Multifamily Real Estate Valuation at Freddie Mac
Freddie Mac Corporate Overview

- Freddie Mac is a government-sponsored enterprise (GSE), and we are now in conservatorship as managed by FHFA since September 2008.

- We operate in the secondary mortgage market, buying loans through a network of Seller/Servicers noted on FreddieMac.com.
We began shifting in 2009 from a “buy and hold” to a “buy and sell” model and are currently securitizing more than 95%+ of the loans we purchase

» The third-party reports, including appraisals, survive closing to be reviewed by securitization folks 3 to 12+ months after original loan funding
Background -- Multifamily Appraisals
The underlying exercise of a Freddie Mac review of a third-party real estate appraisal review is to determine if the appraiser has adequately supported his/her opinion of market value.
For us to have an opinion of the validity and veracity of the appraiser’s estimate of market value, we need to know what the appraiser knows, how the appraiser knows it, and how he/she used that information to derive the valuation of the subject property.

We don’t want: “Based on my years of experience and knowledge of the area...”
Revised Seller/Servicer Guide – Chapter 12 Highlights
We are rolling out revisions, edits, additions, changes, and/or updates

First time since 2008 that we have had a comprehensive set of revisions
Specific Revisions for Multifamily Appraisals
Each appraiser signing the appraisal must be a certified general appraiser in the state in which the property is located

(see “Appraisal Trainee” section, though, for an exception)
Appraisal Trainees

- Appraisal Trainees

  » An appraisal trainee may co-sign an appraisal if the appraisal trainee:

    - Is currently registered as an appraisal trainee in the state in which the property is located, *and*

    - Clearly and prominently identifies the appraisal trainee’s trainee license or certification identification number in the appraisal
Appraisal Trainees (Cont’d)

- Clearly and prominently states in the Letter of Transmittal his/her specific role in the appraisal project and describes in which parts of the appraisal process he/she had a contribution and the extent of that contribution

- Signs the Certifications in the appraisal and takes professional responsibility for the appraisal’s content, conclusions, and discussions

- Notes in the appraisal if he/she has inspected the property
Third-Party Reports

- The Seller/Servicer **must** provide the appraiser the property condition assessments and the environmental reports as soon as available but prior to the Seller/Servicer’s transmittal of the appraisal to Freddie Mac.
  
  » Draft versions of these reports are acceptable to meet these time constraints.

  » But, if the final version is materially different than the draft version, the appraiser must be given the final version and the valuation must be amended to reflect this new information.
Third-Party Reports (Cont’d)

- The appraiser must:
  - Identify the consultant, the effective date of the report, and whether it was a final version or a draft
  - Report the consultant’s conclusions and recommendations
  - Consider the incremental cost to cure, maintain, or operate the property due to the identified issues
  - Use the property condition report as the starting point for the Replacement Reserve
The appraiser must provide market data, analysis, and discussion to support any opinion of the effect or non-effect on value of an identified issue.

If there is an issue identified by the consultant, it is not acceptable for the appraiser to merely state that there is not a loss in value.

The appraiser needs to discuss why he/she has drawn that conclusion.

We don’t want: “Based on my years of experience and knowledge of the area...”
Third-Party Reports (Cont’d)

Although we want the appraisers to receive copies of the PCA or EA, not receiving them does not relieve them of their site inspection responsibilities.

No more of this type of statement:

- “We did not receive an environmental report or property condition report and we are not experts in this field, so we have no knowledge about the subject’s environmental or property condition issues.”

We expect the appraiser to say something like:

- “Even though we did not receive a draft environmental report, we walked around the subject site, including the rear of the buildings, the parking structure, the maintenance shed, the pool area, and down by the stream and over by the storm water management pond, and did not observe any obvious indicators of environmental contamination or adverse property condition issues.”
The appraiser must consider and discuss how zoning and other legal issues affect the value of the property.

Need to reference the authoritative zoning source in the appraisal.

Comparison of the property to competing properties:
  » Parking ratio compliance
  » Density compliance
  » Rebuildability restrictions resulting from substantial damage or casualty loss

How does the appraiser know if these issues have or do not have an impact on value?

