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# What to do with the Real Estate Appraisal

*Dennis A. Webb, MAI, ASA*

Business appraisers are faced with the joy/challenge/responsibility of dealing with real estate appraisers when valuing holding companies, common tenancy positions or any other entity when real property plays a significant role in the economic performance of the enterprise. This article is intended to describe the real estate appraiser's process, with a focus on elements that are needed by the business appraiser *but may not normally be included in a market-value real estate appraisal*. Keys to a successful engagement and collaboration begin with engaging the real estate appraiser, and working together on numerous elements of the report that produce the essential raw material needed for valuation of the entity.

## Overview

All valuation follows the same general process and structure. Real estate appraisal is a highly organized subset of business valuation, largely because of its (relatively) homogeneous subject, and because of the large body of specialized data available to support the process and the value conclusion. The good news is that the types of information covered are predictable, and the value conclusion generally supported with a (relatively) high level of confidence. The bad news is that the real estate appraiser is concerned with modeling the behavior of the market for the specific interest being valued, and may be entirely unaware of the special conditions that can apply within the entity that holds the real property. The business appraiser needs to have at least an awareness of the real estate appraiser's premises and processes, so he or she can extract information needed for the valuation. This article is extracted from the Author's recent book, published by the Appraisal Institute,<sup>1</sup> which includes fully developed case studies for both an FLP and a cotenancy interest.

*Disclaimer:* This summary is not meant to be a complete treatment of the real estate appraisal process. Rather, it is intended to focus attention on those elements that are of particular concern for those using appraisals as a component of an entity valuation. The

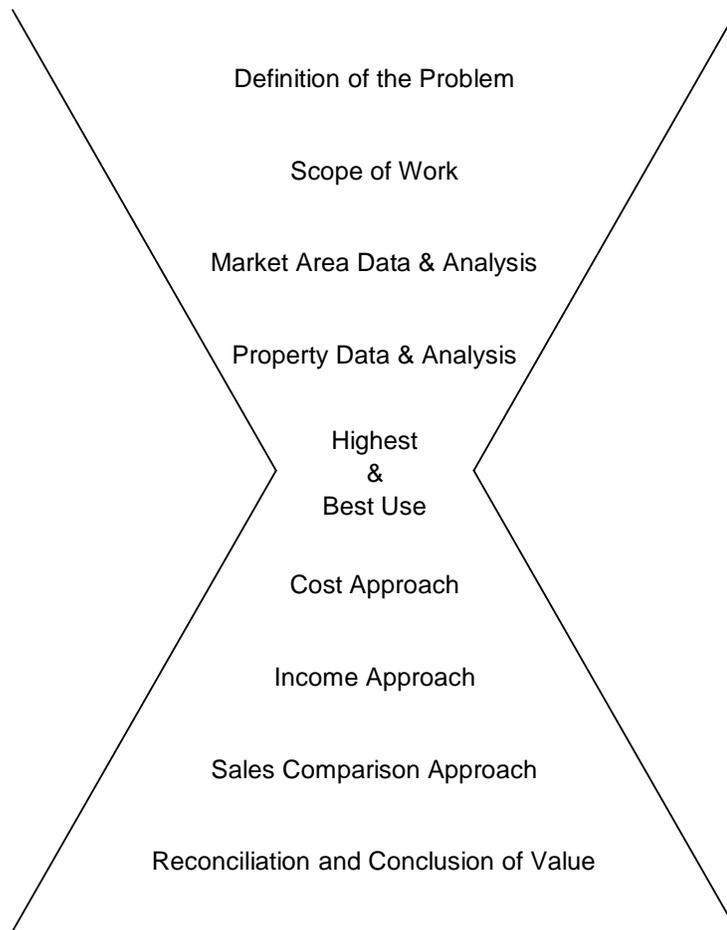
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<sup>1</sup>Appraisal Institute, *Valuing Undivided Interests in Real Estate: Partnerships and Cotenancies*, (Chicago, Appraisal Institute, 2004): Chapter 2.

definitive reference work for the topics covered in this chapter is *The Appraisal of Real Estate*.<sup>2</sup>

The real estate appraisal process is centered on highest & best use, which rests on the valuation premise (definition of the problem, and analysis of market area and property data), and underlies the entire value analysis. The “funnel” of Figure 1 describes its central relationship. The remainder of this article steps through the report, identifying those elements that are of particular interest to the business appraiser.

