

REAL ESTATE LITIGATION
PAPER 8.1

Valuation of Interests in Real Estate: An Introduction

These materials were prepared by Richard J. Olson of McKechnie & Company, Vancouver, BC, and H. Scott MacDonald of Richards Buell Sutton LLP, Vancouver, BC, for the Continuing Legal Education Society of British Columbia, May 2016.

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VALUATION OF INTERESTS IN REAL ESTATE: AN INTRODUCTION

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I. What is an Appraisal?

An appraisal is an opinion of the value of a defined interest in real estate in a specified condition at a specific date.

There are many interests that can be valued, just as they can be bought and sold, including:

- (a) fee simple;
- (b) leasehold;
- (c) lease rental rate;
- (d) an easement;
- (e) a right to purchase;
- (f) an option to purchase;
- (g) a fractional interest as tenant in common or joint tenant in a fee simple or other interest;
- (h) a profit à prendre; and
- (i) a life estate.

Note that a common law condominium held through a long term lease by a shareholder of a company is more likely a share valuation as the leasehold interest is connected to the shareholding. Many recreational properties are also owned through similar structures.

Appraisers carry out current valuations and “retrospective” valuations. A current value opinion refers to an effective date contemporaneous with the date of the report, at the time of inspection or at some other date within a reasonably short period from the date of inspection when market conditions have not or are not expected to have changed. A retrospective value opinion refers to an effective date prior to the date of the report.

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An appraiser might also carry out a prospective valuation or an appraisal that assumes an improvement has been constructed before construction begins. A prospective value opinion is a forecast. These opinions should be judged based on the market support for the forecasts when made, not whether in hindsight they in fact occurred. A prospective value opinion must clearly state an extraordinary assumption in the report citing the market conditions from which the prospective value opinion was developed and an explanation that the appraiser is not responsible for unforeseeable events that alter market conditions prior to the effective date.

An appraiser may also prepare an updated valuation which extends an original appraisal by changing the effective date. In an updated valuation the appraiser must specify any changes in the status of the subject property, in market conditions or in any respect affecting value since the prior appraisal, and analyse these changes to develop the updated opinion. The updated report should stipulate that it can only be relied upon in conjunction with the original appraisal.

Appraisals are carried out for a variety of purposes including:

- (a) financing;
- (b) market value for sale;
- (c) market value for lease rent review or renewal; and
- (d) tax assessment.

II. How are Appraisals Carried Out? (Approaches to Value)

An appraiser relies on three main approaches to determine value:

- (a) direct comparison;
- (b) income; and
- (c) replacement cost.

In a direct comparison approach an appraiser will look for “comparable properties” (either for sale price or rental rate) and adjust the comparable for a number of factors such as:

- (a) the location;
- (b) the date of the transaction (ideally the date an offer to purchase or an offer to lease is accepted);
- (c) the size of the property;
- (d) the quality of any improvements;
- (e) the age of any improvements;
- (f) the use, or permitted use, of the property;
- (g) any restrictions on the property such as:
 - (i) zoning and land use controls;
 - (ii) permitted uses and restrictions in a lease; or
 - (iii) easements or statutory rights of way; and
- (h) the length of the term of the lease, if a rental comparable.

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The direct comparison approach is generally used for both fee simple and lease rental rate appraisals as well as other lesser interests.

In an income approach the appraiser will determine the effective income of the property and apply a capitalization rate to that income to derive a market value. The capitalization rate is derived from the sale of comparable properties. The appraiser will assemble comparables and derive the capitalization rate applicable for each sale and then determine an appropriate rate (referred to as a “cap rate”). The income approach is generally used for appraisals of fee simple properties that are occupied by tenants. It can also be used for commercial buildings not occupied by tenants if the appraiser determines the rental value of the building and then applies a cap rate to that notional income.

A variation of the income approach is the “discounted cash flow” approach in which the appraiser capitalizes the anticipated income stream into the future. This approach is generally used on commercial income properties when:

- (a) some or all of the current income is significantly below market rates;
- (b) the property has significant vacancies;
- (c) the property is under construction or being renovated; or
- (d) there are leases in place which have not yet commenced.

The appraiser will calculate the income into the future to account for these issues and then discount the income to arrive at a market value. A similar approach is used to calculate the present value of a stream of payments (such as an annuity).

The replacement cost approach is not often used and generally involves using a direct comparison approach to determine the value of the land and then a “calculator” to determine the replacement cost of the improvements. Appraisers have computer programs available that calculate the cost of buildings and other improvements. A depreciation factor is then applied to take into account the age of the improvements.

The valuation of a partial interest raises the additional problem of whether there is a partial interest discount. A 40% interest in a property is not necessarily valued at 40% of the fair market value of the whole property.

III. Instructing an Appraiser

Before an appraiser can be properly instructed it is necessary to determine what interest is being valued. This means that the following factors need to be considered:

- (a) the legal interest being valued;
- (b) the effective date of the valuation;
- (c) any specific assumptions the appraiser is to make;
- (d) any relevant facts the appraiser is to take into account; and
- (e) the interpretation of any relevant provision in the lease in the case of a rental rate appraisal.

