CHAPTER 5. VALUATION

5-1. APPLICATION STAGES. There are only two processing stages under Section 223(f): the conditional commitment stage and the firm commitment stage.

a. Conditional Commitment Stage. The appraised value and maximum mortgage amount for an acceptable purchaser are determined at this stage.

b. Firm Commitment Stage. At firm commitment stage, mortgage credit processing determines the amount of mortgage available to the purchaser or refinancing mortgagor in the proposed transaction. No valuation processing is needed at firm commitment stage unless the stages are combined.

c. Combined Stages. When a purchasing or a refinancing mortgagor wishes to combine the processing stages, he must supply (through the mortgagee) all the exhibits needed for both processing stages, with the application for Firm Commitment, and the fee of $3.00 per $1,000 of mortgage amount requested. All processing required for both the Conditional and Firm Commitment Stages will be performed (concurrently insofar as possible) to result in the issuance of a Firm Commitment. If the property is found to be eligible for a Conditional Commitment, although the mortgagor is found not eligible for a Firm Commitment, the Conditional Commitment will be issued, together with a separate written statement of the reason why a Firm Commitment is not issued.

5-2. APPLICATION FOR CONDITIONAL COMMITMENT. The sponsor submits application for conditional commitment on FHA Form 2013 with a fee of $2.00 per $1,000 of mortgage amount requested. Sections A, C, D, E, F, J and K are completed as well at Item B-25. Year built must be shown in Section A. Living area of each apartment type in Section C is the area of a living unit measured from the inside faces of corridor and exterior walls, and from the inside faces of partitions separating the living unit from other living or commercial areas. Net rentable residential area in Item C-34 is the sum of all the rentable living areas shown in C-27. In Item J-1 the name, address and telephone numbers of the sponsor(s) and of the owner(s) of the property are shown. Section K is completed by the sponsor and mortgagee. The following exhibits shall be forwarded to the Valuation Section.

a. Balance Sheets and Operating Statements. The most recent year's statement shall be certified by an Independent Public Accountant or Certified Public Accountant.

b. Rent Roll of Subject Property, in columnar form, as described in Chapter 2 of this Handbook.

c. Legal Description shall be provided.

d. Repair List. A list of repairs (if any) which are proposed to be completed before final closing, an which are to be included in the value.

e. Plans and Specifications. Applications on projects less than 10 years old shall be accompanied by project plans and specifications (completed to the extent possible). For projects 10 years old or more, plans are not required but should be submitted, if available.

5-3. VALUATION PROCESSING. The principal purpose of the appraisal is to estimate the market value of the project. Market Value is defined as the most probable price for which a property could be sold, if offered for sale for a reasonable time upon the open market, assuming that both the buyer and the seller were well informed, acted intelligently and without compulsion. To estimate the market value, it is necessary to use value limits indicated by the project replacement cost, by capitalization and by direct sales comparison.

5-4. INSPECTION. The appraiser participates in the joint inspection of the property with a member of the Architectural Section and possibly a representative of the local building inspector's office to identify any code violations.

In those offices where it would be more expeditious for the Architectural representative to make the physical inspection separately it may be so scheduled. Upon completion of the work write-up the results are transmitted to the Valuation Section and the appraiser may visit the site and begin his processing. It is not necessary for the appraiser to inspect all the units. The appraiser observes and discusses the eligibility of the property and need for required repairs while at the same time supporting or disproving occupancy and rental data shown in the owner's rent roll by observations on the spot. When he has established that the rent roll appears to be correct, he will enter in Remarks on Form 2264, for example, "Actual occupancy, based on owners rent roll as of 4/1/75, is 87%." The appraiser must also determine whether apartments are rented furnished or unfurnished. He may assist in selecting equipment and short-lived building components to be considered in developing the initial deposit into the Replacement Reserve Fund.

5-5. ENVIRONMENTAL CLEARANCE. Subsequent to the inspection of the property, the appraiser will use the Form ECO 2/3 HPMC, Normal and Special Environmental Clearance for Subdivisions and Multifamily Projects, as a checklist to determine that no unacceptable environmental features affect the property. Only Sections A, B and C on the form are to be completed and it should be noted that A-95 procedures are not required. If the environmental factors so warrant the project should be rejected as not eligible for mortgage insurance. Review and comment on the ECO 2/3 is not required beyond the Field Office level.

