Credit Risk Ready Podcast

Host Linda Keith CPA With Gina Marotta

CRE Valuation and Appraisals: Who, When, and What Else

Linda Keith:
Hi, this is Linda Keith CPA with Credit Risk Ready, a podcast where we interview senior credit and lending professionals from community financial institutions across the United States, their regulators, and banking advisors to better understand and mitigate credit risk.

Our guest today is Gina Marotta, an independent consultant in commercial real estate due diligence. She currently works directly with community, regional, and national financial institutions who need a CRE collateral subject matter expert for loan origination or review. Her deep expertise comes from 30 years in this field and includes loan re-underwriting and due diligence on behalf of high-yield investors purchasing commercial real estate loans and assets. During the Great Recession, she was on a team that revalued CRE portfolios of banks the FDIC had slated for closure, and add to that Gina has worked with a major private equity firm building a distressed debt platform to invest in small-balance mortgage loans of failed community banks throughout the US.

In this episode, we focus on CRE valuation and appraisals: who does what, when, and what else.

Welcome back, Gina.

Gina Marotta:
You're welcome. Thanks for having me back, Linda.

Linda Keith:
Appraisals and valuations are a critical part of loan origination and loan review. But in an environment of shutdown of businesses, physical distancing, consumer angst, and business uncertainty, landing on a valuation you can be comfortable with is a daunting task, isn't it, Gina?

Gina Marotta:
Really a big puzzle right now for portfolio managers and the industry where there's national appraisal firms: CBRE, Colliers, Cushman & Wakefield… all these appraisal firms are going out there and they're

buying very talented regional and local appraisal operations. And I actually am concerned about that, because I think that a lot of these lenders are using these bigger firms because they have data, but that doesn't mean they have real local market knowledge and incorporating that into your valuation. These larger firms, while yes, they have a lot of data available to them, they oftentimes utilize offices in different locations to pull certain parts of the reports together. So, you don't have the same author working on your lease comps, your sales comps, selecting them, I should say, or your submarket and your neighborhood analysis. So be careful about using the big firms. Understand that the some of the smaller local firms do have local market knowledge, especially that is needed right now in this time.

So, consider the local and the regional appraisal network sources. Diversify it, don't use one for everything, and be careful about using the bigger firms all the time for too many things. One of the things we do when we do an appraisal review is not only understanding cash flow available for our debt service, but also trying to understand do we have collateral support to our loan amount, namely the LTV? And do we have balloon risk? Will another lender be able to come in and refinance us out at our unpaid balance of a loan of maturity? So really hard as a loan reviewer to come up with a value because you're really trying to come up with a cap rate, and a cap rate is a point in time valuation metric.

The other analysis tool is a discounted cash flow. Most portfolio managers do not do discounted cash flows, which is typical over a 10-year holding period. And they don't ask their appraisers to do them, because appraisers will charge more to do a discounted cash flow, which is typically done in ARGUS.

So what we do from an appraisal or from a loan review perspective is we come up with our underwritten NOI, and that's assuming we've got a stabilized property. A lot of us now, we don't have a stabilized cash flow. An unstabilized property is defined as one that is not occupied at the submarket level. So maybe you lost a tenant that occupied 50% of your property. That tenant’s vacated. Your market runs at a 10% vacancy. So, you're unstabilized. But also have a property that's reached stabilized occupancy, but it's not stabilized in terms of its income, because that tenant may be in a long free-rent period; they're in occupancy, the lease has started, but they've got 12 months of free rent. It’s still not stabilized because the income isn’t stabilized, so you've got an unstabilized property. So, what I recommend from an appraisal and this is what, you know, the norm is in the industry, in order to do a mark-to-mark market on your property, do a stabilized value and then apply a lease-up discount. And that lease-up discount is associated with the income lost due to the vacancy and your tenant improvement leasing commission costs, and any deferred maintenance, to come up with an as-is price value.

Linda Keith:
How do you decide how long it's going to be vacant?