**Figure 1 – The Real Estate Appraisal Process**



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<sup>2</sup>Appraisal Institute, *The Appraisal of Real Estate*, 12th ed., (Chicago, Appraisal Institute, 2001).

## **Report Introduction - Definition of the Problem and Scope of Work**

### **Client and other intended users, and intended use**

These first two elements should be compatible with the corresponding elements presented in the entity valuation. Using an appraisal prepared for a different use, and for different users, raises some sticky questions. If the intended user, as stated in the appraisal, is the client but not the entity valuer, then does the latter have the right to rely on the value conclusion? If there was an error or omission that affected the property value conclusion, and consequently the partnership interest value conclusion, does the entity appraiser have legal recourse?

The most prudent course is to have the real estate appraiser acknowledge the entity valuation or appraiser as an intended user, along with the client, or at least for the client and its assignee. The intended use should then be the same as the intended use of the entity valuation. This can be specified when ordering the appraisal.

But, what to do when the client wants to use an existing appraisal, having a different intended user and use? Under the Uniform Standards of Professional Appraisal Practice, a valuation service is applicable only for the identified use and users, based on an agreement between the appraiser and the client. If the real estate appraiser prepares a report for intended use A, then the appraiser has no responsibility to the client or any other third party if the client decides to use it for use B.

A second set of client/user/use is by definition a new assignment, and since a report is the communication of the results at the end of an assignment, a new assignment means a new report. (In developing the new assignment under these circumstances, an appraiser might rely on work done in a previous assignment, with potential cost savings to the new client, but that does not alter the reality of the new assignment, client/user/use.) The new client/user/use may or may not result in the same value conclusion since the premise of the appraisal might be different; this is discussed below.

All of this is not to say that an older appraisal, prepared for another use, cannot possibly be used for the valuation, only that, if it is so used, the real estate appraiser has no liability for the new use (assuming the original client and use was stated clearly in the original report). It then becomes the responsibility of the entity appraiser to be sure the real estate appraisal he or she is using is consistent with the new requirements. This requires a review of the real estate appraisal, and may burden the entity appraiser with significantly increased responsibility and liability.<sup>3</sup> It definitely benefits the client and the entity valuation to have a

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<sup>3</sup>Some interesting problems can occur when, say, the entity appraiser uses a real estate appraisal that was prepared for another purpose. Suppose the original purpose was financing, and the appraisal was performed only shortly before one of the owners died. The entity appraiser uses the existing real estate appraisal as-is. Distribution of the estate results in a division of assets. At some later point, one of the heirs becomes concerned with whether the division is equitable, and has the property reappraised as of the date of death.

real estate appraisal that is intended specifically for use in the valuation, even if the entity appraiser can offer his or her own opinion of value for the real estate.

### **Purpose of the appraisal**

The purpose is the stated reason for the appraisal assignment, to develop an opinion of the [defined] value of the [specified] real property interest. (Both are discussed further, below.)

### **Real property interest appraised**

This should be the interest held by the partnership, e.g. *fee simple* if not encumbered with leases longer than one year, *leased fee*, or other specified rights. Other, less commonly valued interests are leasehold, sub-leasehold and sandwich lease positions, easements, life estates and others.

### **Type and definition of value**

When specifying the appraisal assignment to the real estate appraiser, it would be a good idea to specify a definition that is entirely consistent, or, better yet, the same as, the definition being used in the valuation.

Real estate appraisals use various definitions of **market value**, although such definitions are also reasonably consistent with **fair market value** used in business valuation, defined as: “The amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.”<sup>4</sup> This definition also comports to Revenue Ruling 59-60 and the IRS Regulations.<sup>5</sup>

It is important to watch for incompatible definitions, especially when using appraisals prepared for another purpose. For example, appraisals prepared for use in eminent domain proceedings may apply a much different definition of **fair market value**, such as: "... the

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The appraised value differs significantly from the lending appraisal, which is subsequently found to be flawed. They look to the original appraiser to make them financially whole. The real estate appraiser notes that his work was performed for the lender, and that the estate was not an intended user. The real estate appraiser may be off the hook, but what about the entity appraiser that used the flawed value in its valuation for the estate?

Some states, including Colorado, allow CPAs to opine on real estate values. Should the entity appraiser also be a real estate appraiser, then such appraiser could conclude real estate value. However, this is not necessarily an advantageous solution, since the work is being done by someone. Under USPAP, changing the value would require conforming with Standard 3, Appraisal Review, and may also involve Standards 1 and 2. An appraisal for a new purpose is always a new appraisal assignment under USPAP.

