Real Estate appraisal review: lessons from the past

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During the last downturn of 1988-91, many lenders accepted appraisals of commercial property values without making any real attempt to verify the appropriateness of the assumptions or to view resultant values with a healthy degree of skepticism. Given the increasing softness in commercial property values, it makes sense to revisit lessons learned during that time, if only to serve as a reminder to those lenders who shared my experiences and to assist newer lenders in focusing on recent history.

Appraisal data lags the market. Appraisers rely on detailed market data, which often takes months to compile. In a rapidly falling market, rents as reported from traditional sources therefore will be substantially below real-world conditions. The simple remedy is to visit similar properties and inquire about rental terms. If you are visiting a loan prospect and the building across the street has vacancies, just stop by.

Comparable sales occur with less frequency. In the early stages of a downturn, sellers tend to hold to historical price expectations and the volume of property sales therefore drops dramatically. This phenomenon, in turn, leads to stale comparables, which reflect historical but not current market rents. Challenge your appraisers to produce recent sales data to support their valuation assumptions. If such support is not available, require appraisal modifications or take other appropriate defensive steps such as lowering advance rates.

Beware of "as completed" appraisals. Unless you are providing properly monitored construction financing in the amount required to meet the completed standard, do not assume that things will all come out as planned.

Assume owner-occupied properties are rented at market rates. As with special-purpose properties, it is dangerous to assume that historical business income will continue to cover your debt service, especially if the business is thinly capitalized. Consider what level of market net effective rent could be garnered on a theoretical basis and test that number against required debt service and current valuation multiples.

Screen approved appraisers carefully. Maintain a management-approved list of competent appraisers who meet prevailing regulatory requirements and whose prior work has withstood the test of time. Avoid real estate industry "gurus" who may lack objectivity when rental rates show initial signs of weakening.

Require reappraisal covenants. Properly drafted real estate term loan agreements should provide the lender with at least one reappraisal covenant at the borrower's expense. The conditions prevailing at initial loan closing cannot be expected to continue until final maturity, especially if you are providing maturities of three or more years.

Conclusion

During the last real estate credit crunch, many lenders and their appraisal counterparts were oblivious to the storm clouds on the horizon and later denied that a storm had arrived, even amid the real estate equivalent of thunder, lightning, and torrential rains.

Once the resultant floodwaters rose to calamitous levels, the same crowd also failed to see that the floodwaters were receding and missed out on terrific opportunities to finance new and solvent owners of previously distressed properties.

As William Saroyan once told us, students of history are not doomed to repeat its failures!