



# How to Validate a Previous Appraisal

Institutions should establish criteria for assessing whether an existing appraisal or evaluation continues to reflect the market value of a property.

BY **GEORGE R. MANN** AND  
**LARRY R. WOODALL**

A BANK MAY not be able to rely on a previous property appraisal if changes have been made to the property or if the value of surrounding properties has fallen. This article advises lenders on how to see if an earlier appraisal is still acceptable by using a process known as validation.

The two most important factors to consider in a validation include the physical condition of the property and the strength of the real estate market compared to when the previous appraisal was performed.

Validation analysis is used to determine whether the value estimated in a previous appraisal remains valid. Specifically, validation aids in determining if negative changes have occurred to the property or in the market. If so, a new appraisal should be obtained.

#### Section XIV of the Guidelines

Section XIV of the December 2010 Interagency Appraisal and Evaluation Guidelines advises: "An institution should establish criteria for assessing whether an existing appraisal or evaluation continues to reflect the market value of the property (that is, remains valid). Such criteria will vary depending upon the condition of the property and the marketplace, and the nature of the transaction."

Methods to determine if a validation can be performed include the following:

1. The review of a comprehensive real estate market study that reports on the performance of real estate within the institution's footprint.
2. A formal inspection of the property to determine its condition.
3. A review of the property's income and expense history as well as a current rent roll, if applicable.

These analyses can be performed by a third-party consultant or by individuals within the institution who are qualified to perform these types of services. The documentation for these analyses should be kept in the credit file because they provide the facts and analyses that support the institution's decision.

The section is silent on who can perform a validation. It seems logical that the following items in Section IV of the Interagency Appraisal and Evaluation Guidelines would also apply to validations:

- Provide for the independence of the persons ordering, performing, and reviewing appraisals or evaluations.
- Ensure that appraisals and evaluations contain sufficient information to support the credit decision.
- Maintain criteria for the content and appropriate use of evaluations consistent with safe and sound banking practices.
- Provide for the receipt and review of the appraisal or evaluation report in a timely manner to facilitate the credit decision.

The validation should be performed in an unbiased and professional manner acceptable to the agencies governing the institutions, and the regulated institution must properly

**The December 2010** Interagency Appraisal and Evaluation Guidelines state, "An institution's board of directors or its designated committee is responsible for adopting and reviewing policies and procedures that establish an effective real estate appraisal and evaluation program. The program should:

- Provide for the independence of the persons ordering, performing, and reviewing appraisals or evaluations.
- Establish selection criteria and procedures to evaluate and monitor the ongoing performance of appraisers and persons who perform evaluations.
- Ensure that appraisals comply with the agencies' appraisal regulations and are consistent with supervisory guidance.
- Ensure that appraisals and evaluations contain sufficient information to support the credit decision.
- Maintain criteria for the content and appropriate use of evaluations consistent with safe and sound banking practices.
- Provide for the receipt and review of the appraisal or evaluation report in a timely manner to facilitate the credit decision.
- Develop criteria to assess whether an existing appraisal or evaluation may be used to support a subsequent transaction.
- Implement internal controls that promote compliance with these program standards, including those related to monitoring third-party arrangements.
- Establish criteria for monitoring collateral values.
- Establish criteria for obtaining appraisals or evaluations for transactions that are not otherwise covered by the appraisal requirements of the agencies' appraisal regulations."

# Criteria for determining whether an appraisal remains valid include the condition of the property, the market, and the nature of any subsequent transaction.

document the basis for its findings and keep the documentation in the credit file.

Another issue that has been left to each institution to decide is how long an appraisal may be considered valid. Should a 2008 appraisal be validated? Or will only appraisals that are less than three years old be validated? Ultimately, it is up to each institution to decide.

## Factors to Consider in Validation

Criteria for determining whether an appraisal remains valid include the condition of the property, the market, and the nature of any subsequent transaction. The institution must document the information and analyses used for validation. Factors that could cause changes to originally reported values are listed in Section XIV and discussed below. Any of these factors can eliminate the validation option and require a new appraisal or evaluation.

➔ **The passage of time.** Have changes occurred in the market or to the property since the original transaction? Federal regulations do not establish time frames during which appraisals or evaluations are presumed to be valid. However, it would probably be a stretch to say a 2008 or 2009 valuation is useful today.