<sup>4</sup>ASA *Business Valuation Standards—Definitions*.

<sup>5</sup>The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.” *Internal Revenue Service Regulations §20.2031-1(b)*.

highest price on the date of valuation that would be agreed to by a seller, being willing to sell but under no particular or urgent necessity for so doing, nor obliged to sell, and a buyer, being ready, willing, and able to buy but under no particular necessity for so doing, each dealing with the other with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available."<sup>6</sup>

### **Effective date of the appraisal**

Dates of value should be the same for the valuation as for the appraisal. This somewhat obvious notion is nonetheless an issue when the client wants to use an appraisal prepared as of an earlier date, usually for a different use. This can introduce multiple problems for the entity appraiser, as noted earlier.

Without a new (updated) appraisal, and if there has been no value change between the two dates, it *might* be reasonable to handle the dates as part of the valuation: Report the real estate appraiser's statement that market conditions are stable, or at least that further analysis for the later data would not result in a changed opinion of value. If the asset value is changed as part of the valuation, then the real estate appraisal will have been reviewed, and the process is subject to the requirements of USPAP Standard 3. (This only works if the valuation is being prepared by an appraiser who is qualified to appraise the property under consideration. A business appraiser or accountant changing the real estate value, for any reason, might want to consider competency provisions in their governing standards.)

### **Description of the scope of work**

This statement states or describes the extent of the appraisal, and is particularly important for short reports that summarize the data and analysis, retaining important information in the appraiser's workfile. The user should know what the appraiser did do, did not do, and what information was relied upon in developing the value conclusion. Limited scope assignments are entirely suitable for many situations, but it is the appraiser's job, under USPAP, to determine that the reliability of the conclusion is suitable for its purpose and use, and why.

### **Assumptions, hypothetical conditions and limiting conditions**

Often considered boilerplate, but these should be reviewed for incompatible conditions and limitations. Of particular concern would be a hypothetical or limiting condition that was relevant for the real estate as a whole, but not for a noncontrolling interest in the partnership, or limitations that exclude important considerations. (e.g. Excluding the income approach because the market consists almost entirely of owner/users. This issue is discussed below.)

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<sup>6</sup>California Code of Civil Procedure § 1263.320.

## Market Area Data and Analysis

The appraisal includes both broad and local views of economic and other conditions and trends that impact value. Analysis usually begins with the region in which the property is located, although for properties with a national market, say, this section may begin with national conditions and trends. It also includes characteristics of the specific jurisdiction (city or county) and district or neighborhood; generally, everything *external* to the property.

This step satisfies Rev. Rul. §4.01(b), which requires the appraiser to consider “the economic outlook in general and the condition and outlook of the specific industry in particular.” (*Specific industry* means both the real estate industry in general, and the market for the particular property type. Interpreting the Revenue Ruling for real property applications requires some conversion of terminology.)

Of particular interest for our valuation are growth rates and trends, the time frame of any anticipated events (changes in demand/supply relationships, zoning, nearby development, rental market trends, etc.). The buyer of the 100% fee interest will have an anticipated holding period defined by market observation (such as investor survey data), but the period anticipated by a (hypothetical) buyer of the subject interest may depend on specific conditions, and may be substantially different from the market’s. Thus, assumptions used for appraisal of the fee interest may not make sense for the entity.

It is often the case that trends are not quantified in the appraisal. A real estate appraiser that is aware of how the report is being used may be able to anticipate this, but it is more likely that the entity appraiser will need to develop the necessary information in an interview with the appraiser.

## Highest & Best Use

Highest and best use is defined as: “That reasonably probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value.”<sup>7</sup> This section of the report provides the basis for selection of comparables, and the analysis presented in the approaches to value.

The four criteria of highest and best use must be met sequentially; that is, only those uses which are legally permissible and physically possible will then be considered for the productivity tests. All uses which then produce a positive economic return are considered financially feasible, and, finally, those that produce the highest return (are maximally productive) are highest and best.

This section is often shortened to the point that the four elements are not explicitly discussed. This may be appropriate when the existing use of the land is permissible and

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<sup>7</sup>Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 4th ed. (Chicago: Appraisal Institute, 2002).

feasible, and no one expects to replace the improvements with another use in the foreseeable future. However, there are many instances where the situation is less clear, and where a good understanding of the appraiser's highest and best analysis is definitely needed for the valuation.

