Book Review

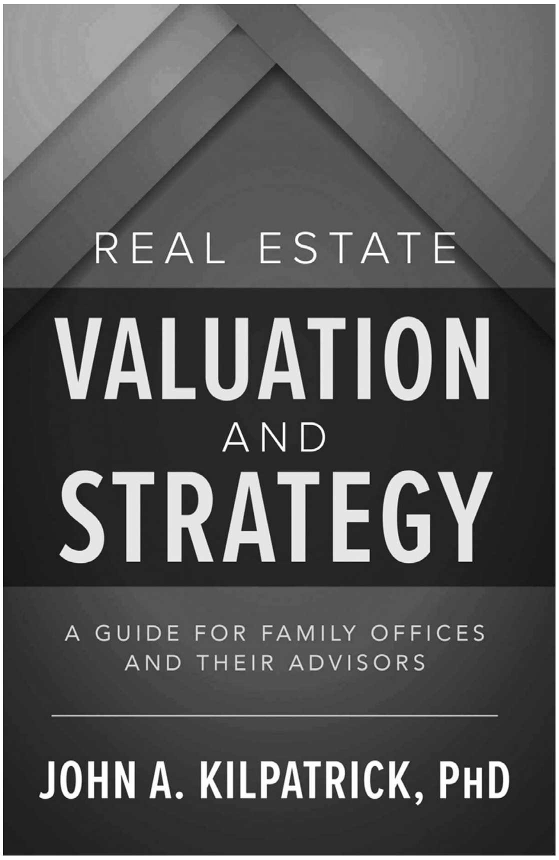
by Warren Klutz, MAI, SRA, AI-GRS

Reducing Real Estate Portfolio Risk

John A. Kilpatrick, PhD, MAI, presents a comprehensive guide for real estate investors on wealth maximization through interesting stories and an easy-to-understand narrative in *Real Estate Valuation and Strategy: A Guide for Family Offices and Their Advisors*. While the text is aimed at those who are investing in real estate and their advisors, practicing real estate appraisers, brokers, and lending professionals also should find the material interesting and enlightening. Readers will benefit from the diverse real estate knowledge distributed throughout this text.

Dr. Kilpatrick, chairman and managing director of Greenfield Advisors, accomplishes his stated goal of preparing investors/advisors in understanding real estate appraisals. He reminds readers the book was not written for those who wish to become appraisers. While the purpose is not to produce appraisers, the many examples and short stories included in the book should be a beneficial learning experience for appraisal professionals. Dr. Kilpatrick describes how to use real estate appraisal methodology to find, oversee, and enhance wealth. He cautions readers to avoid overpaying when purchasing real estate, and he maintains as a core premise that one makes money when buying real estate, not when selling it.

Chapter 1 discusses the real estate cycle, net present value, and differences between book value and market value. Chapter 2 includes a case study example involving a proposed office building and valuation in which the cost of construction is used to extract land value where inadequate land sales are available. In Chapter 3, the author addresses why buyers invest in real estate. The after-tax cost of debt is demonstrated through an equation suggesting the cost of money is less than one might think. Appraisers are typically dealing with rates of return, net present values, capitalization rates, internal rates of return, and economic considerations with proposed purchases. They seldom confront non-return-generating reasons in nonresidential real estate.



Real Estate Valuation and Strategy: A Guide for Family Offices and Their Advisors
by John A. Kilpatrick, PhD, MAI

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The discussion next moves on to noninvestor purchases. Chapter 4, "Valuing the Personal Residence," is more about how to maintain value rather than how to value the residence. The importance of maintaining the roof, inspecting heating and air systems, appliances, floors, and the property's curb appeal is stressed. The author cautions that most appraisers and brokers are not skilled at dealing with the complexity of trophy real estate. Tips on buying and selling trophy properties are included, and the necessity of obtaining valuations from appraisers familiar with such properties is advised.

Chapter 5, "Valuing Rental Property," deals with buying rental real estate. Gross rent multipliers and capitalization rates are discussed along with capital rate extraction and the mortgage equity analysis method of capitalization (band of investment method). Emphasis is placed on using comparable sales that are truly competing rental properties when valuing a specific property.

Chapter 6, "Approaches to Value," introduces the principle of substitution and how appraisers are guided by this in determining value. The definition of *market value* establishes conditions that should be present in the comparable sales in order to be included in the sales analyzed. For this reason, foreclosure sales, assemblage sales, and other non-arm's length sales do not meet the definition of *market value* and should be excluded from consideration when selecting comparable sales. The author asserts the importance of using property sales with similar highest and best uses for analysis in the sales comparison approach. Different value conclusions are addressed with examples of market value, liquidation value, and investment value.

