ATTACHMENT 7-A

VALUE TYPES USED IN MULTI-FAMILY APPRAISALS

A discussion of the various types of value used in Rural Housing Service (RHS) appraisals follows. A definition of each value type and the source for each definition is provided. These value types and definitions are acceptable for use by State Contracting Officers in writing a Statement of Work (SOW) and a Request for Quote (RFQ) when contracting for an appraisal and by appraisers in writing a Multi-Family Housing appraisal for RHS. General procedures for developing and reporting some of these value types are included.

Market Value

The 4th Edition of The Dictionary of Real Estate Appraisal includes several definitions for *market value*. The following definition from the dictionary is used by the federal agencies that regulate insured financial institutions in the United States.

"*Market value: the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:*

- *Buyer and seller are typically motivated;*
- *Both parties are well informed or well advised, and acting in what they consider their best interests;*
- *A reasonable time is allowed for exposure in the open market;*
- *Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and*
- *The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.*"

Most appraisers and users of Agency Multi-Family Housing appraisals understand the definition of *market value* to mean the value as a conventional or unrestricted or market property. However, to avoid confusion when requesting or reporting this value type, the term "as conventional or unrestricted" should be added to the term *market value* (i.e. "market value, as conventional or unrestricted").

In an appraisal report, a *hypothetical condition* on which the *market value* is based should be clearly and conspicuously stated. The *market value* of a Section 514/515 housing project is always based on a *hypothetical condition*, which is defined by the 4th Edition of The Dictionary of Real Estate Appraisal as, "that which is contrary to what exists but is supposed for the purpose of analysis." An existing 514/515 apartment complex that is the subject of an appraisal ordered by the Agency is subsidized (restricted) at the time of the appraisal. A market value concluded for the property would be based on the hypothetical condition that the property is a conventional (market) property, which it is not. *Uniform Standards of Professional Appraisal Practice*

(*USPAP*) Standards Rules 1-2(h) and 2-2(a)(viii), (b)(viii), and (c)(viii) require the appraiser to identify and state any hypothetical conditions necessary in the assignment.

Market value should be requested by the Contracting Officer and reported by the appraiser when the intended use of the appraisal is to aid in determining:

- the appropriate amount of an equity loan as a prepayment incentive;
- the amount of an equity loan in a preservation transfer;
- a reasonable sale price, or the basis for a liquidation value, for a property in foreclosure; or
- a reasonable sale price for a non-program property.

Market Value, subject to restricted rents

A definition of *market value, subject to restricted rents*, as the term is used by RHS, derived from the definition of *market value* above, is stated as follows. *Market value, subject to restricted rents: the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:*

- *Buyer and seller are typically motivated;*
- *Both parties are well informed or well advised, and acting in what they consider their best interests;*
- *A reasonable time is allowed for exposure in the open market;*
- *Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and*
- *The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.*

It considers any rent limits, rent subsidies, expense abatements, or restrictive-use conditions imposed by any government or non-government financing sources but does not consider any favorable financing involved in the development of the property.

Market value, subject to restricted rents, refers only to the value of the subject real estate, as restricted, and excludes the value of any favorable financing. The *market value, subject to restricted rents,* is based on a pro forma that projects income, vacancy, operating expenses, and reserves for the property under a restricted (subsidized) scenario. This restricted pro forma includes the scheduled restricted rents, a vacancy and collection loss factor that reflects any rental assistance (RA) or Section 8, and operating expenses and reserves projected for the subject as a subsidized property. Subsidized apartments typically experience higher management, auditing, and bookkeeping expenses, relative to similar conventional apartments, but often have lower real estate tax expenses.

Rural Development will provide a 3-year operating history of the subject property and the most recent operating statements for a set of expense comparables, if available, to the appraiser.

Expense comparables data is proprietary information. Therefore, if a copy of the appraisal is requested by an owner/applicant, the names and locations of the expense comparables must be redacted from the appraisal by the Agency before the copy is released. Much of this information is available on the Multi-Family Information System (MFIS). For the appraisal of a Section 8/515 project, Rural Development should provide the appraiser with a copy of the Housing Assistance Payment (HAP) contract and a contact at the agency that administers the HAP contract for the U.S. Department of Housing and Urban Development (HUD). The appraiser must consider the restrictions imposed on the subject property by both the U.S. Department of Agriculture (USDA) and HUD in concluding the *market value, subject to restricted rents*.