For example, it is not unusual, particularly in down markets, for the highest and best use of an underdeveloped property to be "hold for future development," since that's exactly what the hypothetical buyer would do in that market at that time. However, the valuation needs more: When is development feasibility expected, based on market trends? Would the *current* owners actually redevelop the property? What if the property just needs a facelift? Suppose a tired retail center is valued assuming capital expenditures and an increased revenue stream. The general partner might not be willing to do this, and future cash flows under his or her management may be very different than for a typical buyer of the 100% fee. (This would not change the concluded value, which is based on a hypothetical sale of the whole property, but it would change expected cash flows, which very much affect the entity valuation.)

Highest and best use may have to be considered further in common tenancy ownership, where feasibility of dividing the property can become an issue. If the property is divisible, then what is the highest and best use of each part? Is it the same, or is it changed? For example, a 10-acre agricultural parcel bordering on suburban development may have "develop with a single-family residence" as its highest and best use. If zoning regulations mandate a 5-acre minimum lot area for residential use, then a two acre parcel (20% of the whole) would not be developable, and its highest and best use may be only its current agricultural use. Thus, the highest and best use analysis provides the key to understanding feasibility of partitioning the property.

Highest and best use is also the key to the value analysis. When ownership issues, consideration of the time element, and other entity-level matters are imposed, *highest and best use can change*. Careful consideration of reasonably probable and legal uses, which are physically possible, appropriately supported, financially feasible, and that result in the highest value, is often needed in order to fully understand the position of the minority interest holder.

## **Cost Approach**

This approach to value is a technique for developing an opinion of value based the cost of developing a similar property, exhibiting the same condition and utility as the subject. This approach process has four steps: (1) Conclude the value of the site as if vacant; (2) Estimate the cost of reproducing or replacing the existing improvements; (3) Estimate and deduct depreciation from all causes; and (4) Add the value of the site to the depreciated value of the improvements.

The cost approach is used most often by market participants when evaluating new construction or special purpose properties. The usefulness of this approach is diminished if differences between the subject and comparable sites are large or site value is otherwise difficult to determine, if the improvements are old and/or obsolete (conditions which result in

large deductions for accrued depreciation) and data to measure depreciation is not adequate, or if the site is not developed to its highest and best use as-if vacant.

The cost approach includes land value analysis, although this is often set apart as a separate section. Land value may be needed independently, or for use in the other two approaches to value, and may be included even when the cost approach is otherwise not appropriate.

## **Sales Comparison Approach**

This approach is a technique for developing an opinion of value by analyzing sales of properties which are similar to the subject. In this process, sales prices are adjusted for *elements of comparison*,<sup>8</sup> or particular differences, between the subject and the individual comparables. Prices are reduced to generally accepted *units of comparison*, between the subject and the individual comparables (e.g. \$/square foot). Once these adjustments have been applied and analyzed, the most indicative of these units is (are) applied to the subject to arrive at a value conclusion.

This approach is often used for smaller properties and in owner/user markets, because values for its application can be obtained and applied with relative ease by market participants. The reliability of this approach is diminished if the differences between the subject and the comparables are large, sufficient market transactions are not available, or if large imbalances exist between the land and its improvements, the property and its environment, or supply of and demand for similar properties.

Transactional data used here, as well as other general market information from surveys and interviews, forms the basis for the appraiser's estimate of exposure time that is linked to the value opinion. It may be presented here, or following the reconciliation, as in the Case illustration. Exposure time may be important if conditions encountered through analysis of the fractional interest argue for some type of shortened period or forced sale.

Other than exposure time data, this approach does not usually contain information that is interesting for the entity valuation.

## **Income Approach**

The most important step in the real estate appraisal process, at least for entity valuation, is the income approach, which relies on the premise that the value of a property is represented by the present worth of its anticipated net income.

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<sup>8</sup>These elements include real property rights conveyed, financing terms, conditions of sale, market conditions, location, physical and economic characteristics, use, and any non-realty elements that may be involved.

The reliability of this approach is diminished if the future benefits that typical buyers expect to receive cannot be directly measured. For example, in owner/user markets (single-family and small units, some industrial/office building markets, property owners are not investors, and their properties do not generate rental income which can be measured. Such owners often anticipate personal or business-related benefits to their occupancy, and base purchase decisions on cost or sales comparison methods.

Regardless of whether income measures are typical for the specific property market, elements of this approach are still needed for the entity valuation, because minority interests are *financial* interests, and the market for minority interests is typically an investor market. When appraising an owner/user property, the appraiser may entirely ignore an income approach, because it often has nothing to do with the actions of buyers and sellers of the particular property. However, the income and expense analysis, capitalization rates, growth rates and other information developed in this approach are almost certainly needed for the entity and minority interest valuations.

