also the keys to a successful life.