

Best Practices

Real Estate

Valuation Management

July 2019



Introduction

Transparency, cost savings and independence are the most common reasons for hiring an Appraisal Management Firm (“AMF”). On the heels of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, the financial services industry (including real estate) now operates in a heightened regulatory environment where regulators and standard setters have established new accounting and reporting rules. Transparency and independent oversight are critical elements in fair value reporting practices. It has become common for institutional funds to engage an AMF to perform expert consulting assignments such as external appraisal review, performance measurement and benchmarking, debt valuation and insurable value analysis.

The following pages outline the strengths and weaknesses of common appraisal management policies and procedures. We have highlighted what are considered to be current best practices in the industry and what a typical institution is likely to find most beneficial when considering appraisal management services. For simplicity, we have ranked applicable concepts from lowest to highest in four significant categories:

Independence

This refers to the level of objectivity that would be perceived from outside the fund for a particular process. For instance, a valuation process that requires external valuations on a quarterly basis has a higher degree of independence than a mixture of external and internal valuations due to the neutrality of the third-party appraiser.

Outsource Cost

Simply put, this is the cost of engaging a third party, whether an external appraiser or an AMF for the process described.

Opportunity Cost

One of the primary benefits of using an AMF is the ability to free management and staff to focus on higher valued and complex issues. Opportunity cost refers to the time and hard costs lost when performing specified processes in-house.

Market Knowledge and Exposure

An experienced AMF will have exposure to a number of processes and assets in multiple funds and markets. The result is a breadth of exposure to national and local market conditions, recent transactions, investor sentiments, etc. Typically, the highest degree of market knowledge and exposure is in a collaborative environment that includes the fund, an AMF and an external appraiser.

Process	Best Practice
External Appraisal Frequency	Quarterly (Open-end) Annual (Closed)
Appraiser Rotation	Three Years
External Valuation Guidelines	Collaboratively written with AMF
External Appraiser Approval Process	Qualified by AMF and collaboratively approved
External Appraiser Engagement Process	AMF managed process with fund input and approval
Appraisal Review	AMF reviews
Reporting and Analysis	Depending on fund requirements and needs
Data Management System	Hosted by AMF

External Appraisal Frequency

Assuming quarterly valuations are required for accounting purposes, there are two primary options to consider; external and internal valuations. Both are widely used, each with seemingly equal strengths and weaknesses.

Concept	Independence	Outsource Cost	Opportunity Cost	Market Knowledge and Exposure
External Valuations Annually and Quarterly	Highest	Highest	Low	Highest
External Valuations Annually AMF Valuations Quarterly	Highest	High	Low	Highest
External Valuations Annually Internal Valuations Quarterly with Support from AMF	Low	Low	Highest	High
External Valuations Annually Internal Valuations Quarterly	Lowest	Lowest	Highest	Low

Strengths and Weaknesses

Sensitivity to independence and cost are the major factors in determining external appraisal frequency.

Best Practice

The most common policy is to require external valuations on a quarterly basis for open-end funds. This policy works best in an independence sensitive environment. It is highly recommended that related administrative tasks be outsourced to an AMF with an online data management system to minimize opportunity costs and to maximize the expertise of professionals who regularly perform these duties for a variety of clients.

In a cost sensitive environment, engaging external appraisers on an annual or semi-annual basis and performing quarterly update valuations internally with the support of an AMF is a recommended practice. This option is more cost effective than engaging the AMF to perform restricted-use appraisal reports but provides a relatively similar level of independence and knowledge base.

Closed, separate accounts often have less stringent compliance standards and may operate best under an annual or semi-annual valuation cycle. If the fund is GIPS compliant, then monitoring of values by an independent AMF would also be necessary in the event an interim appraisal should be triggered.

Appraiser Rotation

The vast majority of real estate funds engage external appraisers for a three-year period, regardless of the frequency of delivery.

Concept	Independence	Outsource Cost	Opportunity Cost	Market Knowledge and Exposure
Regular Rotation (Typically Three Years)	Higher	Higher	Higher	No Difference
No Required Rotation	Lower	Lower	Lower	No Difference

Strengths and Weaknesses

Regularly rotating appraisal assignments allows for a fresh look on each asset every time it rolls to a new appraisal firm. The weakness however is more time and/or cost dedicated to the engagement process and review each time an asset rolls to a new firm.

Best Practice

Whether working with internal or external appraisals, engagement timing and delivery schedule is completely dependent on portfolio financial reporting dates and the level of internal involvement. Typically, it is best to engage new assignments up to a year in advance, particularly for assignments that include quarterly external appraisals. This generally results in the best pricing for appraisal services and allows all aspects of the process to unfold with a standard level of care. Simply put, it provides the necessary lead time for appraisers, those providing property information, and reviewers to efficiently perform their jobs. Further, it is typical to require external appraisals to be delivered 45 to 60 days prior to financial reporting due dates.