This approach partly satisfies Rev. Rul. §4.01(d) and (e), which requires the appraiser to consider “the earning and dividend-paying capacity of the company.” For a real estate holding company, its earning capacity is directly tied to the income-generating capacity of its holdings.

The income approach section of the real estate appraisal includes a forecast of gross rental income, a lease analysis, an expense analysis, and an analysis of capitalization rates. Application of capitalization rates to net operating income<sup>9</sup> gives a value by this approach.

### **Potential Gross Income**

The initial step in this approach is to determine the gross income potential of the property. This potential is based on fair market rental rates and/or scheduled rental income from leases, and may include income from other sources (laundry income in an apartment building, for example). If the property is leased, actual rental income as well as the probability of continuing to receive this income in the future is considered, and compared to the fair rental value of the property. Potential rent is then forecast for the year following the date of value.

If the property is not rented, then a market rental rate is imputed and rent forecast. This can be done even if the property would most likely be occupied by an owner/user.

If leased, the relationship between the rent level, lease terms and market rents and terms becomes important. Is rent above or below current market rents? Or, based on the lease terms, will it be above or below in the future? (e.g. The market may be expecting annual

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<sup>9</sup>The word “income” is not tax-effected in this context. The word “revenue” is not typically used in real estate appraisal, except for hotels.

increases based on the Consumer Price Index (CPI) of 3%, but the lease may provide for an increase at 5%/year, or it may be flat for the remaining term.

If there is such a mismatch between lease and market, the appraiser should conclude whether the lease is likely to be renegotiated (if too high), whether rent can be increased to market on termination (if too low), and analyze the value effect. This can be done by adjusting capitalization or vacancy rates, by calculating the present value of excess or lost rent, or by showing annual rental income explicitly, in a discounted cash flow (DCF) model (discussed below).

The appraiser also forecasts expected vacancy and collection loss, and any expense reimbursements due under terms of the lease(s). Although management may have the right to charge tenants for certain expenses, they may not have done so for a variety of reasons, and the likelihood of receiving agreed reimbursements in the future may be impaired.

Potential gross income, less vacancy and collection loss is termed *effective gross income* (EGI).

## **Expense Analysis**

The next step in the process of determining the income generating capacity of the subject property is to examine its current and historic operating expenses, and then forecast operating expenses which a market participant would expect the property to incur during the year following the date of value. A trailing 12-month forecast is used with direct capitalization, but a multiperiod forecast may also be needed for yield capitalization.

Expense elements are usually divided into three groups; *fixed expenses, variable expenses, and replacement reserves*. Fixed expenses are incurred regardless of whether the property is occupied. Variable expenses are related to the operation of the property, and generally vary with occupancy. Replacement reserves allow for the replacement of short-lived items on an annualized cost basis.

The income and expense statement is typically constructed to show actual expenses at the date of value in one column for reference,<sup>10</sup> and forecast expenses (for the 12 months following the date of value) in a second column. Actual expenses are generally provided by ownership. The forecast is usually developed by the appraiser, and is intended to reflect income and expenses that would be realized after transfer of the property, and based on typical and competent management. This, after all, is what a new owner would expect would happen. Expenses are forecast based on historic patterns, market survey data, and/or projection of current cost items. Some items, such as ad valorem taxes, may be based on the purchase price, and other taxes and management fees might be recalculated based on the forecast EGI.

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<sup>10</sup>This may be the previous reporting period, the expense rates at the date of value, or other (defined) and meaningful period, typically used to support the forecast.

The statement is important for the valuation, since some of the expenses may have to be adjusted to develop an income stream that would be realized within the partnership after transfer of the minority interest. Thus, it would be important to have the reasoning behind each expense stated in the real estate appraisal. For summary reports, it may be necessary to discuss some items with the appraiser to be able to know whether adjustments would be needed. Some expense items that might require adjustment are:

- Management fees

Usually set at a market-supported percentage of EGI, since the fee interest holder can change marketing companies, and would presumably maximize its return. However, a general partner or affiliate might be charging a higher rate, with the apparent agreement of the other partners. Since the minority holder cannot cause the management arrangement to be changed, the actual expense amount should then be used in the valuation.

It is also possible that some of the fee might have been for partnership management services, but allocated to the property. The entity valuation should then show a portion of the fee reallocated to partnership management as a normalization adjustment.