5-6. ESTIMATED RENTAL INCOME. Rental income is estimated as outlined in Chapter 5 of 4465.1, except that commercial net rentable area is limited to 20% of total net rentable area (both residential and commercial) with commercial income limited to 25% of total income. Properties having commercial net rentable area or commercial income in excess of the above percentages are not eligible. The rental income estimated is that income obtainable for the subject unfurnished apartments and commercial areas as evidenced by rentals obtained for similar unsubsidized properties in the open market, with reasonable adjustments made for significant differences observed in the structures, living units, locations, or services included in the rent. However, when a property is subject to local rent control, the rents used in the income estimate must never exceed those that may properly be charged in accord with rent control provisions.

5-7. OPERATING EXPENSE ESTIMATES. Expenses are estimated by data from comparable projects as described in Chapter 6 of 4465.1.

5-8. OPERATING HISTORY. In making his estimates of rental rates, occupancy rates, operating expense, and net income, based on data from comparable projects, the appraiser also analyzes the operating history of the subject project. This very pertinent source of information is not available in cases of proposed construction, but must not be overlooked in cases of existing construction. Estimates of future performance need not be identical to the history of past performance, but the differences should be reasonable and probable and explained by brief logical comment in remarks. For example, analysis of trend might indicate that rents and/or expenses could be expected to be higher (or lower) in the next year, than was the case in the last operating history year. For another example, the market value sought is the estimated market value of the property after completion of required repairs. If the effect of the repairs would be to increase rents, or to increase occupancy rates, or to decrease (or increase) total operating expense, the estimate of net income and of value by capitalization would reflect conditions after completion of repairs required by the commitment. (Note, however, that if the amount of repairs is sufficient to constitute substantial rehabilitation for the insured mortgage programs as defined in paragraph 1-4i, the project is not eligible pursuant to Section 223(f), but may be considered as a rehabilitation project under another appropriate section of the Act).

5-9. CAPITALIZATION. The estimated annual net income remaining after payment of expenses is transformed into the estimated market value by capitalization, in accord with Chapter 7 of 4465.1. Since in 223(f) it is the estimate of market value by capitalization which is desired, it is suggested that the selected rate be extracted from market transactions of comparable properties as a composite overall capitalization rate, as described in paragraph 7-4 of 4465.1, or extracted form market transactions as a cash flow to equity rate and that cash flow rate be used to construct an overall rate as shown in paragraph 7-5 of 4465.1. Each of these rates is readily extracted from sales of comparable properties and will produce values reflecting the comparable sales. The Cash Flow to Equity Rate Method is generally the most responsive to fluctuating mortgage rates and terms.

5-10. ESTIMATED REMAINING ECONOMIC LIFE. The remaining economic life of a building is its remaining period for earning net income. For the purpose of this Handbook this shall be interpreted as meaning as a residential property. How long will the entire property return sufficient net income to exceed that portion of net income allocated to the return on the value of the land? When this invisible border is crossed, the economic life of the buildings has ended and the value of the buildings has dwindled to salvage value less demolition costs (sometimes a minus number). The last years of economic life are more difficult to predict than the first years. For this reason, the appraiser must use caution, and avoid overly long estimates of remaining economic life for old buildings in old declining neighborhoods. Also because of the uncertain nature of the last years of economic life, when the estimated economic life of the buildings is not sufficient to support a mortgage term of 10 years, the property is not eligible for mortgage insurance pursuant to Section 223(f). It is entirely possible that applications will be received for properties with economic lives which ended last year.

