
CHAPTER 1. THE VALUATION PROCESS

1-1. INTRODUCTION.

- a. Purpose. Valuation Analysis is made for the purpose of evaluating the property as security for a long term insured mortgage. Included in the evaluation is the analysis of market need, location, earning capacity, expenses and taxes and warranted cost of a property.
- b. Content. Valuation Analysis develops conclusions with respect to feasibility, suitability of improvements, extent, quality and duration of earning capacity and other factors that have a bearing on the economic soundness of the property. The objective is to have a properly designed project in the right location capable of a maximum loan. Such a project meets the demands of the rental market at rents which will pay all expenses of operation, debt service and return to equity where such return is permitted.

1-2. ECONOMIC JUSTIFICATION FOR COSTS.

- a. Cost - Income Relationship. The cost of producing a property must be properly related to the net income to support a maximum loan.
 - (1) The following elements bear directly on this relationship:
 - (a) Cost of producing the property, including site.
 - (b) Cross Income.
 - (c) Cost of operating and maintaining the property.
 - (d) Net income available for debt service and equity.
 - (2) The valuation process requires considering the wisest use of cost dollars to obtain the best project for the intended occupancy. This requires not only competent planning, but the avoidance of materials or features involving the high first costs or maintenance expense or whose utility or appeal does not provide economic justification for their inclusion. Economic justification can be directly tested for any given item of cost

or additional expense. If such item does not increase net income by at least the debt service rate (plus equity return, if applicable) the item is not economically justifiable. Net income may be increased either by increasing rents, decreasing operating expenses, or both.

- * (3) The use of solar energy for residential space heating and/or domestic hot water heating must be considered in terms of the cost-income relationship. The field Office must determine that a ready market exists for the property with the increased cost of the solar equipment. The cost of this additional equipment may be recognized in value in an amount that can be demonstrated by an analysis of the market. The potential savings in operating costs are a consideration in determining acceptability in the market. *

- b. Land Cost. Site Cost is directly affected by the quality of the site in terms of physical suitability, conveniences, and competitive appeal to the market to be served by the project proposed. Sites requiring costly preparation will have an obvious detrimental effect on land cost even if purchased at a reasonable price. Of equal importance is the effect on rents obtainable or occupancy expectancy.

1-3. PROCESSING SEQUENCE.

a. Processing Stages.

- (1) Stages in Valuation Analysis conform to the general underwriting stages. These are:
- (a) Feasibility Stage.
 - (b) Conditional Commitment Stage.
 - (c) Firm Commitment Stage.
 - (d) Construction Stage.
- (2) The Director, Housing Development shall determine which, if any, stages shall be combined based upon the sponsor's needs and state of preparation. Flexible processing permits combining any stage with a subsequent stage or stages of processing wherever practical. Feasibility determinations are always included in the initial stage of processing.

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- b. Processing Methods. The Form 2264 is the basic form used in valuation processing. This form shows the final conclusions arrived at during each underwriting stage. The Form 2264 is accompanied by those additional exhibits necessary to support and substantiate the underwriting decisions. These exhibits include Form 2274, Expense Analysis Worksheet, land sales data, market absorption data, together with the applicable forms required under Section 207. Decisions arrived at are relayed to a sponsor through a commitment or letter and must be supported in the project file.

- c. Assignment of Work. When a project is received for feasibility analysis, the ADTSB/CU will have the Chief Appraiser assign an appraiser to the processing team. The assigned appraiser and other processing team members receive their briefings and instructions from the ADTSB/CU or a Multifamily Coordinator (MFC). The designated processing appraiser should remain the only valuation processor, subject only to supervisory review through all processing phases. The processing appraiser is free to consult with his supervisors or other appraisers when complex problems are encountered.

1-4. FEASIBILITY STAGE.

- a. Elements of Feasibility. The sponsor submits FHA Form 2013 as a preliminary form outlining his proposal in general terms. From this information, data within the office, and inspection and appraisal of the site, the appraiser reaches conclusions as to project feasibility, establishes a construction budget based upon the economics of the proposal and makes his recommendations on FHA Form 2264.
- 1) The following determinations are required in Feasibility Stage:
 - (a) Determine current occupancy rates, market absorption rates and the market need for the number and type units proposed.
 - (b) Analyze site for acceptability and determine land value.
 - (c) Determine market rents reflecting amenities, services and equipment offered.