In the appraisal, the Income Approach for the *market value, subject to restricted rents,* is the best indication of value and should be most heavily weighted. Direct capitalization should typically be used when the subject's operation will be stable and restrictions will be in place long-term. A discounted cash flow (DCF) analysis should be used when significant net income changes are projected for the subject property over a foreseeable period. A DCF is the most appropriate method for valuing phased developments, projects that have several sources of income, and properties with short-term restrictions that will be converted to market apartments.

Using direct capitalization, the Net Operating Income (NOI) from the restricted pro forma can be capitalized using a capitalization rate derived from sales of conventional apartments that have physical and locational characteristics similar to those of the subject. A base capitalization rate is derived from these sales and then adjusted qualitatively for factors related to specific benefits and restrictions of the subject property. Use of an overall rate from the conventional market, which reflects conventional financing, is appropriate because all favorable financing will be valued separately from the *market value, subject to restricted rents,* of the real estate. This procedure, a departure from the method used by the Agency for many years, is standard appraisal practice. National appraisal firms and their clients use this as a primary method in the valuation of subsidized housing. A capitalization rate derived via this method should be supported using other accepted methods, including the band-of-investment technique, the debt coverage ratio formula, and regional investment criteria surveys.

A method that includes the use of note rate rent as Potential Gross Income (PGI) in the Income Approach pro forma to derive a value equal to the sum of the *market value, subject to restricted rents,* plus the value of the interest credit subsidy is not acceptable appraisal practice. Appraisers must not use this procedure in Agency Multi-Family Housing appraisals, and State Appraisers must not accept this procedure when reviewing appraisals.

In an appraisal concluding *market value, subject to restricted rents*, the Income Approach is the most important section of the appraisal and must be complete. Appraisers must provide good support for the income, vacancy, expense, and capitalization rate analyses within the approach. The expense analysis must be well supported by the 3-year operating history of the subject and by expense comparables. A current expense survey from RHS or a State or local housing authority should be used to provide additional support. The capitalization rate selected for the subject must be derived from the most recent sales of similar properties in the local (or nearest similar) conventional apartment market. Support for this overall rate should be provided using the methods discussed above. Rural Development appraisers performing technical reviews must not accept appraisals unless/until all Income Approach analyses are adequately supported.

The Cost Approach can be used to support the *market value, subject to restricted rents,* indication from the Income Approach, especially for new construction. The usefulness of the *market value, subject to restricted rents,* indication via the Cost Approach for existing properties more than twenty years old (typical of the RHS portfolio) is questionable due to the difficulty in estimating the three types of depreciation. However, when ordering appraisals, the SOW should require the Cost Approach for determination of *market value, subject to restricted rents.* Important information, including site value, construction costs, remaining economic life, and external obsolescence, can be extracted from this approach. Deduction for external obsolescence, which is basically calculated by capitalization of the difference between economic NOI and restricted NOI, results in a *market value, subject to restricted rents,* indication in the Cost Approach.

The Sales Comparison Approach is rarely applicable in concluding a *market value, subject to restricted rents,* due to the lack of sales of subsidized apartments in small rural markets and the difficulty of making meaningful adjustments for financing terms to the sales comparables. When ordering appraisals, the SOW should not require the Sales Comparison Approach for determination of the *market value, subject to restricted rents.*

The *market value, subject to restricted rents,* must include the value of any rental assistance (RA) available. When the subject property has RA, the appraisal must include a discussion of the Section 521 Rental Assistance Program, the number of RA units at the subject, and how RA affects the *market value, subject to restricted rents,* of the property. Rental assistance is a rent subsidy provided to owners of 514/515 projects. The renter of an RA unit is required to pay a tenant contribution toward the approved shelter cost (rent plus tenant based utilities) of the unit that is equal to no more than 30 percent of his/her income. RA is the portion of the approved shelter cost paid by the Agency to compensate a borrower for the difference between the approved shelter cost and the tenant contribution. RA usually adds value to a 514/515 project in three ways: 1) it guarantees that the scheduled base rate rent for all occupied RA units will be attained; 2) it usually increases demand for the subject's units and consequently decreases the vacancy rate; and 3) it reduces the risk of investment in the subject project by improving the durability of the income stream. Rental assistance need not be separately valued; the value of RA can be incorporated within the *market value, subject to restricted rents.* This can be accomplished within the Income Approach by taking into account the three ways that RA increases value, listed above, as follows. 1) Base rate rents should be included as Potential Gross Income (PGI) in the restricted pro forma; 2) a vacancy and collection loss factor that reflects the amount of RA at the property should be included; and 3) a capitalization rate for the subject may be adjusted downward to account for the reduced risk to the investor due to RA.

