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Pension Fund Appraisals: Where's the Value?

By Tony Sevelka, AACI, SREA, MAI, CRE

Pension Funds in Canada are the most active participants in the acquisition of so-called investment or institutional grade real estate. There is significant debate as to whether real estate can be characterized as an asset class without a clear ability to effectively measure and control risk. Nonetheless, the return on institutional or investment grade real estate must be at least equal to the rate of return available from investments of equal risk.

Benchmark data such as actual real estate transactions are scarce as Pension Funds typically hold real estate for the long term, and there is no verifiable secondary market to determine asset values and directly measure the financial performance of real estate as an asset class.

Today, mostly out of necessity, Pension Funds must pursue a long-term hold strategy given the lack of liquidity in the real estate market and the absence of non-Pension Fund investors to facilitate an effective and profitable exit strategy for the disposition of their beneficiaries real estate holdings.

Only one index, the Frank Russell Canadian Property Index (RCPI), purports to measure the historic financial performance of unleveraged investment or institutional grade income-producing property held by tax-exempt real estate funds. The RCPI has been tracking the performance of income-producing investment or institutional grade real estate since December 31, 1984, at which time there were 715 properties with a reported market value of $3.666 billion. As of June 30, 1994, the index represented 949 properties with a reported market value of $13.625 billion.

The RCPI performance measure takes into account income (periodic net income and property dispositions), capital expenditures (cash outflows) and capital appreciation (appraised values). However, most of the return indicated by the RCPI is based on the sum of the individual appraised property values, which stand as proxies for deemed disposition prices. The disproportionate weighting of the RCPI caused by its reliance on appraised property values undermines the reliability of the index as a measure of financial performance for investment or institutional grade real estate.

A study of 64 properties sold from the RCPI index during the 1990-1993 period suggests that there is no significant difference between appraised values and actual sale prices. Without comparing the numerical results of those appraisals with those of prior appraisals of the same properties, or knowing if the intended function of the appraisals was in anticipation of the sell-offs, any inference drawn from the appraisals as to their reliability to stand as proxies for the deemed disposition prices of all properties in the RCPI is conjectural.

Pension Fund appraisals are routinely prepared either by in-house staff or external fee appraisers, and in both circumstances the appraisal process is directly controlled by the Pension Fund managers without any apparent independent input or oversight. Some Pension

Fund managers employ or retain only designated appraisers such as MAIs (Member of the Appraisal Institute) and AACIs (Accredited Appraiser Canadian Institute), but it is not unusual for undesignated appraisers to be hired or retained.

Since real estate assets are held for the long term, Pension Fund managers typically earn their compensation by generating actual or reported increases in net income (cash flow) and/or capital appreciation (appraised values), without actually testing the marketplace. This formula for compensation has significant potential for abuse of the appraisal process in overstating property income, value and investment performance, all to the detriment of Pension Fund beneficiaries.

There are no industry-wide Pension Fund guidelines for the selection of appraisers and appraisal standards for preparation of appraisals, and reportedly there are no uniform RCPI reporting requirements for computing property income as it relates to capital expenditures, tenant improvements and leasing commissions. Depending on whether these items are expensed, amortized or treated as one-time capital expenditures has significant impact on property net income (cash flows) and market value (appraised value), and the compensation to which the Pension Fund manager is entitled.

Additional appraisal-influencing factors within the control of the Pension Fund manager which can significantly impact the appraiser's value estimate and the usefulness of the appraisal as a measure of financial performance are:

- the appraisal instructions,
- the property rights appraised (i.e., freehold, leasehold),
- the extent of ownership (i.e., partial or full interest),
- the definition of market value,
- the function of the appraisal, and
- the degree of access to critical property-specific documentation, including partnership agreements and options to purchase or sell partial interests.

Complete appraiser independence and objectivity of the appraisal process is an essential underpinning for reliably measuring the financial performance of Pension Fund real estate, and can only be achieved if the authority for retaining an appraiser rests with the beneficiaries of the Pension Funds, as opposed to the Pension Fund managers themselves. Pension Fund managers with in-house appraisal staff should be avoided outright, unless the Pension Fund beneficiaries are able to exercise control over the appraisal process by mandating that every property in the portfolio be appraised annually or biannually by independent, objective, qualified and professionally designated external fee appraisers chosen by the Pension Fund beneficiaries. As well, beneficiaries should commission an independent annual building condition report for each property in its portfolio to ensure that potential capital cost items are not being overlooked or postponed to artificially inflate the financial performance and market value of any specific property.

If appraisals are to stand as proxies for deemed disposition prices, all Pension Fund appraisal reports should be prepared within a consistent framework in which the appropriate property rights are clearly and accurately stated and defined, and embraced in the context of Market Value (Value In Exchange), defined as:

> The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:
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> - buyer and seller are typically motivated;
> - both parties are well informed or well advised, and acting in what they consider their best interests;
> - a reasonable time is allowed for exposure in the open market;
> - payment is made in terms of cash in Canadian dollars or in terms of financial arrangements comparable thereto; and
> - the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

When estimating market value, the Pension Fund appraiser should be specific as to the estimate of exposure time linked to the value estimate. Exposure time is defined in the USPAP as:

> the estimated length of time the property interest being appraised would have been offered on the market prior to the hypothetical consummation of a sale at market value on the effective date of the appraisal; a retrospective estimate based upon an analysis of past events assuming a competitive and open market.

A value estimate premised on an unreasonably long exposure time would tend to overstate the market value of the property.

All appraisal reports whether prepared internally or externally should be mandated to comply with the Uniform Standards of Professional Appraisal Practice (USPAP) as adopted by the Appraisal Standards Board and adhered to by MAIs and AACIs throughout North America. External fee appraisers should be restricted to appraising the same property to a maximum of three years in a row which would facilitate a fresh perspective of market value. For independent third-party appraisals to be meaningful as a measure of financial performance, appraisers must have open and unrestricted access to all property-specific documentation such as that listed below:

- Letter of Authorization to permit access to municipal data;
- Name and telephone number of contact for access to the property and any information required;
- Survey and Building Plans;
- Building Condition Report(s) and Study(s);
- Environmental Audits;
- Soil Test Reports;

- Partnership Agreements and any Options to Purchase or Sell relating to partial ownership interest;
- All successful and unsuccessful Offers to Purchase, solicited and unsolicited, received within the last three years;
- Offers to Lease, Leases, amendments and renewals, executed and pending;
- Copy of standard lease/tenancy agreement;
- Copy of most recent Rent Roll;
- Income and Expense statements for the past three years and a budget for the current fiscal year;
- List of any arrears and postponements of either rent or expenses; and
- Any other information relevant to the valuation of the property.

The lack of independent and appropriate appraisal controls and standards has caused significant financial harm to shareholders and depositors in the trust, banking and insurance sectors of the Canadian economy, a fate that Pension Fund beneficiaries can avoid by charting a prudent course for their appraisal needs.

As an immediate first step, every beneficiary should call for an acid test of its Pension Fund manager's performance by commissioning independent audit appraisals of a few randomly selected properties within its real estate portfolio, especially in those instances where the pension fund manager controls the appraisal process and is compensated directly or indirectly based on the appraised values of the properties within the portfolio.

A truly independent and uniform appraisal process, and one that incorporates market value or value in exchange as its basic premise, would enhance the reliability of the RCPI as a measure of financial performance for income-generating investment or institutional grade real estate.