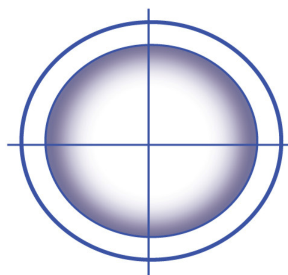

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The Appraisal & Effective CRE Loan Underwriting

It's More Than Just Comps, Cap Rates & Even the Value Estimate

November 15, 2012 by William L. Pittenger, MAI, SRA

A reliable appraisal report is an important piece of information that a bank should use when evaluating a prospective borrower's ability and willingness to repay a loan. In today's troubled real estate markets, where distress transactions often outnumber new originations, the appraisal is also an essential tool in loss mitigation, workout or asset disposition. Regardless of the proposed decision, the appraisal report should include reliable and relevant information about the security property and its competitive marketplace, which the user should then use to formulate an informed business decision. Indeed, when reliable property and market information are combined with reliable borrower information, such as that obtained from loan applications, financial statements, credit reports and other relevant documents, the bank should be well prepared to make a an informed and reliable business decision.

Too often, however, banks underutilize the appraisal. They fail to accept the economic reality that value alone does not repay a loan. Cash does. With a commercial real estate loan, the property, not the borrower, must produce sufficient revenue to both operate the property and service the debt. If it can't do both throughout the life of the credit arrangement, repayment could be in jeopardy. If one accepts that premise, it follows that the bank's underwriter should first identify and then seek to mitigate property and market conditions that will most likely frustrate the property's ability to produce sufficient cash. Oftentimes however, mitigation is impossible and that means the bank should walk away from a proposed loan or change strategy in a workout situation.

But what about borrower guarantees? Most community banks require them. In reality, however, they are rarely sufficient to pay the debt if the property does not perform. Guarantees tend to be more psychological than financial.

At the risk of over simplification, a skilled commercial loan underwriter or credit analyst could make a yes or no loan decision without knowing the value of the security property as long as they had reliable property, market and borrower information. With that information, and assuming thorough and meaningful analysis, they will have identified the most significant risks to repayment.

From a property risk perspective, for example, the analyst or underwriter will have identified what is *wrong* with the security property and how those defects might affect revenue production and, by extension, loan repayment. By meaningfully analyzing the competitive marketplace, they will also understand what external forces are at play and how those forces are likely to affect the security property's ability to produce revenue and therefore loan repayment. Finally, with reliable borrower information, they will learn the most relevant aspects of the borrower's income, financial condition, history and much more. By that time, the analyst can reasonably decide if the bank should make the loan and how much the borrower can afford. When the value of the security property becomes known, they will have the final piece of information and will know more precisely how much the loan amount should reasonably be.

Over the years, appraisals have sadly seen their importance and relevance marginalized. Whereas an appraisal was once — and should be again — a useful tool to help banks measure the probability of loan repayment, their current relevance has been obscured to the point that an entire generation of loan officers, processors, underwriters, analysts and even novice appraisers have forgotten, or have never learned, the real function of an appraisal in a lending or workout environment.

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Today, the relevance is often limited to producing a single point value estimate; doing it quickly and doing it at the lowest possible cost. That unfortunate mindset has, in very large part, contributed to the loan losses the industry has experienced over the last decade.

Sources of CRE Loan Repayment
Revenue to repay most commercial real estate loans is derived from three fundamental sources.

Net rental income produced by the security property. It is unlikely that a loan secured by an office building, shopping center rental apartment project or a warehouse building will be repaid in a timely manner if the *property* does not produce sufficient revenue to operate the property and service the debt. If it can't do both, loan repayment may be in jeopardy. The borrower (and the bank) are left in an impossible situation if the property's net operating income is only sufficient to meet the debt service and the property is not adequately maintained. Conversely, if there is revenue sufficient to only operate the property and not meet the debt service, the consequences are grave.