➔ **Volatility in the local market.** Examples include the closing of a school in the neighborhood, construction of a penitentiary nearby, the redevelopment of a major roadway to alleviate traffic congestion, and the sudden and significant increases in demand experienced in shale gas markets in recent years (as in North Dakota, for example).

➔ **Changes in terms and availability of financing.** What are current interest rates? How available is money to finance a real estate transaction in the current market, compared to when the original transaction occurred? Since 2008, this has been a significant issue.

➔ **Natural disasters.** Examples would be Hurricanes Katrina and Sandy. Such events might make appraisals and evaluations that are only six months old of no use today.

➔ **Limited or over-supply of competing properties.** Have there been changes to supply-and-demand factors? What effect do they have on the occupancy potential of the property? For example, a shortage of housing in North Dakota has resulted in apartment vacancies in the 2-3% range and double-digit annual rent increases.

➔ **Improvements to the subject property or competing properties.** Have improvements been made to the property or to competing ones that could be viewed as negative influences on value? An example would be increasing the size of a house to, say, 5,000 square feet when surrounding homes are 1,500 to 2,500 square feet.

➔ **Lack of maintenance of the subject property or competing properties.** Has the property been properly maintained since the date of the previous valuation? Is there deferred maintenance that could cause a loss in value?

➔ **Changes in underlying economic and market assumptions, such as capitalization rates and lease terms.** Between 2008 and 2009, capitalization rates increased about 200 basis points, resulting in market-wide value declines of 25% to 35%. Many properties are re-leasing today at rates significantly below those in leases signed between 2006 and 2008.

➔ **Changes in zoning, building materials, or technology.** Have there been zoning changes? Could they dramatically affect the property's potential for development? Is an existing building at a disadvantage to new construction that has cutting-edge technology and green characteristics?



**Environmental contamination.** Has the property, its improvements, or the adjoining and surrounding properties been subject to environmentally hazardous changes since the previous appraisal or evaluation? Examples may include the discovery of asbestos in the subject improvements and groundwater contamination caused by leaks in underground storage tanks on or near the subject site.

**Steps in Performing a Validation**

A validation should include a thorough review of the original appraisal or evaluation, compilation and analysis of relevant market data on the subject neighborhood and comparable markets, and a formal site inspection of the property and the surrounding neighborhood.

- The review should always be the first step. The lender will then understand the quality and condition of the subject and its marketplace at the time of the original transaction. Interviewing the loan officer or asset manager, the property owner, tenants, and local brokers may also provide insight into the property and the market.
- Upon gaining sufficient knowledge of the property and its market, data such as rental rates, sales prices of similar-use properties, and current building costs can be used to identify trends in value.
- A thorough site inspection of the property and its surrounding neighborhood should follow to reveal any indication of decline or improvement.

If any changes have occurred from the date of the appraisal, they should be documented and included with the collateral or credit files of the institution. Furthermore, in cases where negative changes are found, a new appraisal or evaluation should be performed to determine the amount of value lost. If there appear to be no changes (the market is stable) or if the changes are positive (property appreciation is evident), a new appraisal or evaluation would not be necessary, and the previous appraisal can be used.

**Methods for Evaluating Market Trends**

An analysis of real estate assessments is a simple, inexpensive way to evaluate market trends. In addition, known methods of valuation—the income approach, the sales comparison approach, and the cost approach—can be used to assess the direction of potential changes and the stability of the previous value. A review of the prior appraisal or evaluation should reveal which approach to valuing is most appropriate.



**Real estate assessments.** The tax assessment represents an independent, unbiased estimate of value but may be considered less reliable than an appraisal or detailed evaluation. The date of an assessment is an obvious consideration in determining whether it is appropriate to use. Also, the

frequency of assessments may vary by state. For example, county assessors in Maryland assess property on a three-year rotation, while most of those in Virginia do so on an annual basis. For a validation, the trend is more important than the actual, assessed value. Is the most recent assessed value at least as great as the assessment at the time of the prior appraisal or evaluation? If so, then the indication of value by the assessment supports the use of a validation. If the assessed value has declined since the previous appraisal, then it's likely that the collateral value may also have deteriorated; this situation would not support validating the previous appraisal. A new one would likely be required.

**Income Approach**

The income approach to valuation is most applicable to leased industrial, office, and retail properties and to apartment projects and hotels. Income data is needed for both the subject property and the market.

