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Next on the hit list: Could it be the commercial real estate appraisals?

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Real estate appraisals are crucial in real estate lending transactions. Whether the loan is residential or commercial, the appraisal is a central document with respect to value. For commercial deals, the appraisal addresses factors such as the size of the building, its income (if applicable), the market environment in which it functions, and other concrete and interpretative factors.

Most knowledgeable market participants now that an appraisal is an opinion, albeit a supported one, and that there are many factors that can affect the accuracy and the credibility of an appraisal. Most also now that the value is subject to a myriad of assumptions and conditions and the art in writing and correctly interpreting an appraised value is often in understanding and identifying those assumptions and conditions.

Most informed users understand that the appraisal is a decision-making tool, one of many. Those who rely solely upon appraisals for loan decision making will probably go down with the ship when the loan goes bad.

An article in the New York Times by Julie Satow discusses a recent study published in CRE Finance World found "just how inaccurate these appraisals can be." The study used data from thousands of securitized real estate transactions between 2007 & 2011 where the properties were taken back by lenders and subsequently liquidated. The study, by KC Conway of Colliers International, and Brian Olasov, a managing director at McKenna Long & Aldridge, found wide discrepancies between appraised values and the eventual sales prices of the properties.

The reporter quotes one of the authors: "This study confirms what many of us have thought but heretofore have only known anecdotally: That appraisals are not very accurate," Mr. Conway said.

The study found that appraisals overvalued properties, often significantly. Of 2,076 properties examined, 64% were appraised at values that exceeded sale prices, while 35.5% were appraised at less than the sale price.

At the extremes, the appraised value was more than double the sale price, and in 132 examples, the appraisal was less than 70 percent of the sale price. The authors commented on the results that appraisal is like "a game of horseshoes and throwing grenades ... Close is good enough."

I read the study: provocative findings and comments. I was intrigued with this study since it dealt with recent data and dealt with it in a systematic fashion. The results were not startling and appraisals and appraisers did not fare well based on the study's conclusions.

The study is a good beginning in understanding the role appraisals play in lending transactions. However, the study is not without its flaws and certainly should not be considered definitive.

The study did not do a good job in adjusting for factors that could affect appraisal "accuracy" such as extraordinary assumptions and other conditions and assumptions that assume something uncertain would occur. If that something did not take place, the "assignment results would be

affected" in the language of USPAP. For example, if a major tenant pulled out, or the local economy crashed, or the subject's market unexpectedly turned, or the project was not built out as appraised, these are all factors that might cause the appraisal to be "inaccurate."

Before condemning all commercial appraisals to an ignominious end based on a single study, more academic work needs to be done in this area using large samples and rigorous methodologies. Done correctly, valuable insights would result that would ultimately improve the art and science of appraising.

To conclude based on one study using data that is not representative of the industry as whole, and not controlling for the possibility of legitimate divergences, that the entire process is flawed is wrong. I will return to this subject; you can count on it.

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