5-11. MARKET VALUE BY DIRECT SALES COMPARISON. The market value after completion of repairs is estimated by direct sales comparison as described in Chapter 8 of 4465.1. At least two units of comparison must be used, with Section L from additional Forms 2264 attached to provide space. One of these units of comparison should be either the gross income multiplier (GIM) or the effective gross income multiplier (EGIM), as shown in paragraph 8-2d of 4465.1, derived from, and applied to unfurnished annual rents. It should be noted that no adjustment for time should be made to the estimates of GIM or EGIM as both the comparable and the subject rental should be regarded as current. The appraiser also selects additional units of comparison which will give the truest estimates of indicated value in view of the data available and the characteristics of the subject property. The indications of value by various units of comparison are correlated into one indication of value by direct sales comparison and it is entered in Item L-9, "COMPARISON."

5-12. SUMMATION OR COST APPROACH. The appraiser estimates the market value of the land by market comparison in accord with instructions in Chapter 2 of 4465.1. He receives from the cost analyst the cost of land improvements, structures, and fees, through Item G-52, Form 2264. He then enters the Warranted Price of Land and completes the Total Estimated Replacement Cost of Project as he would for Section 207. If an Engineering Survey is required due to age of building or concern for structural soundness or because of other problems observed at time of initial inspection, the cost of this survey will be entered on Line 60 of Section G of Form 2264 after lining out the word AMPO and entering the words Eng. Survey.

* 5-13. REPLACEMENT RESERVE FUND. The annual amount which shall be deposited in the Replacement Reserve Fund is .006 multiplied by Item G-41, Total structures, from Form 2264. However, since many shortlived items of equipment may have used a good portion of their useful life at the time of appraisal, it is necessary to make an initial deposit into the Replacement Reserve Fund at time of closing.

a. Calculation of Replacement Cost. If, for example, equipment 10 years old had a normal life of 12 years, 10/12 or 83% of its useful life has been used, and an initial deposit of 83% of the replacement cost of this equipment is needed at closing to prevent the Replacement Reserve Fund from becoming insolvent in two years.

b. The Appraiser's Estimate. The estimate of initial deposits into the fund is made by the appraiser after consideration of the cost and useful life information about replaceable items received from the cost and architectural processors or from the engineer's survey. *

c. Calculation of the Initial Deposit. This initial deposit to the Replacement Reserve Fund may, at the discretion of the Chief Underwriter, be calculated by either a physical takeoff of the items to be considered in the replacement reserve or by multiplying the dollar amount established as Total Structures (Line G-41) by .004 and multiplying the result by the age of the project, not to exceed 15 years, rounded to the nearest full year.

d. The Chief Underwriter's Options. In determining the method to be used in computing the initial deposit to the Replacement Reserve Fund, the Chief Underwriter should consider effective age of the items considered in establishing the Reserve Fund. It would be inequitable, for example, to compute the amount of the reserve on the age of a 15-year old project if most of the Replacement Reserve items had just been replaced. Conversely, the deposit for a three-year old project with extreme wear or very low quality appliances might be far below the needed reserve amount if calculated on the physical age of the project.

e. Deposit of Fund, This fund may be deposited in an interest bearing account insured by an agency of the Federal Government, so arranged that withdrawal from this account requires the concurrence of the mortgagor, the mortgagee, and HUD.

5-14. CORRELATION. In Section L of Form 2264, the appraiser has entered the Total Estimated Replacement Cost of Project (without depreciation) as Summation; the value indicated by the income approach as Capitalization; and the value indicated by direct sales comparison as Comparison. He must correlate these possible indicators of value into his final estimate of value. The Summation estimate can provide only an upper limit; a ceiling, not a floor. It will determine the final estimate of value only when it is less than other indicators of value. In most instances, the final estimate of value will be best located by the indications of value by direct sales comparison or by capitalization. The comparison approach indicates what investors are likely to pay for the property based on comparison with similar sales transactions, and the income approach estimates the present worth of the future income stream as evidenced by transactions of investors in the market. The appraiser should select a final estimate of value between that indicated by comparison and that indicated by capitalization, giving more weight to the approach supported by the best data. However, in no event shall the final estimate of value exceed the Total Replacement Cost of Project, or Summation.