- Property (ad valorem) taxes

Adjustments for property taxes may be necessary (in states where property is only reassessed on transfer) if the appraisal assumes that the new buyer will be taxed based on a reassessment at the appraised value. In that event, such property transfer would *not* be an assumption of the entity valuation, and the actual property taxes expected for the coming year should be substituted for the appraiser's forecast taxes.<sup>11</sup>

- Reserves

Immediate repair requirements may be identified and adjusted in the appraisal, and future repairs might be expressly considered in the DCF analysis. However, it is more likely that the real estate appraiser, guided by the market's method of dealing with such issues, may not consider a potential expenditure that might not be required for several years. An additional reserve for such items may be needed in the valuation unless such a reserve is already implicitly or explicitly included in the real estate appraisal.

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<sup>11</sup>In California, reassessment is triggered if more than 50% of the property interest is transferred. Should the interest be above this threshold, increased taxes would have to be considered, and the new partner might have to bear the entire increase by some agreed-upon formula.

The need to make adjustments does not affect valuation of the 100% fee, since the appraisal's forecast is constructed to emulate the expectation of a buyer who will control the entire property.

## **Income Capitalization**

Capitalization is a generalized process, used to convert expected future benefits into a present value. The process may include a detailed analysis of the income stream, as in *yield or discounting methods*, typified by analysis of explicit annual cash flows in a DCF model. Explicit analysis is typically done for larger properties (being the normal process of institutional and other sophisticated investors), and for properties whose income stream is not "stabilized" (such as a shopping center or office building undergoing renovation, or nonmarket rent levels under short-remaining term leases.) This type of analysis is ideal for developing the entity valuation, since growth and yield rates are made explicit, as are future cash flow-influencing events.

*Direct capitalization* (or just capitalization, in business valuation parlance<sup>12</sup>) is a method used to convert a single year's<sup>13</sup> income expectancy into an indication of value in one direct step; usually by dividing the net income estimate by an appropriate *overall capitalization rate* ("overall rate," O.A.R. or Ro).

There are lots of data sources. The appraiser will typically extract rates from local market transactions, and also use published investor survey data<sup>14</sup> when the market for the property is adequately described by the investors being surveyed.

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<sup>12</sup>Capitalization is defined as: "A conversion of a single period of economic benefits into value"—*International Glossary of Business Valuation Terms, second edition*, a joint effort of the American Institute of Certified Public Accountants (AICPA), the American Society of Appraisers (ASA), the Canadian Institute of Chartered Business Valuators (CICBV), the National Association of Certified Valuation Analysts (NACVA), and the Institute of Business Appraisers (IBA). By contrast, capitalization is defined more generally in the real estate context as: "The conversion of income into value"—*Dictionary of Real Estate Appraisal*.

<sup>13</sup>The single year is typically the trailing 12-month period, but an annualized current amount is sometimes used. The real estate appraiser should match the period to the data source from which the capitalization rate is developed.

<sup>14</sup>PriceWaterhouseCoopers, "The Korpacz Real Estate Investor Survey," CB Commercial, "National Investor Survey," Realty Rates.com "Quarterly Investor Survey," Real Estate Research Corporation, "RERC Real Estate Report," and others.

*Yield capitalization*<sup>15</sup> uses a discounted cash flow model,<sup>16</sup> where the annual patterns for income and expense items are made explicit. This is the great advantage of such a model: it leaves nothing to the imagination. Annual rental income can be shown varying with lease turnover, if its pattern is expected to be unusual. Vacancy and collection loss and expense reimbursements can be likewise varied by year. Expenses that are a function of income (like management fees) are shown varying with EGI. Reserves for major repairs or capital replacements can also be made explicit, although it is more typical to show a constant annual amount for this item. Growth rates are applied for individual items, and expected growth for both cash flows and value can be calculated directly from the DCF model.

The model assumes termination of the investment at the end of the selected period (the “reversion” of the property), usually by applying an overall rate (termed a “terminal rate” or “going-out rate”) to the expected NOI for the year following the period (year  $n+1$  for a holding period of  $n$  years). The terminal rate usually bears a relationship to the overall rate discussed above for direct capitalization (also called the “going-in rate”), and can be developed in the same way, or from investor survey data.

The terminal or reversionary value might be developed differently if, for example, the improvements were expected to be worthless at the end of the holding period, and the property sold for land value to a developer. In that case, a land value would have to be forecast or projected to the end year, and that value would be used directly for the reversion.