In Chapter 8, "Various Other Tools and Techniques," the author delves into specialized valuations, including timberland valuation and valuation of trophy properties. An interesting example of valuing timberland is offered where future values are discounted to present value and netted against the present value of cost incurred in growing the timber. Chapter 9 has a related topical discussion on valuation quirks.

Chapter 10, "A Deep Dive into Sales Comparison Approach: Residential," takes the reader through the process of how a residential appraisal is processed, and several methods of extracting market conditions (time) adjustments are discussed. Chapter 11, "A Deep Dive into the Sales Comparison Approach: Income Properties," explores several types of adjustments including size, market conditions, quantitative, and qualitative adjustments. Several sales adjustment grids are used to demonstrate appraisal concepts for agricultural land, shopping malls, simple retail,

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apartments, warehouses, and hotels. Key in most appraisals is an understanding of what constitutes a comparable sale and the proper selection of comparable sales. The author provides a good framework for comparable sales selection by digging deeper into sales data, beyond the broad information provided earlier in the text.

The discussion then moves from the sales comparison approach to "Income Approaches to Value" in Chapter 12. Here the focus is on the income approach from the perspective of investors. The author advises, "Higher levels of gross rent multipliers (GRMs) indicate markets with significant capital gain and rental growth expectations, and lower GRMs are observed in slow growth markets." Common ways of deriving capitalization rates, including market extraction, market surveys, and band of investment (mortgage equity analysis) are explained. The reasoning behind the author's positing the superiority of rank ordering of potential investments using net present values rather than internal rate of return (IRR) is made through alternative investments that are compared based on resulting IRR and net present value. He reminds us that when comparing projects, internal rates of return ignore project size and an IRR assumes that cash flows can be continuously reinvested at the same rate of return. Reinvesting all cash flows at the same rate may not be possible or a reasonable alternative.

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Reproduction cost and reconciling approaches to value are treated in Chapters 13 and 14, respectively. Valuing raw land for income or development is considered in Chapter 15. The importance of highest and best use for vacant land is stressed with examples of alternative highest and best use calculations provided for different potential uses. Value upon completed development less development costs provides net profit for various proposed uses, which are then compared to determine highest and best use for a vacant property. Feasibility tests, net ground leases, and subdivision analysis are also explored in Chapter 15. A table displaying the percentage of federally owned land in twelve western states is eye opening. Did you know that 84.9% and 64.95% of Nevada and Utah, respectively, are owned by the federal government? Would you believe the federal government owns 61.6% of Idaho and 61.6% of Alaska? The significant level of the federal government's ownership leads into a discussion of the Uniform Appraisal Standards for Federal Land Acquisitions and its appraisal compliance nuances.

One matter that is not made clear and may lead to misunderstanding relates to the differences between the "federal rule" and "state rule" that apply to appraisals made for condemnation or acquisition purposes. The author when comparing state rule to federal rule mistakenly states, "The state rule should end up in the same place, dollarwise, but gets there in a different fashion." (Page 326) Some additional clarification is required here. As the rules apply to appraisals, the federal rule requires an appraisal of a property as it exists before the acquisition and an appraisal of the remainder property after the project, as though the project is completed on the date of the acquisition. The difference between the two appraisals is the amount due the owner under the federal rule. The state rule requires an appraisal of the property, before acquisition, as it exists on the date of acquisition (Step 1). Further, an appraisal of the acquisition is made (Step 2) and subtracted from Step 1 to arrive at a new number typically referred to as "value of the remainder before the take" (Step 3). The remainder property is also appraised as it is at project completion; this value is typically referred to as "value of the remainder, after the take" (Step 4). Subtracting the value of the remainder after the take (Step 4) from the value of the remainder before the take (Step 3) allows one to conclude whether there are damages or enhancement to the remainder property. If the result is negative, damages are present; if the result is positive, value enhancement is the result of the taking. Under the state rule, the value of the property acquired plus any net damages establishes the amount due owner but in no event is the amount of the take reduced by enhancement value after the project. Benefits or enhancement value can partly or wholly offset damages under the state rule but it cannot reduce the value of the take in calculating the amount due the property owner. Under the federal rule, it is entirely possible for the property value, after the acquisition, to be increased to a point where the increase in value of the remaining property partially or fully reduces the amount that may have been due under the state rule. Stated differently, under the federal rule, if the increase in value of the remainder property is greater than the value of the acquisition, the amount due could potentially be zero. That is not the case under the state rule. Under the state rule, the property owner is entitled to the amount equal to the value of the property taken, *regardless* of any increase in value to the remainder after the take. Often an example of a farm is used to illustrate this situation, where an interstate highway crosses the farm and leaves it with four parcels at the four corners of the interchange. Under the federal rule, assuming the four corner sites at the interstate interchange exceed the value of the property acquired, the property owner is owed zero even though an acquisition has occurred. Therefore, the state rule will not end up in the same place, dollarwise, as the federal rule.