5-15. MORTGAGE AMOUNT. The appraiser estimates the maximum mortgage amount for purchase transactions on a valuation trial copy of Form FHA-2264-A. The mortgage shall not exceed 85% of value, or the amount which can be paid by 85% of the net income under the debt service criterion. The mortgage is also limited by the unit limitations under Section 207. The least of these three amounts is entered in remarks as Tentative Maximum Mortgage Amount. When a purchaser is identified or application for refinancing submitted, the firm commitment mortgage amount is determined by processing in the firm commitment stage by the Mortgage Credit staff. *

5-16. REMARKS. Before releasing the case, the appraiser makes sure that the Remarks Section, Form FHA-2264, contains the following:

a. The appraiser's statement of actual occupancy, based on owner's rent roll.

b. The required amount of initial deposit into the Replacement Reserve Fund estimated by the appraiser, with assistance from the Cost staff and Architectural staff.

c. The estimated cost of required repairs supplied by the cost analyst. (Repairs proposed by the sponsor are included, since they will be considered in the value, and required by the commitment.)

d. The estimated amounts for legal, organizational (if applicable) and title and recording expenses based on the maximum insurable 223(f) loan.

5-17. OPERATING DEFICIT. The operating deficit will not be estimated by the appraiser in the conditional commitment stage. This estimate will be made at time of firm commitment by the mortgage credit processor, and an escrow required based on conditions which prevail at time of firm commitment. The appraiser enters "SEE FIRM COMMITMENT," in Section I of Form FHA-2264. However, for the purpose of assisting the Mortgage Credit Processor in estimating the amount of the operating deficit escrow, the appraiser will enter in the Remarks portion of Form FHA-2264 his estimate of the time required to reach sustaining occupancy based on market absorption data. The appraiser's estimate of the time required to reach sustaining

occupancy will cover a time span beginning with the estimated month of initial/final endorsement of the mortgage for insurance and ending with the month in which sustaining occupancy is expected to be reached. If the appraiser determines from market absorption data that the project will require more than 18 months to reach sustaining occupancy, the project must be found infeasible.

5-18. RENT FORMULA. The Rent formula for Existing Rental Housing Under Section 223(f) is completed in accord with instructions in the format shown as Exhibit III.

* 5-19. RECOMPUTATION OF RENT FORMULA. This paragraph provides procedures which will allow a reasonable return on investment to the purchaser of an exiting housing project, in the event that the acquisition cost, as determined by HUD, exceeds the estimated value of the project. When the cost certification procedures described in paragraph 6-19 have been completed in a purchase transaction and when the mortgage credit examiner has determined that the acquisition cost (as described in subparagraph 6-2b(4) of this Handbook) is greater than the HUD estimate of value of the property, the mortgage credit examiner shall return the file to the Valuation staff for recomputation of the rent formula, with a memorandum to the file which gives the acquisition cost resulting from cost certification procedures, and which also states the amount of secondary financing, if any included in the transaction in accordance with paragraph 6-11a. The processing appraiser shall take the following steps:

a. Reduce the acquisition cost by 50% of the amount of any secondary financing included in the transaction.

b. Compare the reduced estimate of acquisition cost with the HUD estimate of value of the property. No change is made to the estimate of value.

c. If the appraiser's estimate of acquisition cost (with secondary financing discounted 50%) is less than the estimate of value of the property, the appraiser shall prepare a memorandum to the file which gives the amount of each estimate, and which states that no change in the rent formula is needed because the acquisition cost, as determined by HUD, is less than the estimated value of the property. *

(5-19) d. If the appraiser's estimate of acquisition cost is greater than the estimated value of the property, the appraiser shall prepare a memorandum to the file which gives the amount of each estimate, and which states that an amended rent formula is required because the acquisition cost, as determined by HUD, is greater than the estimated value of the property and that the amended rent formula dated (current date) has been prepared. The appraiser shall recompute the rent formula using the format shown in Exhibit III of this Handbook, striking out the words "value of property" in Line 1 of the rent formula, and substituting, "acquisition cost." The discounted acquisition cost used in Line 1 and the remainder of the format is accomplished in accord with instructions in Exhibit III. The amended rent formula shall be distributed to project files, and the Director, Housing Development Division, shall arrange that the project sponsor be notified of the amended "maximum allowable monthly rental for all living units," from Line 14 of the amended rent formula. *