When determination of *market value, subject to restricted rents,* is part of an appraisal assignment, all favorable financing in place at the time of the appraisal must also be valued, but separately from the real property. Multi-layered financing, involving multiple financing sources, has become the norm in the building and rehabilitation of affordable housing. Favorable financing is offered to developers of subsidized housing to offset external obsolescence that results from a weak apartment market and restrictions placed on the properties by the financing sources. Favorable financing is valuable to the developer/owner, and an appraiser can calculate the value of each type of favorable financing. Several types of favorable financing can be used to develop 514/515 projects, including 514/515 direct loans with interest rates as low as 1 percent, low-interest loans from non-Agency sources, tax credits, tax-exempt bond financing, and grants. When favorable financing is involved, the appraisal report should contain a narrative identifying each source of financing. The amount and terms of each type of favorable financing should be described, and each type of favorable financing should be valued separately from the *market value, subject to restricted rents,* of the property. The appraisal SOW should specifically request each value type required, including the value(s) of each type of favorable financing.

Valuation of "interest credit subsidy" from Section 514/515 loans should be consistent with Attachment 7-H. The methodology presented in Attachment 7-H can also be used to calculate the value of low-interest loans from non-Agency financing sources.

It is emphasized that the *market value, subject to restricted rents,* includes the value of any rental assistance at the subject property but does not include the value of any favorable financing, including Agency financing. The value(s) of any favorable financing must be reported separately. The *security value* of the property, which may be calculated by an Agency Loan Originator in making a loan decision, is typically derived from the sum of the *market value, subject to restricted rents,* plus the total value of the applicable favorable loans. However, an appraisal report should conclude with the value(s) of the real estate and separate value(s) for any intangible items, including favorable financing. These values should not be added together by the appraiser because their sum does not represent the market value of the real estate in appraisal terms. Separate reporting of value(s) of favorable financing, including the value of tax credits and grants, which cannot be considered collateral for a loan is advised by *USPAP* (Advisory Opinion 14) and provides useful information about the security of the project to the Loan Originator.

"As-Is" Value

The 4th Edition of the Dictionary of Real Estate Appraisal defines *value as is* as follows. "*Value as is: the value of specific ownership rights to an identified parcel of real estate as of the effective date of the appraisal; relates to what physically exists and is legally permissible and excludes all assumptions concerning hypothetical market conditions or possible rezoning.*"

The term "As-Is" applies not only to the physical condition of the subject property at the time of the appraisal but to the legal status of the property. Therefore, the term "As-Is" should not be used with the term *market value* unless the property is a conventional or market property at the time of the appraisal. The term "As-Is" should precede the term *market value, subject to restricted rents,* when the *market value, subject to restricted rents,* of the project at the time of the appraisal is required.

Prospective Value

The term *prospective value* is defined by the 4th Edition of The Dictionary of Real Estate Appraisal as follows. "*Prospective value: a forecast of the value expected at a specified future date. A prospective value opinion is most frequently sought in connection with real estate projects that are proposed, under construction, or under conversion to a new use, or those that have not achieved sellout or a stabilized level of long-term occupancy at the time the appraisal report is written.*"