*We don’t want: “Based on my years of experience and knowledge of the area...”*
The Seller/Servicer must direct the appraiser to include the following language in the letter of transmittal above the appraiser’s signature and/or on the appraiser’s Certification page above the appraiser's signature:

“This report is for the use and benefit of, and may be relied upon by,

a) The Seller/Servicer, Freddie Mac and any successors and assigns (“Lender”);

b) Independent auditors, accountants, attorneys and other professionals acting on behalf of Lender;

c) Governmental agencies having regulatory authority over Lender;

d) Designated persons pursuant to an order or legal process of any court or governmental agency;

e) Prospective purchasers of the Mortgage; and

f) With respect to any debt (or portion thereof) and/or securities secured, directly or indirectly, by the property which is the subject of this report, the following parties and their respective successors and assigns:

- Any placement agent or broker/dealer and any of their respective affiliates, agents and advisors;
- Any initial purchaser or subsequent holder of such debt and/or securities;
- Any Servicer or other agent acting on behalf of the holders of such debt and/or securities;
- Any indenture trustee;
- Any rating agency; and
- Any institutional provider from time to time of any liquidity facility or credit support for such financings

In addition, this report, or a reference to this report, may be included or quoted in any offering circular, information circular, offering memorandum, registration statement, private placement memorandum, prospectus or sales brochure (in either electronic or hard copy format) in connection with a securitization or transaction involving such debt (or portion thereof) and/or securities.”
New Inspection Requirements

- The appraiser must inspect:
  1. All down units to determine and comment on the amount of repairs/renovations necessary for occupancy
  2. All vacant units to determine the state of readiness for occupancy
  3. At least one of each type of unit to comment on the marketability of design, layout, amenities, level of finish, etc.
     - A minimum of five units
     - A maximum of 25 units

Note: If the combination of #1, #2, and #3 are more than 25, the appraiser can sample to get down to a maximum of 25

- The appraisal must identify the specific units inspected
Reparis and Deferred Maintenance

- The appraiser must:
  - Estimate the cost to complete the required repairs and any accompanying entrepreneurial profit, if applicable, and
  - Estimate the prospective date that repairs are to be completed, and
  - Analyze and describe any prospective vacancy issues resulting from the repair process, and
  - Estimate the prospective date that lease-up due to repairs is estimated to be completed, and
  - Adequately describe, analyze, and discuss the effect of the repairs on market value
The appraiser must: (Cont’d)

» The appraiser may rely on (should rely on!!) the data, discussion, and conclusions of the property condition report and the environmental report in analyzing and reporting on the property’s improvements.
Everyone who signs the appraisal must have inspected the property.

Everyone who signs the appraisal must be certified in the state in which the property is located.
Property Tax Assessment Requirements

- **We no longer want to see this type of language:** “There is a risk of reassessment, so we increased the capitalization rate by 50 basis points to account for this risk.”

- The appraisers must specifically address the risk of a property tax reassessment and to quantify that risk.

  » That is:

    - Will the property be reassessed in the near term?
    - If so, then estimate the magnitude of reassessment and/or taxes
    - Draw a conclusion about the impact on value
    - Any adjustment to the capitalization rate must have adequate support and discussion
Property Tax Assessment Requirements (Cont’d)

- These following two slides are *suggested methodology*, not requirements

- Local practice may vary

- Please don’t say, “Marty said I had to do it this way…”

- We want an analysis of the impact of the risk of a potential reassessment and a *supported* adjustment to the value, *if* warranted
Suggested Methodologies for Analyzing Potential Tax Assessment Changes

- **Method #1** -- Pick sales within the same jurisdiction which had a similar re-assessment risk at the time of sale.