- (d) Complete Project Income Computations using the gross income developed from market rents and/or administrative income limits. Use a realistic occupancy ratio to arrive at effective gross income.
- (e) Estimate total expenses reflecting the degree of maintenance and management necessary for the project.

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 - (f) Determine the project replacement cost.
 - (g) Develop the estimate of value.
 - (h) Compute the rent formula to determine total maximum monthly rental which may be charged.
 - (i) Calculate the Construction Budget.
 - (2) Based on the appraiser's findings, the appraiser processes the case to a conclusion of feasibility or non-feasibility without alteration of the physical characteristics of the sponsor's proposal. In the initial processing, it may be necessary, however, to alter estimates of rents, expenses, replacement cost, occupancy ratio or mortgage amount whenever data indicates that any of these items should be significantly different from the sponsor's estimates.
 - (3) If the project proves infeasible, or if analysis reveals that the project can be substantially improved by a change in design, number of units, unit composition, or utilities and services contemplated, the ADTSB/CU must be advised. The valuator will continue processing the sponsor's proposal until advised to stop. If it is the ADTSB/CU's decision to process a counter-proposal, that proposal will be processed to a conclusion on a new FHA Form 2264 while retaining the original form to demonstrate the infeasibility of the original proposal.
 - b. Site Acceptability. Analyze site for acceptability and determine the land value. If site analysis is required, determine the following:
 - (1) Environmental Clearance and Flood Hazard. See References 3 and 4 of the Foreword.
 - (2) Determine if the location is acceptable for the type of project proposed and the market to be served. For low-rent or rent supplement projects, proximity to services and work is generally more important than absence of all detrimental influences, particularly in

neighborhoods which are experiencing, or will soon experience, revitalization through rehabilitation or reconstruction.

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- (1-4) (3) Determine if site is adequate in size, shape, exposure and contour for the proposed project. Building height limitation, project unit size and numbers, necessary on-site parking and play areas must be considered. The services of a land planner will be utilized when necessary. The LUI determination, while used as a guide only, will be of great assistance in this analysis and is prepared by the appraiser.
- (4) Determine if the zoning is permissive for the project proposed. If it is not, and zoning change is required, there should be evidence of community predisposition for such change or evidence from the sponsor that he is cognizant of the need for zoning and has a workable timetable for effecting the change.
- (5) Determine if utilities and streets are available to the site and if they are adequate for the project proposed.
- (6) Determine if there is any information in the data files or any evidence on site that there may be subsoil problems which will be inordinately expensive to overcome. Evidence of excess site cost of any kind should be reported so that it can be considered by cost, land planning and engineering personnel.
- c. Land Appraisal. Site analysis and appraisal conclusions are recorded on page 3 of FHA Form 2264. The Project Site Analysis and Appraisal, Section J, should be completed in its entirety in the feasibility stage. Where the site in the "as is" condition is fully improved, or very nearly fully improved so that the two approaches would be analyzing the same level of development, no "as is" value estimate will be required at any stage in processing.
- d. Replacement Cost Estimate. Complete the cost estimate begun by the Cost Analyst. Use sponsor's figures shown on the preliminary FHA Form 2013 wherever they appear reasonable for all items which are valuation responsibility. Compute the appropriate fees and charges, based on the Cost Analyst's estimate, and use data bank figures for taxes, insurance, title and recording, and legal and organization expenses. The FNMA commitment and purchase and marketing fee totaling 1 1/2%, or an equivalent amount if other than FNMA is to be the permanent lender, may be included in estimated replacement cost for unassisted multifamily housing projects. See Reference 2 of the Foreword.

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- (1-4) e. Value by Capitalization and Market. An estimate of value is determined from the capitalization approach and market approach.
- f. Operating Deficit. Estimate the operating deficit, if any, in early years. A project which cannot rent-up in the first years should be carefully examined from a feasibility standpoint. On the other hand, it takes time to move tenants into a large project, and it is almost inevitable that the average overall occupancy percentage for the first year will be something less than the long-term percentage.

