Risk Management Insights

Appraisal Review Part I: Sales Comparison and Cost Approaches

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Sales Comparison Approach

Almost every appraisal report contains a Sales Comparison Approach. This is the most common approach used to value both vacant land and improved properties. Therefore, it is important to recognize when this approach is understandable and convincing.

Comparable Sales

We begin a review of this approach by asking the following questions:

- What is the availability of sales data in this market?
- How recent are the comparable sales selected for comparison?
- What has been the market trend since the date of sale of each comparable property?

In 2009, most markets have seen a significant decline in the number of transactions occurring. Therefore, it will not be unusual to see appraisals with only 2007 and 2008 sales.

What we should first look for is how the appraiser adjusted 2007 and 2008 sales for changes in market conditions. Although values change at different rates depending on location and property type, a downward adjustment is typically warranted for any pre-2009 sales.

The appraisal under review should support the magnitude of the market conditions adjustment. This can be supported in a variety of ways:

- Sale and Re-Sale of the same property
- Paired Sales – Sale of a similar property in 2007 or 2008 compared to a 2009 sale
- Survey of market participants – e.g., brokers
- Change in cap rates from 2007 to 2008 to 2009
- National price indexes

As a generalization, we look for a downward adjustment of 40 percent for sales that occurred in 2007 and 2008. This is based on information we have seen in the marketplace. For example, Moody's/REAL Commercial Property Price Index recently indicated the average value of commercial real estate is down over 42 percent from its October 2007 peak. Our conversations with appraisers that value pension assets on a monthly or quarterly basis confirm a 40 percent + decline since the Lehman Brothers bankruptcy in 2008.

Obviously not every market or property type has seen a 40 percent decline in value since 2007 or 2008. Therefore, if we see a different percentage used, we look to see how the appraiser supported his/her adjustment. A stated figure of -10 percent or -20 percent without any market support is not acceptable. As noted above, there are many ways of supporting this adjustment.

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Lastly, most appraisals we have reviewed recently have included one or more 2009 sales. Although sales volume may be down, there still are sales occurring in most markets. These sales should be given greatest weight as they best reflect current market conditions. An unadjusted 2009 sale is better than an adjusted 2007 sale.

Another question to ask: how comparable are the sales selected for comparison in terms of property characteristics?

In order to determine if the comparables used are truly comparable, you need to require that appraisers include photos of the sales and detailed sales sheets (not just adjustment grids) that summarize the property characteristics.

No guidelines exist that say a sale that is 50 percent larger or smaller than the subject is not comparable. However, some logic should come into play as to how different the sale is from the subject before it is no longer a true comparison. We typically ask the question – would a buyer interested in the subject property also be interested in the comparable sale the appraiser used?

For example, if the subject is a 50-unit apartment project, it is unlikely the same buyer would be looking at a 200-unit apartment project. If the subject is a 10,000 square foot warehouse, it is unlikely the same buyer would be looking at a 50,000 square foot warehouse. Judgment comes into play in selecting comparable sales, but some reasonableness is required.

Adjustments

Another way of determining if the sales used are comparable comes from asking the following questions:

- What is the magnitude of quantitative adjustments?
- What are the gross and net magnitudes of total adjustments?

Sales that require a series of plus or minus 25 percent adjustments probably are not good sales. If a sale is truly comparable, then why would it require numerous large adjustments?

The overall net adjustment can be misleading, so it is best to calculate the gross adjustment made to each sale (if the appraiser has not provided such). In my opinion, the most comparable sale is the one that requires the smallest gross adjustment. An adjustment accounts for a difference between the subject property and the sale property – thus, if the total gross adjustment is small, then doesn't that indicate the subject and the sale are very comparable?

You may encounter some appraisals that do not include percentage (aka quantitative) adjustments. These appraisals use the qualitative method, which indicates if the sale is inferior, equal, or superior to the subject property. Such comparisons are usually shown for each property characteristic with an overall comparison also provided.

Qualitative adjustments are more difficult to analyze to determine how comparable a sale is to the subject. However, numerous 'inferior' or 'superior' ratings probably indicate a sale is not very comparable.

The last item to consider is how the appraiser reconciles all the data and analysis. Sale prices are converted to a unit of comparison – e.g., price per square foot or price per unit. Most appraisals have two ranges of prices – unadjusted and adjusted. We look to see if the appraiser's conclusion is within both ranges. If so, no red flag is raised.

However, if the value conclusion is above the range of unadjusted sale prices per unit, then we have an appraisal that is saying the subject is worth more than any comparable property has sold for. The opposite is the case if the conclusion is below all unadjusted sale prices per unit. Either way, we want to be sure the appraiser has convinced us of this logic.

Regardless of the above, no appraisal should conclude outside the range of the adjusted sale prices per unit. Adjustments theoretically make all the comparable properties similar to the subject and thus a final value conclusion should be within the range of values indicated.

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Resources for Bankers

The following resources are helpful in determining if the appraisal being reviewed omitted any pertinent sales or listings.

- In-house appraisals of similar properties
- COMPS/CoStar – www.costar.com
- Local brokerage firms
- Loopnet – www.loopnet.com

We especially like Loopnet (free!) as listings can be very helpful in showing what the subject is competing with and how the list prices compare to recent sales. In-house appraisals are also valuable as a different appraiser may have found different sales that may be more comparable than those used in the appraisal being reviewed. If you believe that is the case, do not hesitate to inform the appraiser of these other sales and ask him/her to consider them in a revised report or let you know why he does not think they are comparable to your subject property.

Cost Approach

If the Sales Comparison Approach is the most common approach used in appraisals, the Cost Approach is probably the least common. Although no official stats exist, our experience is that 75 percent or more of all commercial real estate appraisals do not contain a Cost Approach.

The Cost Approach is developed when appraising new or newer buildings and special purpose properties (e.g., large places of worship) that do not have an active sales market. Some appraisers believe a Cost Approach is useful for buildings up to ten years old and others limit that to five years. No set age exists as to when the Cost Approach should or should not be developed.

In very simple terms, the Cost Approach involves estimating land value and then adding the cost to build the improvements less depreciation. This indication is more reliable when a building is newer and the amount of depreciation is minimal.

In today's oversupplied market, market value is typically well below project cost new. As usual, the percentage that current market value is below project cost varies by product type and location. The greatest divergence we have seen is high-rise condominium projects. A recent portfolio review of over 100 condominium projects across the country revealed market value was about 65 percent below project cost new. This is probably the worst-case scenario. Other property types like office and industrial are likely experiencing a smaller difference between cost new and value.

The bottom-line is the appraisal being reviewed should address external obsolescence, as this currently exists for almost every property in this country. For a new property, external obsolescence represents the approximate difference between market value and cost new.

As this approach is not often developed, the most important point we can make is to not accept an appraisal with only a Cost Approach unless the property type is so special use that even in good markets, sales did not normally occur. It is not acceptable for an appraiser to say there are no current sales so I only developed the Cost Approach. There are very few property types where only a Cost Approach provides a credible appraisal. Almost every property type has some amount of market activity that warrants a Sales Comparison Approach, also.

Next article in the series: Appraisal Review Part II: Income Capitalization Approach

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