

1. Introduction

The Michigan State Housing Development Authority (MSHDA) obtains real estate appraisals from time to time to inform its decisions as an allocator, a regulator, and a lender. These guidelines present MSHDA's baseline expectations for the quality and content of those appraisals, although specific requirements may vary in the context of specific transactions or decisions and supersede these guidelines. The guidelines also highlight specific issues that may arise without attempting to be exhaustive or definitive.

2. MSHDA's several roles

MSHDA plays several roles in transactions to preserve affordable housing. It:

- Allocates state and federal subsidy resources
- Makes loans to finance acquisition, construction, or renovation of properties
- Regulates property operations, including approving proposed transactions

In each of those roles, MSHDA is called upon to evaluate whether a property's value supports the transaction. Frequently, an appraisal informs that evaluation. Since the roles differ, MSHDA's approach to property value and the use it makes of an appraisal also differ.

As a **lender**, MSHDA observes value as collateral—is the property sufficiently valuable to protect MSHDA's investment? MSHDA performs detailed underwriting to evaluate the property's ability to pay the proposed debt service, but it also relies on an appraisal (among other sources) to determine whether the property provides sufficient collateral. As a lender, MSHDA works closely with the borrower to size the loan and negotiate terms. In these instances, MSHDA looks to an appraisal for an independent check where it already has a detailed understanding of the property.

As an **allocator** of resources, such as the Low Income Housing Tax Credit (LIHTC), MSHDA must assess whether a proposed transaction is an efficient and effective use of public funds. This calls for less precision than a lender's analysis and a more programmatic approach, in which properties often compete for funding under a set of rules. MSHDA determines the amount of resource to allocate within the parameters of the program. It may use an appraisal to assess how a property fits within the rules of the program.

As a **regulator**, MSHDA is often called upon to approve a transaction that has already been negotiated or is in under negotiation. While MSHDA's veto power does typically give it some leverage to alter terms, in the end the response required is a yes or no. MSHDA may rely on an appraisal, among other data sources, to assess whether the proposed transaction is consistent with the affordability requirements applicable to the property and a proper use of public resources.

3. Expectations for appraisals

MSHDA expects appraisals to provide independent expertise on the value of properties. As indicators of that independent expertise, MSHDA requires:

1. Appraisals should be complete, self-contained reports prepared in accordance with Uniform Standards of Professional Appraisal Practice (USPAP).
2. The appraiser should be licensed by the Michigan State Board of Real Estate Appraisers as Certified General Appraisers.
3. Appraisals should be delivered in electronic format (Adobe PDF or equivalent) suitable for printing or electronic distribution.

These guidelines are no substitute for the appraiser's professional judgment. Rather, they are meant to assist appraisers in addressing the specific issues that arise with regulated multifamily properties. MSHDA encourages appraisers with questions about these guidelines and their implications for specific appraisals to contact John Hundt at hundtj1@mshda.gov.

All appraisals are delivered subject to MSHDA's approval as to their quality and appropriateness to the particular circumstance. MSHDA, in its sole discretion, may request revisions or reject an appraisal outright.

4. Affordable housing appraisal issues

Affordable housing is a particular asset class that raises issues that are rare in other asset classes. Indeed, the Appraisal Institute has observed that "appraisals for subsidized housing require knowledge and experience beyond typical appraisal competency."¹ MSHDA offers the following guidance on specific issues to inform appraisers as they conduct their appraisals. These guidelines are not a substitute for an appraiser's independent expertise, nor are they exhaustive in their coverage of potential issues.

4.A. Affordability commitments affect value

Affordable housing developed under a public-private partnership is based on a bargain—the owner commits to regulated use renting to low-income tenants often at below-market rents, and government commits to provide public resources for capital and/or operating support. Both sides of this bargain affect value:

- Rent restrictions reduce potential income
- Regulation increases the overhead cost of operating and managing the property
- Tenant selection can affect operating costs
- Operating subsidy or required rent advantage can reduce economic vacancy and increase the certainty of the income stream
- Capital subsidy can, in some circumstances, indirectly support a higher purchase price
- In rare circumstances, long-term operating support can result in above-market rental income
- Long-term use restrictions can limit the timing of or even ability to access new capital

Assessments of value need to take into account how in a particular instance the particular public-private bargain affects a property's value.

¹ Excerpts from USPAP Advisory Opinions 14, available at http://www.uspap.org/2010USPAP/AO/ao11_20/ao_14.htm

4.B. Affordable housing and discontinuity

The long-term nature of most affordability commitments creates discontinuities in a property's financial structure and operations—points in time where the owner and/or the regulator have options about how the property will operate in the future. That optionality relates directly to value, particularly if the optionality rests with the owner.

An assessment of value like an appraisal should take into account such discontinuities. For example:

- A property has a long-term property-based Section 8 contract at above market rents. At expiration, the contract may renew, but only at a lower rent. Valuation must take into account the expected change in income.
- A property is eligible to prepay its mortgage, which would cancel its affordability commitment and allow market-rate operations. Valuation must address the potential for conversion to market rate use.
- A property is subject to a 50-year use restriction that limits occupancy to very-low income residents at affordable rents. Such use restrictions run with the land and would survive a foreclosure. Valuation must recognize the long-term nature of the use restriction.
- A property receives annually authorized operating subsidy that may be cancelled by government. Valuation must address the risk (if any) of such cancellation actually occurring.

Simply put, the value of the property is the higher of market or affordable use, taking into account how and when each use is possible and accounting for the risks that adhere to each option.