When it is anticipated that the entire project net income will not be available during the initial rent-up period, the appraiser estimates the anticipated project operating deficit as follows:

- (1) Determine the estimated rent-up period.
- (2) Determine the approximate date of project construction completion and the date of the probable commencement of amortization of the mortgage loan.
- (3) Estimate for each period the average number of units occupied and the estimated dollar rental income based on unit occupancy.
- (4) Estimate the expenses for each period taking into account probable initial increases in administrative expenses and decreases in maintenance expenses. Reserves for replacement should not be included in the estimate of the expenses prior to start of amortization, but they would be included subsequent to commencement of amortization.
- (5) Total expenses for each period are deducted from the dollar rental income estimate based on unit occupancy to indicate the net income available to defray the dollar debt service amount.
- (6) For any period of anticipated income deficit prior to start of amortization, the debt service requirement is determined by multiplying the mortgage amount by the sum of the interest rate and the mortgage insurance

premium rate, if any, and by adding to the total the ground rent for the period where a leasehold is involved. For any period of anticipated income deficit after the start of amortization, debt service requirements are determined by adding payments for principal, interest, MIP, and ground rent if a leasehold is involved.

If the dollar debt service for a period is greater than the net income for the same period, the difference represents the amount of the operating deficit for that period.

- g. Rent Formula Maximum. The maximum allowable gross income is computed at this time using present instructions and the Format in FHA Form 2264 instructions. The amount computed is entered in Section H, Item 1 of FHA Form 2264.
 - h. Feasibility Determination. Determine the Budget for Construction Cost. For simultaneous processing purposes, the appraiser makes a preliminary estimate of the project mortgage using FHA Form 2264A as a worksheet and following applicable instructions for that form. The maximum mortgage amount is based upon the applicable criterion (cost, debt service, value or other statutory limitations). The project mortgage amount which results is used by the appraiser to complete the construction budget. A finding of feasibility is justified when data indicates, and when sponsor agrees that he can build the project for the amounts estimated in the Construction Cost Budget.
- 1-5. CONDITIONAL COMMITMENT STAGE. In this stage preliminary plans and another FHA Form 2013 are submitted by the sponsor through the mortgagee. Plans are reviewed in the Valuation Section, if requested, to assure that the project is being designed and conceived as envisioned in the feasibility stage. In addition, where requested, the income, expenses, and project costs are re-analyzed as necessary to resolve discrepancies between the decisions reached in the feasibility stage and changes created by the sponsor's new submission. Where necessary to resolve conflicts, individual items of expense are analyzed in depth, and in all instances, a copy of the data sheets and the expense analysis worksheet from which the applicable expense estimate was determined in the feasibility stage and confirmed by the exhibits submitted for conditional commitment is included in the docket file.

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- 1-6. FIRM COMMITMENT STAGE. When requested, final plans and specifications are examined for conformity with previous concepts and decisions agreed upon with the sponsor. With a design representative assigned to the project, there should be no changes in plans which have not been reviewed by the design representative.

In this stage, all processing not completed in previous stages is completed. For example, detailed estimates of on-site and off-site land costs, verified sales price of the site and "as is" value of land for cost certification purposes, if not already performed because of insufficient information, are completed.

Also, any significant changes in expenses or income due to plan changes are made and the project re-analyzed as required.

- 1-7. CONSTRUCTION STAGE. Analysis of Construction Changes. If a request for change is received during the construction stage, review is accomplished in accordance with instructions relating to FHA Form 2437.

It is anticipated that construction changes will be few since the Design Representative will work closely with the sponsor's architect and since comparable products for each item can be specified.

1-8. ANALYSIS AND APPRAISAL.

- a. Project Analysis. The project analysis and appraisal includes a determination of the market as well as an analysis of the physical security being considered.
- b. Identification of Property. The property inspected must be positively identified as being that described in the application and related exhibits. Examination of the legal description and the sketch plan of the site during site inspection should suffice.
- c. Analysis of Location. The analysis of location involves a determination of the desirability and utility of the site by reason of its location. The analysis of location requires a forecast of the changes likely to be experienced at the site due to probable future neighborhood trends in addition to an appraisal of the present situation.