Actual subject income and expense information must be obtained from the owner of the property. This information should be compared with market rent and expense data to determine if the subject figures are above, at, or below market rates. In addition, two other items must be analyzed to arrive at a value using the income approach: market vacancy rates and capitalization rates. This data can be obtained from area market reports or the institution's appraisal archives.

All information should be analyzed together, as some factors that influence value increase while others decrease. What matters is the overall indication. The table on this page provides a sample income valuation that compares the prior appraisal valuation with current data.

This example indicates an increase in subject rental income with no change in market vacancy (15%). Expenses increased from 45% of effective gross income to 50%, and market rates of return also increased since the previous appraisal. In this scenario, the various increases and decreases can be summarized by an overall 15% decline in property value, suggesting the need for a new appraisal or evaluation.

Comparison of Prior Appraisal Valuation with Current Data		
Category	Prior Appraisal	Current Pro Forma
Potential gross income	\$100,000	\$105,000
Less: vacancy allowance	<u>-\$15,000</u>	<u>-\$15,750</u>
Effective gross income	\$85,000	\$89,250
Less: fixed/variable expenses	<u>-\$38,250</u>	<u>-\$44,625</u>
Net operating income	\$46,750	\$44,625
Capitalization rate	8.0%	9.0%
Value indication	\$584,375	\$495,833
Rounded to...	\$585,000	\$495,000

### Sales Comparison Approach

The sales comparison approach to valuation is most applicable to owner-occupied properties and some income-producing properties. Sales data can be obtained from such sources as CommercialSearch, COMPS, LoopNet, Xceligent,

A validation is a simple comparison of values at two points in time. It answers the question: Is a previous appraisal or evaluation still valid?

real estate appraisers, realtors, assessors, and in-house appraisals. The idea is to compare current value indications with the prior value conclusion for the subject property.

Typically, sales are analyzed by price per square foot of building area for improved properties and by price per square foot or acre for vacant land. A review of the prior appraisal or evaluation should reveal the unit of comparison that is appropriate for the subject property.

Current sales of comparable properties are adjusted for differences from the subject property and then compared with the subject's prior value indication. For example, the subject may have been valued at \$100 per square foot of building area. If recent comparable sales range from \$90 to \$105 per square foot, then it is reasonable to conclude that the prior value remains valid.

### Cost Approach

An analysis of current building or construction costs of similarly designed buildings and of land sales can be used to determine value changes in special-use properties, such as churches, golf courses, health clubs, horse or auto race-tracks, auto dealerships, and data centers. This analysis focuses on the trend in which land values and building costs are moving, but also considers the overall physical condition of the subject improvements in comparison to their condition in the previous appraisal.

### Conclusion

A validation is a simple comparison of values at two points in time. It answers the question: Is a previous appraisal or evaluation still valid? In other words, is the property's potential current value equal to or greater than the value estimated in the previous appraisal or evaluation?

The two most important factors to consider in a validation are the physical condition of the property and the strength of the subject's current real estate market compared to when the previous appraisal or evaluation was performed. A blanket assumption about the validity of all past values based solely on a current position in the real estate cycle would be inappropriate, as the determination can depend on the particular date of a prior valuation.

A validation of a prior appraisal or evaluation can be a



straightforward task when real estate values are increasing across the board. Until the credit crisis of 2008, real estate values were generally trending upward, resulting in values at the time of loan renewal being equal to or higher than values at the time the loan was made.

However, from 2008 until now, almost all banks and their examiners have ordered new appraisals as loan renewals, refinancings, or subsequent transactions have occurred. Validations were not a viable option because values from 2009 through today are almost always lower than values from 2008 and earlier.

Real estate is cyclical, and many markets have been showing stable values over the past few years. In fact, some markets (such as Austin, Texas) and property types (such as apartments) have shown value increases since 2010 or 2011. Current market conditions make the validation option more likely today. As such, a validation is a reasonable and cost-effective way for institutions to reevaluate the strength of their real estate portfolios. ❖



*George R. Mann is managing director and Larry R. Woodall is founder, managing director, and chief appraiser, Collateral Evaluation Services LLC, Atlanta, Georgia. They can be reached at [georgermann@aol.com](mailto:georgermann@aol.com) and [lwoodall@ces-wm.com](mailto:lwoodall@ces-wm.com).*

RMA offers a course called *Understanding and Interpreting Real Estate Appraisals*. For more information, visit [www.rmahq.org](http://www.rmahq.org). Click on Events and Training.