Although a schedule where appraisal assignments are not required to roll would translate to lower outsource and opportunity costs, the benefits of rolling assignments on a regular basis to new appraisal firms are significant from an independence perspective. Therefore, a regular rotation schedule is recommended for all fund types.

External Valuation Guidelines

It is important to have a detailed and comprehensive scope of work for external appraisers to use as a guideline to ensure consistency in reporting. Often the scope of work differs for an annual appraisal versus a quarterly appraisal. Assuming the fund has a manager with a valuation background or expertise, a collaborative effort in writing external or internal valuation guidelines works best.

Concept	Independence	Outsource Cost	Opportunity Cost	Market Knowledge and Exposure
Fund Written Guidelines	No Difference	Low	Highest	Low
Collaboratively Written Guidelines	No Difference	High	Low	High
AMF Written Guidelines	No Difference	High	Lowest	High

Strengths and Weaknesses

From an independence perspective, there is really no difference who writes the guidelines as long as they follow valuation techniques used by valuation standard setting groups (e.g. USPAP, IVS, US GAAP, IFRS, REIS, GIPS, etc.). Fund written guidelines work best when there are pre-established or partner driven guidelines and an internal valuation manager with strong appraisal industry background and contacts. Valuation guidelines written entirely by an AMF work best when either all administrative processes are being outsourced or the internal valuation manager has little valuation background. The strength of using a collaborative process is the ability to maximize synergies between the AMF’s experience and exposure to other guidelines and processes with the fund’s specific requirements and experience.

Best Practice

While all three practices are widely used, we have found the greatest success in collaboratively creating and managing the valuation guidelines. An adequate set of valuation guidelines will establish global consistency, audit and compliance procedures, valuation policies and procedures with consideration of local practice, and overall documentation of the funds approved valuation guidelines. Some examples include cash flow modeling guidelines (chart-of-accounts), scope of services documents, and other procedural documents outlining the performance of the valuation process.

External Appraiser Approval

The involvement of the fund in the approval of external appraisers typically depends on whether an approved appraiser list has already been established.

Concept	Independence	Outsource Cost	Opportunity Cost	Market Knowledge and Exposure
Fund Approval Only	Low	Low	Highest	Lowest
Collaboratively Approved List	High	High	Low	Highest
AMF Approval Only	Highest	High	Lowest	High

Strengths and Weaknesses

There is an element of independence added from engaging an AMF to create and maintain an approved appraiser list. This option also eliminates time and costs involved in qualifying, interviewing and researching appraisers and firms. The weaknesses are the cost of outsourcing and potential loss of market knowledge and exposure from the fund. A common alternative is a collaborative effort in creating and maintaining an approved appraiser list. Although the outsource cost is going to be relatively similar, allowing an AMF to develop the list with input and approval from internal management creates a synergistic combination of fund exposure with the AMF’s exposure and contacts in the appraisal industry.

Best Practice

The greatest success has been found in collaboratively creating and managing the approved appraiser list.

External Appraiser Engagement

The engagement process includes developing and sending RFP’s, receiving bids, negotiating contracts and creating and delivering engagement letters. The involvement of the fund in the engagement of external appraisers typically depends on the availability of internal staff and current systems in place. When companies outsource administrative processes to an appraisal management firm, this service is almost always included. The benefit of outsourcing the time it takes to thoroughly manage the engagement process far outweighs the costs involved.

Concept	Independence	Outsource Cost	Opportunity Cost	Market Knowledge and Exposure
Fund Manages Engagement Process	Low	Low	Highest	Lowest
AMF Manages the Process with Fund Input and Approval	High	High	Low	High
AMF Manages Engagement Process	Highest	High	Lowest	High

Strengths and Weaknesses

A fund managed engagement process works best in an environment where independence from the valuation process is not a high priority and there is an established valuation team, process and data management system already working. Depending on the size of the fund and the frequency of engagement, the cost of having an individual or team perform this task internally can be significant. Conversely, an AMF managed process works best when both independence and outsourcing administrative tasks are high priorities.

Best Practice

It is recommended that an AMF manage the engagement process with fund input and approval. This creates a collaborative environment that maximizes market knowledge and exposure while maintaining a high level of independence and low time commitment internally. The AMF typically pre-qualifies firms and recommends a minimum of two and maximum of three to bid on each appraisal assignment. Consideration is given to regional and property-type expertise as well as overall performance with similar previously engaged assignments. The AMF makes final recommendations and considers fee and the fund’s exposure to each appraisal firm in combination with regional and property-type expertise.

Appraisal Review

When valuations are performed by an independent external appraiser, a review can be conducted based on procedures outlined by the client and/or AMF. Reviews are USPAP compliant and facilitated in a manner that is consistent with fund guidelines. Reviews can be very time consuming and costly to employ full-time internal reviewers. This is an area where outsourcing can be a significant cost savings to the fund.