Net sales income derived from sales of a portion of the property such as lots in a subdivision or units in a condominium project. Here too, sales revenue must be sufficient to maintain the property, fund sales efforts and pay down the debt.

Sale proceeds from disposition of the entire asset such as what might occur at the end of an investment holding period or in the event of foreclosure.

The role of the appraisal. In most routine loan or workout transactions a reliable appraisal is the primary source of property and market information. The appraisal should provide a wealth of information for the underwriter and loan decision makers. How much income and how long it will continue are the two most fundamental questions to be answered. Without a reliable appraisal, the lender is potentially overlooking two of the three broad categories of risk. A loan or workout plan without complete facts will succeed only by accident but is more likely to fail, especially when influenced by volatile market conditions such as those being experienced today and in the recent past.

Drilling deeper into property and market risk. By virtue of their appraisal education, appraisers should be familiar with property and market risk. These concepts, however, are usually expressed differently. Appraisers think of and routinely estimate *physical depreciation,* as well as *functional and economic obsolescence* (sometimes called locational or external obsolescence). These factors detract from value. From the viewpoint of a knowledgeable underwriter, however, the same factors are thought of in terms of *property and market risk* that need to be identified and quantified. Each of these factors imply that something is wrong with the property being offered as security for a loan or that something is wrong or out of balance in the competitive marketplace.

The bank must understand what is wrong with its prospective collateral; whether it is temporary or permanent, quantify it and decide how severely it is likely to affect loan repayment.

Physical risk factors are characteristics of the security property such as deferred maintenance, shoddy construction, or inefficient or aging mechanical systems such as heat, air conditioning, plumbing or electrical systems. From the appraiser's perspective, deferred maintenance would be a downward adjustment to value. From the bank's perspective, these are expenses that may be incurred now or in the short term future or which make the property non-competitive or more expensive to operate and maintain.

Functional risk factors, or *functional obsolescence* in appraiser lexicon, can be either curable or incurable. It might refer to design flaws such as an unusual or unappealing building design, site plan, layout or other factors that contribute to limited market acceptance. Adverse functional characteristics might even include zoning or land use issues, environmental or legal constraints or even locational issues such as a misplaced improvement or any other characteristics that limit in whole or in part the property's ability to optimally function for its intended use.

Market risk refers to the external forces affecting the security property. Appraisers usually refer to it as economic obsolescence, or sometimes locational or external obsolescence. Regardless of the terminology, the risk is the same. Something in the competitive market in which the security property exists and, *most importantly must compete for tenants or buyers*, is creating an adverse effect that may negatively impact revenue production, marketability or value of the security property and, by extension, timely loan repayment either in whole or in part. It may be excess supply, for example, which has plagued many markets for several years now.

How Long Does It Take to Prepare a Reliable Appraisal?
At the risk of seeming cynical, the short and answer is *"longer than appraisers are usually given."* A reliable appraisal results from the skillful combination of both science and judgment brought together by a trained professional. In other words, the appraiser uses property and market facts. Where facts end, judgment takes over and the finished product brings with it a significant level of risk for both the appraiser and the user of the appraisal report. If the final appraisal report omits important facts; is based on faulty or incomplete data, flawed logic or reasoning or is presented with errors, the appraisal report may not be the reliable decision tool the user expected to receive and rely upon.

Preparation of an appraisal can also be likened to *peeling an onion* On the outside, the onion may look very normal. As layers are removed, however, abnormal conditions may become apparent. When preparing an appraisal, the appraiser may uncover unanticipated facts or conditions which require additional research, data or analysis. If the appraiser uncovers the need for additional work, they are confronted with the difficult choice of doing the additional work and delivering the product late or finishing the appraisal assignment and delivering the report on time. Too often, the choice is the latter and an unreliable appraisal may be the result. Each information element that is not considered may add another level of risk to the transaction. Similarly, the lender, servicer or other user of the appraisal report must use the product in its entirety and avoid the all too frequent temptation to fast forward to the bottom line value estimate and call it a day.