Gina Marotta:
Well, with the COVID, obviously, it becomes problematic. But there's typical rules of thumb, you know, dependent on when you are urban, suburban. How long is the marketing period? So, I'm going to layer in another tool that is really effective that I recommend managers to do is to put a phone call into local brokers, and ask, you know, just have a conversation. Tell them you work for lender. Tell them you're doing a loan review. The local brokers will know your property. A lot of them like to talk. They'll definitely like to talk to a lender because you’re a potential client if you ever took the property back or had a receiver in place and you needed to lease it. They know you're going to work with them, or they

know now that you could potentially work with them. Talk to local brokers. There's no substitute for local broker knowledge. So, that's how you get that downtime.

You also hear from them. What are 10 improvement rates right now? What kind of free rent are you giving? They turn from assumptions to analytics. These are very important analytics to understanding where your value is, because not a capital investment that needs to be made to earn that income is going to translate into your value.

I do want to make a note because I think some of your listeners might be considering or using CoStar. CoStar is a national database. You've done a phenomenal job of tracking market trends, market statistics related to rental rates, occupancy, and sales comps. They classify office, retail, industrial, apartments by class, so A-, B-, C-quality properties. They do a great job. They generate an underwriting report, which is typically 90-to-110 pages. CoStar is expensive. I would be very careful relying on CoStar information to re-underwrite a property. It's good data, but it's a secondary source of information. There's no substitute for the primary source of information by having these local broker calls and speaking specifically about your property, and also taking into consideration the reporting information that you get in the rent roll in the operating statement for your particular property.

Linda Keith:
So, if you do both of those things, and they seem to support each other, then you'd be in a really strong position?

Gina Marotta:
Yeah, and at the end of the day, Linda, if those that have experienced - I know a lot of podcast listeners have this experience - when you come up with a value, do a quick price-per-pound gut check.

Linda Keith:
What is that?

Gina Marotta:
Yeah, price-per-pound. That is lingo in the industry. It is when you take your value, you divide it by your net rentable area or number of units in the multifamily property. If your value comes up with, say, multifamily at $20,000 a unit, and you know you've got a good mix of one- and two-bedroom apartments, and you know that the market trades have been about $100,000 a unit, you know that there's a big disconnect. The thing in the market right now is there's so much capital going in, there's a lot of capital sitting on the sidelines, that the investment value of a property is a lot higher than what your underwritten values will be.

Linda Keith:
It's because of market forces, not because of actual value of the property?

Gina Marotta:
Right. What they're looking at is not point in time value, but in five to seven years the value of that property will be healthier than it is right now. And that's where the discounted cash flow analysis comes in most portfolio managers don't have the time or the tools to do. It's a real art, but coming up with a value is critical. I'm not a fan of relying on an appraisal, especially when it's more than a year old, and maybe more than six months old in the current market environment.

The other tool that is used… I'm going to speak to your podcast listeners. But there's a fair number of single-tenant absolute net lease transactions going on right now in the marketplace with your borrowers. Borrowers that are retired or they are having some cash and they're buying a Walgreens or buying a CVS or they're buying Dollar General Store. A lot of that going on. There is a group called The Boulder Group out there and they do a fabulous research report on cap rates; cap rate trends; sales prices per square foot; by category: quick service retail, which is like Wendy's, McDonald's, and Taco Bell; by drugstores, which is Walgreens, Rite Aid, CVS; and other categories, like auto dealers. They do a very good job of giving you metrics to be able to do evaluation. Unfortunately, and I've used these resources for probably 15 years now, companies like CDR, Marcus & Millichap, Cushman &Wakefield, they have market research reports on their website that you can download. But, unfortunately, they have gotten weaker, in my opinion, on giving data related to investment sales and valuation trends. They'll give you vacancy and rental rates on a region, but it's really hard to underwrite based on that data. They'll also give you really good narrative. They'll give you a good narrative on what's going on in generally in a market. But again, they're not giving you the numbers that you need in order to do evaluation.

