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Know the market when valuing core institutional assets

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Experienced commercial real estate appraisers know that their basic task is to mirror the market. In that sense, the appraiser's analysis and conclusions should replicate the activities and concerns of informed investors.

Not surprisingly, the appraisal of large, institutional assets is no exception. Appraisers should consider the thought process of market investors, first in defining the asset as of institutional quality and then in valuing it accordingly. Some thoughts on asset definition:

First, core and core-plus assets are almost without exception in infill locations. Moreover, both the MSA and specific sub-market must be viewed favorably within the list of national alternatives. Econometric rankings of cities by investors starts with consideration of their sheer population, but then focuses on the outlook for employment growth, diversification by industry and cyclical history.

The top five cities nationally include New York, Washington D.C. and San Francisco, all of which have significant inventories of institutional assets. Ultimately, most of the top 40 largest cities in the country have some degree of core and core-plus investment.

Second, the physical characteristics of a property must lend itself to institutional investment. Generally speaking, the minimum investment for institutional capital is $35 million, given the relevant economies of scale. The maximum investment varies, but for many investors is $100 million. That being said, larger deals often attract co-investment, and certainly larger is better in terms of drawing "only" institutional capital. Also regarding the physical elements: buyers prefer new. Older buildings can still be attractive to institutional investment, but have to be in very strong locations and in excellent condition.

Third, and finally, the income characteristics of an asset are critical in driving institutional interest. Generally speaking, longer-term leases and staggered expirations are preferred. Investments must almost always be well-occupied, and should have a favorable relationship between market and contract rent. Ground leases are not desirable, and tenant credit is a given.

If the locational, physical and cash flow attributes of an asset define it appropriately, then the valuation exercise for investors and appraisers alike becomes one of establishing return assumptions and generating a value opinion.

The Cost Approach should focus on un-depreciated replacement cost. Investors commonly discuss this item and its implications for appreciation. Could we build it for less? What is the return on cost? Does the market have to appreciate to support new supply? What happens to our investment when the market does add supply?

The best cost data comes from cost comps - recent if available, older if not. Service-based cost estimates are not considered valuable input to the institutional client. Ultimately, the ratio of market value to replacement cost is the key consideration, not depreciated value.

Land sales should be analyzed on the basis of their utility - price per FAR, for instance. A good land sale analysis and valuation can provide an excellent understanding of overall market velocity. What are the land sales telling us?

Next, the Sales Approach can provide a wealth of information for institutional clients. For the appraiser, research effort on verifying sales and calling brokers can really pay off. If institutional clients want one thing, it's for the appraiser to know the market.

With regard to comp selection, institutional investors absolutely do look at other MSAs for "relative" sale data - you should, too. Cap rates should be developed on multiple levels: as is, as stabilized and at market rent. Data on IRRs and cash yield ratios is also critical. In this rapidly changing market, sales from 2010 are not relevant - appraisers should use recent comps if at all available.

The good news for appraisers is that reconciling your Sales Approach should be quite easy with this type of research. If you can place the subject value (from the Income Approach) within the context of the sale data, the specifics of your adjustment grid are typically not a significant concern for the reviewer.

Finally, the Income Approach is the showpiece of the appraisal for the institutional client. Yes, the client will want a copy of the financial model, and the cap rate and financial returns should make sense relative to the prevailing market. The direct cap and DCF should show similar values - why wouldn't they?

While institutional appraisals are typically un-leveraged, debt pricing is a critical consideration. For LTVs in the 40-50% range, appraisers should find reliable contacts and not rely on published surveys. Survey data is often not associated with top tier assets and borrower credit and is therefore not reliable.

In closing, for appraisers that want to tap the institutional market as a source of good business, good fees and interesting work, the advice is simple: know the market. Develop relationships with market participants, confirm sales and don't rely on published data. With the information you collect, mirroring the market will be quite easy to do.

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