How Environmental Issues Affect the Appraisal Process and Practical Case Studies

– 2016 AI Annual Conference –
Presenter Background

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• SVP/ Chief Appraiser & Environmental Risk Manager at HomeStreet Bank
• 18 years at Bank, 11 years in Chief Appraiser role
• Developed and Manages Bank’s Environmental Risk Management Program (implemented in 2012)
Overview

What We Will Cover:

• Bank Environmental Policy Foundation
• Appraisal Regulations and Environmental
• Case Study – Cherry Street
• Case Study – Business Park
• Case Study – Rent-a-Car

- Due diligence required for real estate loan transactions and foreclosure activities.
- Risk-based due diligence based on loan and property type.
- Competency requirement for evaluation of environmental risk.
- Environmental review process is required.
- Appraisal process must disclose and consider environmental risk and conditions.
Appraisal Regulations and Environmental Requirements

Interagency Appraisal and Evaluation Guidelines (IAEG) and Title XI of FIRREA

- Applies to all real estate-related financial transactions by a regulated financial institution.
- “As-Is” Market Value is required.
- Hypothetical Conditions are not permitted under this premise.
Appraisal Regulations and Environmental Requirements

- Environmental impairment must be considered within the “as–is” market value estimate.
- Provided by 3rd-party appraisers or internal licensed appraisal bank staff.
- Environmental impairment should not be managed as a segregated process.
- Example: A cost-to-cure deduction considered internally within a bank’s credit function but is isolated from appraisal process.
Case Study – Cherry Street

Public alley on the west side of the subject (the side of the restaurant/bar is seen on the right). The vacant lot on the other side of the alley is the source of the subject’s environmental contamination. The main entrance to the restaurant/bar is at the far end of this western wall.
Case Study – Cherry Street

Property:

- Two retail buildings – 5,000 sq. ft.
- 1925 age construction
- 8,000 sq. ft. site
- Leases in-place
- High underlying land value
- Redevelopment potential

Loan:

- Acquisition financing
- $1,000,000 purchase price
- Assemblage with adjacent property for mixed-used retail/ multi-family development
Environmental Scenario:

- Dry cleaner source contaminants present from adjacent property to west (1944–1960).
- Contamination via ground water has migrated to the subject property (above clean-up standards).
- Contamination source parcel was purchased by borrower (chain of title).
- Responsible party (prior owner) doesn’t have “deep pockets” – no viable recourse for remediation cost.
- DOE issued advisory opinion letter (Vapor Intrusion Assessment) stating that indoor air screening levels/air quality is acceptable for commercial use – but not residential.
- Vapor intrusion mitigation will be necessary during redevelopment of subject to mixed-use residential use.
Case Study – Cherry Street

Environmental Due Diligence

• Phase I ESA – consolidated all prior environmental due diligence.
• Phase I ESA Review (ORMS):
  • Monitoring requirement of remedial actions associated with the former dry cleaning facility.
  • Vapor barrier requirement upon redevelopment.
  • Operation and Maintenance Plan for ACM and LBP.
  • Review of environmental insurance policy.
Case Study – Cherry Street

Environmental Insurance Policy

• Cleanup costs exclude all known issues (most significantly the dry cleaner source contaminants that migrated on the property).
• The insurance policy has many limitations/exclusions that may very well restrict coverage.
• Bodily injury is covered, even if from known issues.
• Policy excludes any costs related to vapor intrusion prevention/mitigation.
• Coverage for contamination down-gradient.
• Protections if regulations were revised to a lower standard.
Case Study – Cherry Street

Collateral Risk Considerations – Positive

- Financially strong borrower and existing bank customer.
- Environmental insurance policy required as a condition of the loan.
- Acquisition loan prohibits redevelopment.
- Remediation cost outlays are unlikely until redevelopment.
- The subject property is not the contamination source/responsible party.
- Desirable in-city property location with strong redevelopment upside.
- Tenants in-place secure interim income stream.
Case Study – Cherry Street

Collateral Risk Considerations – Negative

• Highly problematic contamination source – almost impossible to fully remediate.
• Removal/ treatment of soil and groundwater in addition to vapor intrusion measures are most probable.
• Contamination is not adequately characterized on subject property.
• Cost–to–cure was not possible to estimate based on known data.
• Responsible party has limited financial ability to cover remediation.
• Subject borrower, who purchased the adjacent contaminated property, is now in chain of title.
Case Study – Cherry Street

Appraisal Result

• No cost–to–cure possible for “as–is” market value determination.