So, one of your questions, Linda, was when does a lender go out and get an appraisal update? A lot of lenders when a loan goes on to a watch list, let's say it's a large loan, or it's a large relationship with a number of loans, a lender will spend the money to go out and get an appraisal update, which could run anywhere from $1,500 to $3,000. It can be a big expense on a per-loan basis. So, it's a real judgment call, business call, by the portfolio manager. Those appraisal updates are helpful, but there's no substitute for paralleling that with a broker opinion of value. I have heard in the past that the regulators don't really want portfolio lenders, banks, to rely on broker opinion values. But the broker opinion values, in my experience, are more relevant to what's going on in the investment community as it relates to the valuation of your property, because those brokers are the ones that go out and market properties for sale. Appraisers do not.

Linda Keith:
So, I would think that regardless of what the regulators want you to do, it doesn't hurt you to have those phone conversations with the brokers. So, you can be making a good judgment call for your bank and for this loan, and, sure, you need to also understand what the regulators appreciate and don't. But I've always been a big fan of making good loan decisions, whether the regulators like your process or not. I mean, obviously, you can't intentionally get in trouble with regulators. But the regulators are not the one in your seat who has to decide, is this loan going to be a performing loan? And what do I need to know to make good decisions? And if picking up the phone and getting broker information enhances your ability to make a good decision, I would just think that just makes sense to do.

Gina Marotta:
Exactly. And rule of thumb, and I always go back to this and it was very important in the distressed debt side, is the property marketable? Is it no purpose? Single-tenant? Special purpose? Those properties are less marketable. But if it's a marketable asset, good market, good location, good curb appeal, then that mitigates your risk regardless of what your current cash flow situation is.

Linda Keith:
So, Gina, you've talked about the lender having a sense of value: getting it from the appraiser, talking to a broker… when you look at all those, and then you look at what the borrower wrote down as their value on their real estate owned, what about the borrower's opinion? And how does that fit in?

Gina Marotta:
Yeah, that's a good point, Linda. So oftentimes, when I conclude a value, I do look at what the borrower is reporting on their schedule of real estate as to their view of value. And, you know, no one knows best their property than the borrower. So if they're a borrower, that is a real estate investor and that's the business they're in, I do take their value into consideration and sort of triangulate it against the source information that I received for values and would document that. And especially if they have other property values that I can validate against a Zillow value, a sense that the borrower is reasonable with regard to their property values. So it doesn't hurt to take a look at what the borrower's view is of the value, and especially if they're asking for forbearance and the value support is there, you can actually ask them how they came up to their concluded value in view of, you know, what they're telling you about the property today.

Linda Keith:
Right? Well, you know, it's interesting. So, I don't do commercial real estate investment myself, but I do residential real estate investment. And I, as I listened to you, I'm thinking, you know, when I think my loan-to-value is pretty darn low, I just go grab Zillow's number and throw it on, right? I don't spend a lot of time because it doesn't make any difference. So, if that very same loan got into difficulty, what I wrote down on the real estate owned sheet might not be what I think it's worth right this minute as we're talking. It may be what I thought it was worth that loan origination or even what I could easily document, because I just didn't think that getting a really good number for a value was important to anybody. Is that just because I'm a residential real estate investment person and most commercial real estate investors actually do pay more attention to the numbers? Or are we all a little bit lazy when it comes to this stuff?

Gina Marotta:
It really depends on the person, their experience, you know, how detailed they are. It's very dynamic.

Linda Keith:
It is dynamic. It is dynamic, and the very same borrower can be willing to get much more careful now, especially if they're coming in for forbearance, or whatever they recognize that they need to perhaps have better numbers and a better justification for their numbers in this circumstance than perhaps they did when they originated a loan.

Gina Marotta:
That's right.

Linda Keith:
Man, what an interesting piece to the puzzle. So that's appraisals. And it's an important part of commercial real estate lending, certainly an important part of loan review of commercial real estate. It is just one piece of the puzzle. But we have to have a good sense of that piece to actually make good decisions both in origination and in review.