The author then takes up a number of real estate situations with special considerations. Chapter 17, "Real Estate and the Family Business," concentrates on situations where the real estate owned by a family is secondary to its primary business. The Walton family is cited as an example since they own numerous stores, warehouses, and distribution centers. Other examples are families involved in manufacturing and automobile dealerships where the family owns the business and the real estate that houses the business. The author cautions family investors that when no rent is allocated to the real estate it may conceal a situation where the value of the real estate is greater than the business. Other matters discussed include circumstances where the different generations have other interests and do not care to continue the family business.

Chapter 18, "Brownfields," discusses apparent brownfields, such as old factories, warehouses, dry cleaners, paint stores, and liquor warehouses. The loss in value is ideally ascertainable based on a comparison of the value of the property as though no brownfield exists and the value of the property as if impaired due to contamination or nearby contamination. The difference is presumed to be the amount of loss in value due to the brownfield's impairment. Net operating income can be reduced due to lower rents, vacancy and collection loss, and increases in operating expenses, which might include legal and other costs associated with monitoring the problem. Other proximity contamination issues are explored with appraisal solutions described that lead to estimates of value loss. The author presents an interesting viewpoint on investment in brownfields, which may involve deep price discounts, tax credits, public brownfield funds, and other local, state, and federal inducements. For knowledgeable investors, the author proposes that investing or speculating on brownfield properties could be profitable.

Chapter 19, "REITs, 1031s, Limited Partnership Interests, and Tenancy in Common," covers a number of subjects. Public and private real estate investment trusts (REITs) are compared. The author favors investing in public REITs over private REITs as private REITs lack the important advantage of liquidity available to public REIT investors and lack the transparency of NASDAQ-traded funds. Additionally, 1031 tax-deferred exchanges and pitfalls are briefly discussed. Minority, noncontrolling interests, and lack of marketability discounts relating to limited partnership interests along with tenancy-in-common investments are also examined here. Several court cases are cited, and minority interest and marketability discounts determined by the courts may provide some guidance as to percentage discounts used in valuing limited partnerships.

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Chapter 20, "Special Topics Frequently Encountered by Family Offices," delves into condominiums and cooperatives and cautions the investor about purchasing such properties without appraisals that consider comparable sales within and outside the same complex. The author notes that developers may set artificially high prices and stimulate sales with marketing gimmicks for initial sales that are not offered in marketing the condominiums later. Eminent domain issues and automated valuation models round out the balance of Chapter 20, along with a look at what happened in the real estate market during 2007 and 2008, with some comparison to the savings and loan crisis in the 1980s.

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Lastly, Chapter 21, "Some Final Points to Ponder," addresses the history of the appraisal profession over the past 85 years. The Uniform Standards of Professional Appraisal Practice (USPAP), real estate appraiser licensing, certification, and professional designations are described in some detail. A brief history of the Appraisal Institute and its predecessor organizations, the American Institute of Real Estate Appraisers and the Society of Real Estate Appraisers, is provided. MAI and SRA designations are described and promoted as top tier and highly regarded. The author points out that there is divergence among states regarding who must be licensed or certified to appraise property, but every state requires an appraiser to be licensed or certified to appraise properties for loans dispensed by a federally regulated lender when the loan amount is above a *de minimis* level.

Dr. Kilpatrick explores a wide-ranging assortment of appraisal topics in *Real Estate Valuation and Strategy: A Guide for Family Offices and Their Advisors*. While the stated target audience for this text is investors and their advisors, other real estate professionals will find small gems of wisdom and experience sprinkled throughout. Interesting real estate trivia—such as the percentage of property owned by the federal government—may be stored away for use at the right moment in time. For example, the author attributes a quote to economist John Kenneth Galbraith: "There are two kinds of forecasters: those who don't know, and those who don't know they don't know." That quote may be applicable in response to questions about the opposing side's expert witness opinions in a court case. On the other hand, appraisers who fail to read this book could fall into both categories of forecasters referred to by Galbraith.

About the Reviewer

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