As used in Agency regulations and instructions, the term "as-improved value" refers to the value of real property after completion of proposed improvements. The Agency's intended meaning of "as-improved value" is the same as the definition of *prospective value*. However, use of the term "as-improved value" can cause confusion for two reasons, as follows. 1) The term "as-improved", as used in a Highest and Best Use analysis, refers to the subject real estate as it has already been improved at the time of the appraisal, not as it is proposed to be improved. Therefore, "as-improved value" could be interpreted to refer to the value of the subject property as it has already been improved at the time of the appraisal. 2) There is a common misconception with the use of the term "as-improved value" that this is a value based on a hypothetical condition; that is, the value of the property as if it were improved, as proposed, as of the date of inspection. Since this scenario is impossible, an "as-improved value", as of appraisal date (inspection date), is not useful. The term *prospective value* is better understood than the terms "as-improved value" and "as-complete value" by appraisers and users of appraisals and has replaced these terms in appraisal literature and common usage. Therefore, the term *prospective value* should be used when requesting or reporting a forecasted value, and the associated date of value should be the projected date of completion of construction.

Value-in-Use

The 4th Edition of The Dictionary of Real Estate Appraisal defines *use value (value-in-use)* as follows. "*Use value: the value a specific property has for a specific use; may be the highest and best use of the property or some other use specified as a condition of the appraisal.*"

Value-in-use is the type of value that should be requested in the appraisal SOW and reported in the appraisal of an on-farm labor housing project. The Cost Approach is the only applicable approach in an appraisal of on-farm labor housing. This type of property does not produce rental income, and sales of these projects are virtually non-existent. Consequently, the Cost Approach is the only approach to value that should be required in the appraisal SOW and included in the report by the appraiser.

USPAP requires a Highest and Best Use (HBU) analysis in all real property appraisals when the value type to be developed and reported is *market value*. When *value-in-use* (not *market value*) is to be concluded, *USPAP* does not require a HBU analysis and neither does the Agency. The Agency identifies the use or intended use of the subject property as farm labor housing to the appraiser. Therefore, the appraisal SOW for a *value-in-use* appraisal should instruct the appraiser to value the property as farm labor housing and not require a HBU analysis as part of the scope of work. The appraiser should explain in the report why a HBU analysis was omitted and include a *limiting condition* in the report that states the *value-in-use* is based on the specified use of the subject property as farm labor housing.

Liquidation Value

Liquidation value is defined by the 4th Edition of The Dictionary of Real Estate Appraisal as follows. "*Liquidation value: the most probable price that a specified interest in real property is likely to bring under all of the following conditions:*

1. *Consummation of a sale will occur within a severely limited future marketing period specified by the client.*
2. *The actual market conditions currently prevailing are those to which the appraised property interest is subject.*
3. *The buyer is acting prudently and knowledgeably.*
4. *The seller is under extreme compulsion to sell.*
5. *The buyer is typically motivated.*
6. *The buyer is acting in what he or she considers his or her best interest.*
7. *A limited marketing effort and time will be allowed for the completion of a sale.*
8. *Payment will be made in cash in U.S. dollars or in terms of financial arrangements comparable thereto.*
9. *The price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.*"

Liquidation value should be requested in the appraisal SOW and reported in the appraisal when it is in the best interests of the Agency: 1) not to take a non-program property into inventory but to sell it at a foreclosure sale; or 2) to dispose of a non-program inventory property when a very limited marketing period is available. *Liquidation value* should be derived from *market value* by applying a discount extracted from the market, when possible. Therefore, *market value* should always be requested in the appraisal SOW whenever a *liquidation value* is sought.

Insurable Value

A definition of *insurable value* acceptable for use in Agency Multi-Family Housing appraisals is as follows: *Insurable value: the value of the destructible portions of a property which determines the amount of insurance that may, or should, be carried to indemnify the insured in the event of loss. The estimate is based on replacement cost new of the physical improvements that are subject to loss from hazards, plus allowances for debris removal or demolition. It should reflect only direct (hard) construction costs, such as construction labor and materials, repair design, engineering, permit fees, and contractor's profit, contingency, and overhead. It should not include indirect (soft) costs, such as administrative costs, professional fees, and financing costs.*

The term "insurable cost" is sometimes used instead of the term *insurable value* because it is based strictly on a cost estimate, not a value concluded in an appraisal. However, the term *insurable value* is more commonly used. Attachment 7-I, *Insurable Value Calculation*, is a worksheet that should be used as a guide by State Appraisers and fee appraisers contracted by the Agency in calculating *insurable value*.