So, Gina, thanks for helping us walk through that. I remind everybody we have a document that's part of the show notes that's going to cover the steps that she has provided here and some of those terms that we don't all know already, so that you can combine looking at that with listening to this and be in a better position to understand what your appraisal is telling you and how you need to look at it to actually make a good decision and document that decision right now. So, thank you so much, Gina.

Gina Marotta:
You're welcome.

Linda Keith:
Thanks for joining us on the credit risk reading podcast. Subscribe, comment or share on social media to stay connected and spread the word. Join me next time as we bring our bank, our customers, and our communities through the recession safe and sound.

Take care.

Resources

- *Do's and Don'ts in CRE Loan Underwriting*: https://lindakeithcpa.com/wp-content/uploads/2020/10/Dos-and-Donts-in-Commercial-Real-Estate-Loan-Underwriting-Credit-Risk-Ready-Podcast.pdf
- *Do's and Don'ts in CRE Loan Reviews*: https://lindakeithcpa.com/wp-content/uploads/2020/10/Dos-and-Donts-in-Commercial-Real-Estate-Loan-Reviews-Credit-Risk-Ready-Podcast.pdf
- Gina Marotta Loan Review Worksheet: https://lindakeithcpa.com/wp-content/uploads/2020/08/Gina-Marotta-CRE-Loan-Review-Checklist-3.xlsx
- Contact CRE Answers and Advisory for answers to questions or transaction-related support services related to commercial real estate: https://creanswersandadvisory.com/

About Gina Marotta

Ms. Marotta is a subject matter expert in mortgage finance, property ownership, and due diligence involving performing and non-performing commercial real estate loans and properties. In addition to structured finance transactions, she works with credit unions on the underwriting analysis of new loan participations and the completion of annual loan reviews, global cash flow analysis, and credit risk rating of commercial real estate loans.

Since 1995, she has held a variety of roles in pooled mortgage transactions that include the re-underwriting of some $70 billion in legacy CMBS loans under the US Treasury's PPIP program; managing the securitization process of commercial real estate loans; and loan re-underwriting and due diligence on behalf of high-yield investors purchasing commercial real estate loans and assets. Between 2009 and 2012, Ms. Marotta worked with a major private equity firm in building a distressed debt platform to invest in small balance mortgage loans of failed community banks throughout the US.

Ms. Marotta has held various senior consultant roles in Latin America since 2004 that include: social interest housing securitization transactions, enterprise risk assessments of social interest housing mortgage companies, distressed small-balance mortgage loans, and operational assessments of regional mortgage and consumer finance companies.

In addition to her corporate and consultancy career in real estate investment transactions, she has been an investor in various commercial and multifamily properties in California and Michigan.

Ms. Marotta began her career in 1987 working in the urban mixed-use development group of the Santa Fe and South Pacific Railroad (Santa Fe Pacific Realty). She holds an MBA from the University of San Diego and an MA in international human rights from Columbia University. She is the founder of the non-profit Human Strategies for Human Rights, which she ran from 2001 through 2004, focusing on NGO capacity building, and held consultancy positions at the United Nations in 2000 and 2001. She maintains consultancy offices in Los Angeles and Detroit.

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About Linda Keith

Linda Keith, CPA, draws on her 30-plus years of experience consulting with and training lending institutions; background in public accounting; 15-plus years as CFO of the family residential construction company; and experience as an Examiner with the Washington State Auditor's Office and as adjunct faculty in Accounting Principles and Managerial Accounting to help lending and credit professionals say "yes" to good loans.

Of course, you know those are not consecutive years or she'd be over 100 by now!

Linda is known by her clients to be both practical and funny. In fact, there is a movement afoot to change the 'P' in CPA to stand for 'Playful'. The fact is, people absorb ideas and learn better when they are having a little bit of fun. So, Linda brings the fun along with her practical knowledge and depth of understanding to provide credit analysis training and presentations that make a difference.

She is the founder of Lenders Online Training, a virtual classroom approach to improving tax return and financial statement analysis capabilities; the host of the Credit Risk Ready Podcast; and a consultant/trainer on credit risk to banks and credit unions across the country.

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