• Due diligence provided characterization of the risk, liability and potential cost outlays to a buyer.

• Remediation cost outlays “as improved” were unlikely, rather only upon redevelopment.

• Highest and best use = higher value “as improved” compared to “as vacant”.

• Future remediation costs, were recoverable (but not guaranteed).

• Off site liability was minimal due to subject not being contamination source.
Case Study – Cherry Street

Appraisal Result

- An environmental impairment discount was developed based on price discounts from commercial properties selling with restrictive title covenants prohibiting redevelopment due to adverse environmental conditions (CRECs).
- A 30% value discount was applied, which considered environmental risk and stigma.
Case Study – Cherry Street

Final Outcome

- Loan funded at 75% LTV and a 50% loan-to-purchase price.
- Loan prohibited redevelopment.
- Business decision considered the strength of the existing borrower relationship and the first right of refusal to fund the (sizable) construction loan of the future assemblage and redevelopment.
- The remediation costs relative to redevelopment were manageable.
- Closed at full price with additional cash (assemblage was primary motivation.)
Case Study – Business Park
Case Study – Business Park

Property:
- Five industrial & office buildings
- 75,000 sq. ft. building area
- 1950 age construction
- 3 acre site
- Multi-tenant investor property

Loan:
- Acquisition financing
- $8,000,000 purchase price
Case Study – Business Park

Environmental Scenario:

- **REC #1 – Historical Industrial Uses**
  - Prior use (1930s) cardboard box manufacturer
  - Prior use of machine shop and printing facility
  - Low-to-Moderate Risk of Impacts

- **REC #2 – Historical Heating Oil**
  - Prior oil burning furnace heating oil source with 1,000 underground tank.
  - Tank removed in 1990 with 30 yards of petroleum-contaminated soil removed.
  - Low-to-Moderate Risk of Impacts
Environmental Scenario:

- REC #3 – Use of Contaminated Fill Material
  - 6 to 9 feet of fill material used in 1910.
  - Fill material known to contain petroleum, metals and other contaminants.
  - Moderate Risk of Impacts

- REC #4 – Hydraulic Hoist
  - Long-term use of in-floor Hydraulic Hoist
  - Low-to-Moderate Risk of Impact

- REC #5 – 2000-Gallon Gas UST
  - Located in adjoining alley and used by subject tenant
  - Inferred up-gradient hydrologic position
  - Removed in 1988 with no records
  - Moderate Risk of Impacts
Case Study – Business Park

Environmental Due Diligence

- Phase I ESA
- Phase I ESA Review (ORMS):
  - RECs accepted – but hydraulic lift categorized as demonisms condition.
  - Risk exposure analysis/ opinion provided relating to existing use vs. redevelopment.
  - Verification of no active investigations occurring on subject or in vicinity triggering remediation.
  - Cost outlay verification only upon redevelopment (30 years out)
- Risk mitigation in event of foreclosure
Case Study – Business Park

Collateral Risk Considerations – Positive

- Property has long-term stable tenancy.
- Desirable in-city location with high underlying land value.
- Knowledgeable buyer with understanding of environmental risk.
- Subject’s environmental condition is typical of surrounding industrial properties.
- REC suggest low-risk of off-site migration/impacts.
- Loan structure prohibits redevelopment with 30-year remaining economic life.
- No remediation cost outlays likely until redevelopment.
Case Study – Business Park

Collateral Risk Considerations – Negative

- Contamination is not adequately characterized on subject property (no phase II work).
- Cost-to-cure was not possible to estimate based on known data.
- Significant remediation cost outlays are probable upon redevelopment.
- No loan recourse beyond subject real estate
- Report ordered by seller
- No recommendations in Phase I
Case Study – Business Park