4.C. Valuation methodologies

Traditional appraisal methodologies—income, comparable sales, and cost—each have particular issues for affordable housing. Appraisers should exercise their professional judgment as to the appropriate valuation methodologies for the particular property being appraised.

4.C.1. Income method

Regulated affordable housing properties typically have restrictions on their use, operation, or distribution of income to the owner. They are also the product of government programs that may no longer actively creating new properties in the same form, so they cannot be replicated now. In these circumstances, the income method may often be the most, or even the only, appropriate valuation method.

Even within the income method, appraisers should take care to use the appropriate technique. For instance, while direct capitalization of income may be appropriate for a property that can raise or lower rents as market conditions dictate, it would be misleading for a property with time-limited, regulated rents. See 5.B. for discussion of a specific example.

4.C.2. Comparable sales method

The comparable sales method can provide relevant indicators of value when sufficient data are available. Appraisers should take care that selected comparables are truly comparable in their tenancy, market position, location, affordability restrictions, and other relevant variables. Two physically similar properties in the same submarket could have very

different values if one is unencumbered and the other has long-term affordability use restrictions or distribution limitations. Appraisals should, in general, avoid using transactions between related parties or transactions involving significant government subsidy as comparables, since these may not be accurate indicators of market value.

4.C.3. Cost method

The cost method is rarely applicable to affordable housing properties. Often, these properties received capital subsidy toward the cost of development to make them economically feasible at reduced rents. Many are older properties that could not or would not be built in their current physical configuration or location if built today. Often, the government programs that produced the properties are no longer active, so the set of financing and regulatory features could not be replicated today. That said, the cost method may be relevant in some instances. Appraisers should consult closely with MSHDA staff if planning to rely on the cost method.

5. Issues frequently raised

Some specific issues arise frequently in MSHDA's review of appraisals. This section provides general guidance on these issues to guide appraisers. It is neither an exhaustive list of potential issues nor a definitive answer on the issues addressed, but rather a tool to ease communication and encourage more useful results.

5.A. LIHTC rents vs. market rents

LIHTC maximum rents are set by regulation relative to area median income. In some markets, where rents are high relative to median income, LIHTC maximums constrain the rent a property may charge. In other markets, supply and demand do not support rents above the LIHTC limits, and so rents are constrained by what the market will bear. Appraisals should not simply use LIHTC maximums by default, but should apply the lesser of market or LIHTC rents, taking into account a full analysis of the local market.

5.B. Above market Section 8 rents

Take the first example in 4.B above: A property has a long-term property-based Section 8 contract at above market rents. At expiration, the contract may renew, but only at a lower rent.

If the appraisal simply applied a capitalization rate to an income based on the above-market rent stream, it could over-value the property because the capitalization method assumes that the income stream is stable into the future. Conversely, if the appraisal based its value on comparables that did not have above market rents, it could under-value the property by ignoring the value of the subsidy stream.

The valuation should use a method that captures the time-limited, discontinuous nature of the above-market rents. One way would be to separate the above-market income component from the market-rate rent component via a discounted cash flow analysis. This is similar to a typical lending approach which sizes two loans: an A loan at market rate rents plus a B loan sized to the time-limited above-market Section 8 payment stream. Other methods are possible, of course, and it is up to the appraiser to select and apply the proper methodology.

5.C. Pre- and post-rehab value

In general, MSHDA seeks an appraisal of a property as-is. In specific circumstances, post-rehab values may be requested. This may be specific to MSHDA's role in a transaction. To MSHDA as a lender, the value of a property post-rehab may well be relevant to the security

of a loan. To MSHDA as an allocator, in contrast, post-rehab value is of far less relevance to allocation decisions.

5.D. Value as market vs. value as affordable

Some appraisals attempt a simple distinction between a property's value as market housing (no rent restrictions or distribution limitations) and its value as affordable housing (receiving capital or operating subsidy). Often, this simple distinction masks the varied ways in which affordability commitments can affect value, as discussed in 4.A above. In general, the value of the property is the higher of market or affordable use, taking into account how and when each use is possible and accounting for the risks that adhere to each option.

Consider two examples:

- MSHDA as a lender requests an appraisal to value a property as collateral for a loan. If MSHDA foreclosed on the loan, the foreclosure would eliminate existing affordability restrictions, so the recovery would be against the property as unregulated market housing. An appraisal that valued the property as unregulated market housing would therefore be appropriate.
- MSHDA as an allocator requests an appraisal to assess a proposed transaction between related parties. Sales price in the transaction is an element of the calculation of resources to be allocated. The property is encumbered by a long-term use restriction and has property-based rental assistance, both of which would remain in place after the transaction. An appraisal that valued the property with those affordability restrictions in place would be appropriate.

5.E. Land Valuation

The value of the land included in project cost shall not exceed the lesser of its appraised value or the purchase price. For in-kind contributions of land, evidence of the value of the contribution must be supported by an appraisal.

The question of how to value a property thus depends on the context in which it is being valued. Appraisers should contact MSHDA staff requesting the appraisal if they are unsure of the context or seek specific direction.

6. Conclusion

Appraisals provide an essential, independent, expert valuation to inform MSHDA's decisions as lender, allocator, and regulator. MSHDA relies on appraisers' expertise and professional judgment, and offers these guidelines only to improve the communication among MSHDA, appraisers, and affordable housing stakeholders broadly. MSHDA encourages appraisers and stakeholders to bring appraisal questions to it by contacting John Hundt at hundtj1@mshda.gov. MSHDA may change or expand this guidance from time to time, and it may provide instructions that override these guidelines to appraisers in specific circumstances.