  » Why wouldn’t these sales already incorporate the market’s reaction/response to the risk or reassessment?
    - In the sales price
    - In the capitalization rate

  » In this methodology, there is probably no reason to adjust the capitalization rate
Methodologies for Analyzing Potential Tax Assessment Changes (Cont’d)

- **Method #2** -- Pick a number of sales within the jurisdiction
  
  » Note the change that occurred in their assessments after the property was sold

  » Maybe construct a table showing the relationship between sale price and reassessment from these sales

  » The jurisdiction’s decision to change a tax assessment, and the aggregate change relative to the sale prices, could be a guide for the appraiser’s appropriate estimate of taxes

  » There is no need to try to adjust the cap rate with this methodology, either
Sales Comparison Approach

- **No adjusting for Net Operating Income (NOI) differential**
  
  » *We are interested in the similarities and differences that affect value, not just that NOI of the comparable is different*

  – We need an analysis of *why* there are variations in NOI
  – Occupancy, location, condition, unit size, amenities, and the like

- **No Net Income Multiplier calculations (NIM)**
  
  » The NIM is just the inverse of the capitalization rate and does not tell us anything new
Income Approach – Market Rents

- Analyze and discuss the difference, if any, between the property’s actual recent contract rents and the appraiser’s market rents

- If the subject’s rents are not at market levels:
  » Why aren’t they?
  » What will it take to achieve market rents?
  » How long will the subject take to achieve market rents?
  » What is the impact on value?
Income Approach – Vacancy

- The former version of the Freddie Mac Seller/Servicer Guide required a minimum 5% vacancy and collection loss, regardless of market conditions.

- This limitation is eliminated.
  
  » The appraiser can use whatever vacancy and collection loss the market indicates.
Income Approach – Capitalization Rate

- Five methods of capitalization rate development is expected
  - Comparable sales
  - Published sources (preferably the subject’s MSA, or similar)
  - Personal surveys
  - Band of Investment model (with sources of financial assumptions)
  - Debt Coverage Ratio model (with sources of financial assumptions)

We don’t want: “Based on my years of experience and knowledge of the area...”
Income Approach – Capitalization Rate (Cont’d)

- Published Sources -- PwC Real Estate Investor Survey

### PwC REAL ESTATE INVESTOR SURVEY
First Quarter 2014

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<th>REGIONAL MALL</th>
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* a. Rate on unleveraged, all-cash transactions. Definitions: b.p. basis points. Discount Rate (IRR), internal rate of return in an all-cash transaction, based on annual year-end compounding. Overall Cap Rate (OAR), initial rate of return in an all-cash transaction. Residual Cap Rate, overall capitalization rate used in the calculation of residual price, typically applied to the NOI in the year following the forecast. Source: PwC Real Estate Investor Survey, formerly known as the Korpacz Real Estate Investor Survey. Personal survey conducted by PwC during January 2014. For subscription information, please visit [www.pwc.com/us/realestatesurvey](http://www.pwc.com/us/realestatesurvey) or call 1-800-654-3387.

Chapter 12: Updates (Appraisals)
Published Sources – CBRE’s Capitalization Rate Survey

### Multi-Housing Suburban | Eastern Region

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<th>Class B</th>
<th>Class C</th>
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<td>6.25% - 6.75%&lt;br&gt;↑</td>
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<td>5.75% - 6.25%&lt;br&gt;↑</td>
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Band of Investment

Band of Investment model

\[
\begin{align*}
\text{Loan } \% \times \text{Mortgage Constant} &= \text{Loan contribution} \\
\text{Equity } \% \times \mathbf{\text{Equity Dividend Rate}} &= \text{Equity contribution} \\
&= \text{Capitalization Rate}
\end{align*}
\]

- Equity Dividend Rate (EDR)
  - Meaning of the rate relationships
Income Approach – Capitalization Rate Models (Cont’d)

- Debt Coverage Ratio Model

\[
\text{Debt Coverage Ratio} \times \text{Loan Percentage} \times \text{Mortgage Constant} = \text{Capitalization Rate}
\]
Photographs

- Date and source of each photo must be clearly identified and dated
  - For example:
    - Appraiser’s original photo
    - Photo copied from the Internet
    - Photo scanned from a marketing brochure

Pictures taken from Internet sources or marketing materials are ok, as long as the appraiser says where they come from
The photographs of the sales comparables must typically be reflective of the sale property at the time of sale.

The photographs of the subject property must be reflective of the subject property as of the effective date of the appraisal value.