Appraisal Result

• No cost-to-cure possible for “as-is” market value determination.
• Due diligence provided characterization of the risk pertaining to timing.
• Remediation cost outlays “as improved” were unlikely, rather only upon redevelopment.
• Buyer and seller’s are knowledgeable of environment risk in market for like-properties.
• Broker survey indicates no discount unless cost outlays are eminent.
• Appraisal adequately considered environment condition through comp selection (no discount).
Case Study – Business Park

Final Outcome

- Loan funded at typical LTV.
- Loan prohibited redevelopment.
- Business decision considered the strength of the market and proven property income stream.
Case Study – Rent-a-Car
Case Study – Rent-a-Car

Property:
- Rental Car Serving and Sales Facility
- 25,000 sq. ft. building area
- 1960 age construction
- 2 acre site w/ 150 parking stalls
- Owner–Occupied

Loan:
- Refinance – no new monies
- $3,000,000 loan amount
- 50% LTV
Environmental Scenario:

- REC #1 – 12,000 Gallon UST
  - Active three pump dispenser on-site (installed 1991).
  - Past recent tank tightness test.

- REC #2 – Former Gas Station Use
  - Parcel in NWC of site was gas station use in 1930’s.
  - Three 1,000 gallon USTs.
  - Demolished in 1990.
  - No records of tank decommission and removal.
Case Study – Rent-a-Car

Environmental Due Diligence

• Phase I ESA
• Phase I ESA Review (ORMS):
  • REC #1 viewed as a Business Enterprise Risk w/ no further action
  • REC #2 warrants limited Phase II testing
  • Risk mitigation in event of foreclosure
  • O&M Plan for Asbestos Containing Materials
Case Study – Rent-a-Car

Collateral Risk Considerations – Positive

• Refinance of existing performing loan.
• Desirable location and proven operation.
• Historical gas station use is isolated on separate tax parcel (could be excluded in event of foreclosure).
• Historical gas station small size of tanks.
• Cost outlays related to off-site migration of soil and groundwater unlikely due to build-up nature of surrounding commercial and industrial uses.
• Low LTV (50%).
• Remediation cost outlays unlikely until redevelopment.
Case Study – Rent-a-Car

Collateral Risk Considerations – Negative

• High probability of soil and groundwater contamination from historical gas station use.
• Possibility of off-site migration into Right-of-Way
• Contamination is not characterized.
• Borrower not willing to comply with Phase II work.
• Cost-to-Cure from Environmental Professional not possible.
• Competing banks willing to waive requirement.
Case Study – Rent-a-Car

Appraisal Result

• No cost-to-cure possible for “as-is” market value determination for appraisal reliance.
• Appraiser not willing to conclude discount without more definitive data due to liability.
• Environmental impairment concluded within internal bank appraisal review document.
• Use of cost-to-cure impairment comparable utilized as basis to conclude “as-is” market value determination.
Case Study – Rent-a-Car

<table>
<thead>
<tr>
<th>Comp #</th>
<th>Contamination Description</th>
<th>Remediation Cost Estimate</th>
<th>Comp #</th>
<th>Contamination Description</th>
<th>Remediation Cost Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Gasoline-impacted soil and groundwater with off-site migration potential</td>
<td>$200,000 to $300,000</td>
<td>3</td>
<td>Extensive soil and groundwater contamination including diesel and oil.</td>
<td>$606,000 to $756,000. Includes $71,000 in Remedial Investigation and Feasibility Study, $500,000 to $650,000 in remediation costs and $35,000 in closure and decommissioning activities.</td>
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<tr>
<td>2</td>
<td>Impacted soil and groundwater with potential for off-site migration under right-of-way</td>
<td>$195,000 to $220,000</td>
<td>4</td>
<td>Impacted soil and groundwater with potential for off-site migration.</td>
<td>$400,000 - Includes $81,000 in Remedial Investigation and Feasibility Study $284,000 in remediation costs and $35,000 in closure and decommissioning activities</td>
</tr>
</tbody>
</table>
Case Study – Rent-a-Car

Final Outcome

• Unimpaired value based on 3rd-Party Appraiser.
• Cost-to-Cure estimated at $300,000 by internal bank reviewer.
• Stigma, profit and contingency at $300,000.
• Total discount due to environmental impairment at $600,000.
• Loan funded at 55% LTV – well below max LTV.
• Outcome consistent with risk-based nature of environmental and appraisal guidelines.
Questions??