A yield (discount) rate is developed in the same manner as for direct capitalization, although more reliance tends to be placed on investor survey data sources, since extracting such rates from local market transactions is much more difficult than extracting overall rates. There may be more than one discount rate required, depending on the relative risk of the cash flows involved. (A land value reversion may be more risky, or less risky, than reversion for a property in continued use, for example. One rate would be used for cash flow, and another for the reversion.) With multiple rates, an internal rate of return (IRR)<sup>17</sup> could be calculated, giving a single yield rate representing the risk associated with the real estate asset.

Rates for this purpose are not typically built-up from risk-free (or “safe”) rates as often in real estate appraisal as they are in business valuation, because of the abundance of

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<sup>15</sup>Yield rate (Y) is defined as: “A rate or return on capital, usually expressed as a compound annual percentage rate. A yield rate considers all expected property benefits, including the proceeds from sale at termination of the investment.”—*Dictionary of Real Estate Appraisal*. A yield rate is used here as a general term for a total investment return. It is the same as a discount rate, but the word “discount” is also applied for control and marketability impairment, and use of yield rate rather than discount rate helps avoid confusion.

<sup>16</sup>The discounted cash flow method is defined as: “A method within the income approach whereby the present value of future expected net cash flows is calculated using a discount rate.—*International Glossary of Business Valuation Terms*. By contrast, yield capitalization is defined in the real estate context as: “The capitalization method used to convert future benefits into present value by discounting each future benefit at an appropriate yield rate or by developing an overall rate that explicitly reflects the investments income pattern, value change and yield rate.”—*Dictionary of Real Estate Appraisal*.

<sup>17</sup>A profitability measure similar to the equity yield rate.

transaction data. As a result, yield rates for real estate holding entities that are developed from yields appropriate for the underlying assets can be more reliable (less subject to the appraiser's judgment) than entity yields developed using build-up methods.

Capitalization rates are discussed in Revenue Ruling 59-60 §6.0, where it states that “a determination of the proper capitalization rate presents one of the most difficult problems in valuation.” The stated most important factors influencing capitalization rates are the nature of the business, the risk involved, and stability or irregularity of earnings. The market-derived rates developed in the real estate appraisal account for the nature of the business, risk, and stability issues for the real property at the asset level of value.

### Yield capitalization and financing

Use of direct or yield capitalization is typically a real estate appraisal decision, based on the property type and the way buyers make purchase decisions, and for the other reasons mentioned above. However, it is also needed to develop yield rates at the minority level when financing is present. The declining loan balance and resulting “equity buildup” prevents using simplified methods for calculating minority yields, and the entity valuation will need a DCF model, regardless of whether the real estate market considers it important or not.

Developing a DCF only for the entity, without one first having been developed for the real property, requires the entity appraiser to make many assumptions concerning the property that would be better made by the real estate appraiser. Accordingly, the best course with financing present, is to require that a yield capitalization be included in the real estate appraisal, even if it is not needed to develop or support the property value conclusion itself.

### Holding period selection

Yield capitalization requires an explicit holding period, selected to match the typical hold for investors in that property type, and in that market area, but possibly adjusted to accommodate some characteristic of the property (expiration of a lease, or a license, for example). However, this may not be the holding period that the buyer of a minority interest in the partnership would expect, because many other facts and circumstances affect the minority holder. It may be necessary to change the period, depending on decisions made by the appraiser of the minority interest. This may require construction of another DCF model, not to recompute the real property value, but to develop accurate yield and growth rates for the valuation.

(A changed period for unstabilized properties could also change the terminal value, which can be a problem for cotenancy and other situations where the interest being valued has the ability to force sale.)

## Reconciliation of overall, yield and growth rates

As this chapter has noted, various rates may or may not be included in the appraisal, but they are often needed for the valuation analysis, and should be obtained from the real estate appraiser.

The ideal appraisal, for partnership valuation purposes, has a discounted cash flow model where the yield rate ( $Y$ ) and growth rates ( $\Delta\alpha$ <sup>18</sup>) are explicitly stated. However, direct capitalization with its overall rate ( $R_O$ ) is the most common. Growth is implicit in this direct model, and the real estate appraiser may have had no need to expressly state growth rates. In that case, the yield rate needed for the valuation may usually be developed from the overall rate by using the constant growth model:<sup>19</sup>

$$Y = R_O + \Delta\alpha$$

Growth rates refer to both distributions and value or reversion, and the valuation may need both.  $\Delta\alpha$  in the model above is a blended rate that reflects the total change or growth in cash flow and value. If the real estate appraisal uses only direct capitalization, then all three expressions of  $\Delta\alpha$  (cash flow, reversion, and a combined term) may have to be obtained. All rates used in the valuation should apply for the period that a buyer would expect to hold the subject interest.