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- (1-8) The pattern of appropriate improvements, the level of available rents, the level of warranted costs of construction and the probable economic life of the structures are to a high degree determined by location factors.
- d. Specific Location. The specific site is considered in relation to neighborhood and city-wide physical, social and economic influences. Limitations of use imposed by zoning or deed restrictions are determined. Trends of development,

stability, decadence and rehabilitation are discovered.

Availability of utilities, services and centers appropriate to the intended use is identified. The many and varied influences operating on the site which affect its market and income potential when improved are analyzed.

e. Considerations in the Analysis of Location. The following are major considerations in the analysis of location:

- (1) Civic, Social and Commercial Centers: When judging the desirability of a location the appraiser must give full consideration to the sufficiency of community facilities as they relate to the needs of tenants of the proposed projects. A location for a multifamily project must be adequately served by grade and high schools, neighborhood shopping centers, churches, playgrounds, parks, libraries, hospitals and theaters.
 - (a) Schools. Accessibility to schools will be judged by the time involved, utilizing the means provided or available, rather than walking distance alone. Thus, if school bus service will be provided and the time involved is reasonable, the location is acceptable. Overcrowded schools are the responsibility of the community in the granting of permissive zoning and the issuance of building permits. A project which is otherwise feasible will not be rejected because the local schools are considered overcrowded. School accessibility will not be a factor in projects designed for the elderly.

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- * (1-8) (b) Neighborhood Shopping Centers The convenience of a shopping facility should be judged on the basis of time rather than distance. The importance of grocery, drug and other neighborhood shopping facilities within a reasonable walking distance will generally increase with the number of tenants who do not have private transportation.
- (c) Religious and Recreation Centers. Ready access to religious and recreation centers is desirable. Projects designed for large families (predominantly 3 and 4 bedroom units) have a greater need for playgrounds and active recreation areas. Adequate on-site provisions for playgrounds and other recreation areas should be incorporated into the proposal where adequate facilities are not in

close proximity to the project site and available to the occupants.

- (2) Transportation. Convenient transportation to places of employment, major shopping districts and civic and social centers is a prerequisite to project location acceptability. In those communities where local public transportation is the principal means of commuting by the prospective tenants, the location of a project designed for such occupancy shall be within a reasonable walking distance to public transportation.
- (3) Special Hazards and Nuisances. Such conditions include unusual topography, subsidence, flooding, unstable soils, unusual traffic hazards and noise, danger from fire and explosion, exposure to airport noise and low-flying airplanes, smoke, chemical fumes, noxious odors, stagnant ponds or marshes and sewage disposal failure. Any of these or similar conditions, if serious and impossible to overcome, will render a specific location ineligible for mortgage insurance.
- (4) In the analysis of any location, consideration must be given to the alternative sites or locations available to the market for which the project is being designed. A location will not be rejected for the absence of the locational features cited in (1) and (2) above unless there are more suitable alternative sites or locations available for the same market.

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- (1-8) f. Market Demand. Data is utilized to determine quantitative demand in the community and qualitative demand for the project proposed in the neighborhood selected. The objective of this analysis is to provide information on market trends and to predict the prospective absorption capacity of the market. Proper analysis of the market for a specific proposal requires interpretation and judgment of such aspects as market reactions to the site location, size and composition of the units, the need and desirability of non-residential facilities and the general level of amenities which have been incorporated into the sponsor's proposal. Housing planned or under construction with conventional financing for the same market must be considered to determine the predicted market.
 - g. Utilities. Adequacy of water and sewerage services is essential. Rental housing projects shall be connected to public systems except as outlined in Reference 1 of the Foreword. In rental projects,

tenants are seldom concerned with water conservation; consequently, water use is high as is the volume of sewage.

- h. Parking Facilities. Consideration must be given to the effect on parking facilities in the neighborhood and on all-night parking in particular, which would be caused by the additional number of cars of the tenants who would live in the proposed project. If the project site lacks adequate space for parking tenants' cars, the availability of other parking space off the street may be considered. An estimate shall be made of the number of parking spaces which would be required by the tenants of the proposed project and their guests and a recommendation shall be given as to the adequacy of indicated parking facilities to meet the estimated need.