Please try to avoid placing the dates and/or source reference on the actual photograph – sometimes they obscure the detail in the photo.
Insurable Value

- Insurable value must be provided in all appraisals

- The Replacement Cost is the cost to reconstruct a property of an equal number of units with equal quality of building materials with equal utility that would be acceptable to the typical investor and tenant in the market in which the property is located

- Replacement Cost is not the cost to construct a replica of the property

- For Freddie Mac insurance purposes, the Replacement Cost may not include goodwill or other intangibles such as value/cost of the land, a deduction for depreciation, cost of site improvements, (e.g., driveways, parking lots, sidewalks, or landscaping), or cost to reconstruct the foundation(s)
The Freddie Mac preferred valuation methodology for tax abatements:

- **First**: Determine the value with full, stabilized real estate taxes

- **Second**: Calculate the present value of the tax savings over the term of the tax abatement
  - The discount rate must be fully supported by the appraiser

- **Third**: The PV of the tax savings is added to the property value with full taxes to yield the property’s value with tax abatement
Tax Abatements (Cont’d)

- If local practice is different from the Freddie Mac preferred methodology, use the local methodology with a full explanation of the differences in technique.

- The appraiser must demonstrate in the appraisal that the tax abatement is likely to continue for its stated term.
  - This can be accomplished by:
    - a review and discussion of the tax abatement agreement, and/or
    - documented confirmation of the tax abatement with the local property tax authority or abatement-granting agency.
New Sections for Specific Property Types

- Student Housing
- Affordable Housing
- Senior Housing
- Manufactured Housing Communities
New Specific Property Types (Cont’d)

- Common themes in the requirements for the new property types:
  - Ideally, use local property specific comparable sales
  - If not available, regional property specific sales are ok
    - The appraiser must explain the locational differences
  - Local *non*-property type sales may be used
    - The appraiser must explain the functional differences
  - The appraiser must discuss in sufficient detail the adjustments necessary to correlate these sales to the subject property
Student Housing

- The appraiser must consider the following:
  - Distance from the subject student housing property to the school, and available transportation
  - Any school policies affecting student residency (for example, requirements for freshmen and sophomores to live on campus)
  - Changes to school-sponsored amenities, whether on- or off-campus
  - Changes in the supply of on- or off-campus housing, whether sponsored by the school or planned and built by private developers (such as dormitories, for-profit or not-for-profit apartments, and fraternity or sorority housing)
Affordable Housing

- If the property has restricted units, the appraiser must include an estimate of market value with the restricted units and hypothetical market value without the restricted rents.
- Must document the source of the property’s restricted rents.
- Must provide adequate support, analysis and discussion for the continuation of the restricted rents.
- If the appraiser concludes that the restricted rents will expire or not continue, the appraiser must use the appropriate methodology to value the property considering the likelihood of the restricted rents expiring.
Conclusions and Wrap-up

To eliminate “Speed Bumps" and “Go-Backs”:

» The engagement letter should reflect the necessity for compliance with all of Freddie Mac’s requirements

» The engagement letter should clearly require that the appraiser use our reliance/intended user language *exactly* as it is written in the Guide

» The appraiser should be given a copy of Chapter 12 of the Guide and a copy of Freddie Mac's Appraisal Best Practices with every engagement

» The Seller/Servicer's appraisal review should also incorporate the appraiser's compliance with the terms of the engagement letter, with the requirements of Chapter 12 of the Guide, as well as with industry standard appraisal practices.

» Typically, the appraisal should not be sent to Freddie Mac until the Seller's review is complete and the appraiser makes any changes/edits/revisions resulting from that review
Conclusions and Wrap-up (Cont’d)

To eliminate “Speed Bumps" and “Go-Backs” (Cont’d):

» The appraiser should read the Seller/Servicer's entire engagement letter and ask for clarification of anything not understood out the outset of the appraisal assignment.

*It truly is ultimately the responsibility of the appraiser to understand and comply with Freddie Mac's multifamily real estate appraisal requirements prior to report submission*
The reality is that nobody wants to pick up a file from six months ago and revisit an appraisal that they thought was already acceptable.

Let’s all work together to get the reports in compliance with the Freddie Mac Guide from the beginning.
Questions?