If the property is not income-producing, then the above rates may have to be imputed. Since the yield rate  $Y$  is intended to be a measure of overall risk associated with the property, it may be necessary to find a proxy for risk.

## **Reconciliation and Conclusion of Value**

The last step in the appraisal process is to evaluate each of the approaches to value, and reconcile their value indications into a final value conclusion. This process is the same for any valuation that involves multiple methods, and applies equally to multiple methods of developing rates, or discounts, or intermediate conclusions at any level of value.

The approaches or methods are each evaluated for their *appropriateness*, *accuracy*, and the *quantity of evidence* on which its value indication is based. Appropriateness is judged by how well the procedures used in each relate to the purpose of the appraisal, the characteristics of the subject property, and the way market participants make decisions. Accuracy refers to the appraiser's confidence in the data, adjustments required, and the resulting precision of

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<sup>18</sup>  $\Delta\alpha$  is an adjustment rate, the  $\Delta$  denoting change. This nomenclature is consistent with that used in *The Appraisal of Real Estate*. Other sources may use different designations.

<sup>19</sup>See *The Appraisal of Real Estate*, page 561, and Pratt, Shannon P., DBA, CFA, FASA, et al. *Valuing a Business, The Analysis and Appraisal of Closely Held Companies*, 4th ed. (Chicago: Irwin Professional Publishing, 2000): 206-208.

indicated values contained within the approach. Quantity of evidence presented affects the statistical validity of the value indication.

As with many such procedures, a summary real estate appraisal might not state the process by which the reconciliation is performed, but the approaches should be evaluated on this basis nonetheless.

## Reports

The appraisal process may be complete or limited; if the latter, then the specific limitations must be identified in the report. If a self-contained report, then the user of the report should have a full presentation of the data and reasoning that lead to the value conclusions. The summary report is provided a great deal of latitude by USPAP. Unfortunately, it is entirely possible, even likely, that it will summarize away key information needed for the entity valuation. Details of many of the internal steps of the appraisal process discussed above need to be understood, but if those details are not presented in the real estate appraisal, then the entity appraiser will often have to fill in the missing information by questioning the real estate appraiser. Such limitations may violate Standard Rule 2-1(b), which states that each report must “contain sufficient information to enable the intended users of the appraisal to understand the report properly.”

Form reports are almost always summary reports, and are typically used for residential and some small commercial properties. The forms are not designed with entity valuation in mind, however, and such reports almost always are short on information, such as growth rates.

Restricted use reports, are intended for a specific user, who is known to be familiar with one or more topics that would normally be included in a summary or self contained report. Much information can be left out or drastically truncated due to this familiarity, often providing significant cost savings for the client. Such reports are not suitable for use with entity valuations.<sup>20</sup>

## Conclusions

This article has presented an overview of the most commonly encountered real estate appraisal process and methods, with the intention of giving real estate appraisers an explicit idea of what they can include in appraisals that are to be used in entity valuations, and to give entity appraisers and other users of real estate appraisals an idea of what to expect from the real estate appraisal.

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<sup>20</sup>The Comments to Standard Rule 2-1 state that when the intended users include parties other than the client (such as the entity appraiser, attorney, accountant, IRS), either a self-contained or summary report must be provided.

There are great dividends to be had through collaboration of both appraisers at the beginning of the assignment. In addition to proper consideration of purpose, use, definitions of value, and the premise of both the appraisal and the valuation, the overall process will be strengthened, and each appraiser will be applying his or her talents within the appropriate discipline.

Revenue Ruling 59-60 is used as a guide to both the appraisal and the valuation; the overall valuation is an integrative process that begins with the real property for real estate holding companies.

There are many less-used but valid and interesting applications of real estate appraisal techniques. The most comprehensive and up-to-date reference on the topic is “The Appraisal of Real Estate” published by the Appraisal Institute, and footnoted throughout this book. This reference should be in the library of every serious user of real estate appraisals.

**Dennis A. Webb, MAI, ASA** is the owner of Primus Valuations, a Los Angeles regional valuation firm. He authored Valuing “Undivided Interests in Real Estate: Partnerships and Cotenancies,” published by the Appraisal Institute, and can be reached at [dwebb@primusval.com](mailto:dwebb@primusval.com).