Not So Fast!

Sometimes It Pays to Get a Second Opinion

A BANK CLIENT recently asked my firm to review appraisals on a portfolio of five fast-food restaurants. At first glance, the reviews appeared routine. The appraised values were below $250,000, and the reports showed a number of improved sales and rent comparables.

As we dug into the reports, however, it appeared that the appraiser hadn't seen what we were seeing. Issue after issue jumped out at us. The first red flag was that all five restaurants had been closed since 2007, and reportedly the franchise had closed all of its restaurants in that area of the country. None of the properties had been leased or sold since being listed in early 2008. This wasn't a good sign for the likelihood that another restaurant operator would be interested in buying or renting the properties.

Next, we learned that the buildings were about 20 years old. However, the appraiser had opined that the improvements had a remaining economic life of 25 years. How many fast-food restaurants are around that were built in 1965 (45 years ago)? Our experience has been that most fast-food restaurants are either substantially remodeled or demolished after 20 years.

We moved on to the first approach to value in each report—*the income approach.* In each report, six to seven rent comparables were presented and analyzed. Some of the rent comparables could be discarded immediately. They were restaurants within multi-tenant shopping centers, and retail stores aren't normally compared to freestanding retail buildings.

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KFC, Dairy Queen, Hot 'n Now, Rally's, and Wendy's. This information added to the mounting evidence that closed fast-food restaurants weren't finding occupants who wanted to use an existing building.

On to the *sales comparison approach* we went. Once again, the only properties truly comparable to the subject were listings and not actual sales.

At this point, the appraisals had told us this much:

- Subject properties have been vacant for over two years and none have been rented or sold.
- Subject improvements were 20 years old, which is about the time buildings are torn down or totally renovated.
- No comparable properties have actually leased or sold in the past few years.

We could not in good conscience accept appraisals that valued the subject properties as if they would continue operating as fast-food restaurants. The data suggested that the appropriate valuation was land value less the cost to demolish the improvements.

Our concerns were obviously numerous. Could the appraiser find and provide actual leases and sales of comparable properties? Would he provide an estimate of the land value for each subject property so it could be determined if the improvements contribute to value or should be demolished?

The appraiser was willing to consider our concerns and did revise all of his reports. His revised analyses confirmed what the market data was telling us all along: The properties were worth land value less the cost to demolish the existing improvements. The buildings had indeed reached the end of their economic lives.

In general, the appraised values were reduced down to $60,000 to $80,000 from $180,000 to $200,000. Considering that the properties were purchased at an average price of $800,000 each, a significant write-down was occurring. More importantly, the bank now had a better indication of how to market the properties and set listing prices.

What's the point?

Per the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), in many loan situations we have no choice but to order appraisals. However, FIRREA provides some flexibility in the level of review undertaken. Every appraisal must be reviewed to ensure compliance with FIRREA and the Uniform Standards of Professional Appraisal Practice (USPAP). But beyond such compliance, how do we know the overall analysis is correct?

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A professional review is probably the best way to make sure the appraisal is accurate and reasonable. After all, it's not unusual for us to go to another doctor for a second opinion. Going to a second appraiser for a review is just as logical. Obviously, the second appraiser needs to be experienced in reviewing and familiar with the subject property type.

As with any service, there is a cost. However, the cost of a professional appraisal review will be insignificant in comparison to the dollar decision being made. Better credit and workout decisions can be made when the bank has confidence in the value of its collateral. Never just assume that the appraisal you have ordered is correct. A small investment in a second opinion can pay big dividends. ❖

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Letters to the Editor

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