Concept	Independence	Outsource Cost	Opportunity Cost	Market Knowledge and Exposure
Fund Performs Reviews	Low	Low	High	Low
AMF Performs Reviews	High	High	Low	High

Strengths and Weaknesses

Engaging an AMF to review external appraisals adds a layer of independence to the valuation process and gives the fund access to additional market knowledge and exposure. Without a formal external review process the burden otherwise falls squarely on internal employees that either do not have the necessary valuation expertise and/or time to dedicate to a thorough review. For example, asset managers may be required to allocate time to review appraisals at the expense of maximizing the value and/or performance of their assets.

Another benefit to the external reviewer is their role as “independent filter” between fund management and appraisers. Not only does the AMF act as a liaison between parties in all forms of communication, but also facilitates the reconciliation of irreconcilable differences that may exist between employees of the fund and the appraiser. It is fairly common for differences of opinion to arise out of the valuation process. As an independent third party, the AMF can objectively review the facts as well as support presented by both parties and form an opinion of their own as to the reasonableness and credibility of the value conclusion(s). This may also involve the reviewer providing supplementary analysis of their own to support a credible result. The one weakness of this process can be isolated to the cost of reviews which can range from \$500 to more than \$2,000 per review.

Best Practice

If independence is important, engaging a third party to review external reports is highly recommended and a common practice among real estate funds.

Reporting and Analysis

There are a variety of additional reports, analyses and consulting services that can be outsourced or assigned to an AMF. The following outlines the benefits of having an AMF perform additional reporting and analysis typical for an institutional fund. These services are frequently labeled as “expert consulting” and are completed collaboratively and in concert with fund guidelines.

Quarterly Real Estate Value Reports

One of the main benefits of using an AMF is to add a layer of independence to the valuation process. By engaging an AMF to review and then report the quarterly real estate values they sign-off on each value as reasonable, credible and current. It also closes the loop of independence which is one of the most critical components in today’s heavily scrutinized and regulated environment.

Value Adjustment Process

Most policies and procedures have a contingency plan should a value need to be adjusted whether due to a significant appraisal error, a last minute but significant change at the property, etc. Engaging an AMF to participate in this process (when necessary) fulfills the need for an independent valuation but also allows for quick and decisive action.

Performance Measurement

Performance measurement such as benchmarking is often requested by partners and investors. Using an outside firm such as an AMF allows focused and innovative analysis that is both meaningful and timely.

Debt Valuation

Debt valuation, particularly the impact of property level debt on fund returns is consistently a hot topic. Using an AMF allows for consistent methodology and a cooperative environment to perform analysis on the debt and place value on it as necessary.

Insurable Value Analysis

As an alternative to having external appraisers perform insurable value, the AMF can create a consistent and seamless process for estimating insurable value and working with insurance carriers. This eliminates the inconsistencies that arise out of the use of various individual appraisers and the volatility over insurable value estimates when rotating to new appraisers.

Data Management & Communication

It is recommended that software be used that allows for online, collaborative and interactive appraisal management. This includes the ability for users to upload and view valuation reports and statistics, interact via a review interface that generates email notifications, auditable documents, and analytical reports. The software can be customized to include bidding, engaging, executive summary reporting, ARGUS extraction, benchmarking and other tools depending on guidelines and requirements of the fund. It also should help facilitate communication throughout the entire appraisal process, including managing the information flow from property contacts (on-site partners, asset managers, etc.) to the appraiser.

Concept	Independence	Outsource Cost	Opportunity Cost	Market Knowledge and Exposure
No System	Low	Low	Highest	No Difference
Fund Hosted and Managed	Low	Low	Highest	No Difference
AMF Hosted and Managed	Highest	Highest	Low	No Difference

Strengths and Weaknesses

Other than the cost of outsourcing, there is no real benefit to not having a data management system. The primary benefit of having a data management system is the transparency it creates and the efficiency it establishes for the valuation process.

Best Practice

For all funds, it is recommended that a data management system be hosted by a knowledgeable and experienced AMF.

Conclusion

The valuation process for any real estate fund is tasked with reporting independent and reasonable fair value estimates. Value conclusions and inputs may be used for financial reporting, client reporting, marketing requests, GIPS reporting, or calculation of the appreciation component of portfolio returns. Industry best practices form the basis for the policies and procedures that build the foundation for these estimates, regardless of use. Many choose to hire an Appraisal Management Firm due to the time and complexity of pulling together all aspects of a process that results in reasonable and credible conclusions. It requires the expertise of valuation professionals typically found only within an AMF that collectively shares a body of work best suited to perform each of the valuation management functions.

Legislative and regulatory changes such as the *Dodd-Frank Wall Street Reform and Consumer Protection Act* have placed renewed emphasis on transparency, cost savings and independence. Regulators and standard setters have established new accounting and reporting rules that are changing the industry and leading to more well thought-out and implemented valuation policies and procedures. The changing landscape of the financial industry is fueled by the desire to earn the public's trust and will continue to focus on transparency and independence as a means to achieving this goal. Appraisal management firms will have a prominent role in the standard operating model for most, if not all, valuation processes. The hiring of an AMF and implementation of industry best practices has quickly become the gold standard in fair value reporting.

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