The appraiser should be given a letter of instruction setting out the assignment and any assumptions of fact the appraiser is to make. Any interpretation of any relevant provision in a lease or other

agreement should also be stated. Note that any assumption of fact will need to be proved independently.

Note that if the appraisal is tendered as an expert report in a trial¹ the duty of the expert is set out in Rule 11-2:

Duty of expert witness

(1) In giving an opinion to the court, an expert appointed under this Part by one or more parties or by the court has a duty to assist the court and is not to be an advocate for any party.

Advice and certification

(2) If an expert is appointed under this Part by one or more parties or by the court, the expert must, in any report he or she prepares under this Part, certify that he or she

(a) is aware of the duty referred to in subrule (1),

(b) has made the report in conformity with that duty, and

(c) will, if called on to give oral or written testimony, give that testimony in conformity with that duty.

If there are any modifications to the assumptions or facts on which the appraiser is to rely, a letter should be sent to the appraiser. Remember that once called as a witness the appraiser's entire file is producible and both the presence and absence of instructions can provide a basis for cross-examination. It is essential in all communications with an appraiser that there be no suggestion the appraiser is being directed to a particular conclusion. An appraisal may be disregarded if counsel has directed an appraiser to a particular conclusion: *Summit Staging Ltd. v. 596373 BC Ltd.*, 2008 BCSC 198 at para. 91-92.

IV. Reviewing an Appraisal

An appraiser's conclusion should be founded on one of the three appraisal approaches described above. The strength of an appraiser's opinion usually depends on the quality and reliability of the comparables used to derive the conclusion of value.

For fee simple appraisals appraisers rely on Land Title records, information from real estate boards and Assessment Authority data as well as interviews with real estate agents and vendors and purchasers. The latter sources are for transactions which have not yet been completed but are in process. Many commercial properties are held by bare trustees so that on a sale only the shares are transferred.² Thus no transfers are recorded in the Land Title Office. Note that this data is generally hearsay.

In a lease rental rate appraisal most of the comparable evidence relied on by an appraiser is hearsay as few leases are registered in the Land Title Office. The data is not often challenged unless the other appraiser raises doubts about the accuracy or reliability of the data. Appraisers rely on their own collection of data, and conversations with property managers, landlords and tenants. Proving data in dispute can be difficult. The *Arbitration Act* provides:

1 There is no similar provisions in the BCICAC or ADRIC Rules.

2 This also avoids payment of property transfer tax.

Subpoena to witness

7 (1) A party to an arbitration or to a reference from the court may issue a subpoena to a witness.

(2) No subpoena may be issued under subsection (1) for a document unless the witness could be compelled to produce the document in an action.

(3) The court may order that a subpoena be issued to compel a witness to attend an arbitration.

In reviewing an appraisal the following should be considered:

- (a) the assumptions made by the appraiser;
 - (i) including any extraordinary assumptions;
- (b) the comparables selected, including:
 - (i) location compared to the subject property;
 - (ii) size of the property;
 - (iii) the date of the transaction;
 - (iv) whether the value of improvements is included;³
 - (v) the use of the property,⁴ including the zoning and any restrictions on use, and whether the appraiser determined:
 - (A) the current use;
 - (B) the highest and best use; or
 - (C) any use;
- (c) whether the appraiser used hindsight evidence; and
- (d) the reliability of the data relied on by the appraiser.

V. Common Appraisal Issues

In a contest over the value to be ascribed to an interest in land there are a number of common issues that arise.

In appraisals generally consider whether:

- (a) the wrong valuation date was used;
- (b) the appraisal is signed by more than one person;
- (c) the appraiser has set out an analysis or only the conclusion;

3 In determining "fair market rent" for a renewal, the value of tenant improvements is to be included unless the lease provides to the contrary: *Fire Productions Ltd. v. Lauro*, 2006 BCCA 497.

4 In the absence of a contrary intention in a rent review clause, the valuation is to be determined on the terms and conditions of the existing lease, including any restrictions on use: *Basingstoke & Deane Borough Council v. Host Group Ltd.* [1988] 1 All E.R. 824 (CA). In determining "fair market value of leased premises as bare land", however, the valuation must be made without reference to restrictions on use contained in the lease: *No. 100 Sail View Ventures Ltd. v. Janwest Equities Ltd.* (1993) 84 BCLR 273 (CA) at para. 22-23, leave to appeal to SCC refused.

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- (d) there are explanations quantifying adjustments;
- (e) there is evidence to support an adjustment;
- (f) the appraiser uses an adjustment that is inconsistent with evidence elsewhere in the appraisal;
- (g) the appraiser shows a relationship between comparables in different areas;
- (h) the appraiser uses hindsight evidence improperly;
- (i) the boilerplate is up to date or inappropriate (e.g.: wrong area, wrong type of appraisal);
- (j) the appraisal complies with Canadian Uniform Standards of Professional Appraisal Practice ("CUSPAP") as prescribed by the Appraisal Institute of Canada ("AIC");
- (k) there are statements in the appraisal that defy common sense;
- (l) the appraiser's CV is misleading or incomplete.

In rent appraisals consider whether:

- (a) the appraiser has valued based on the requirements of the lease or the instructions, such as:
 - (i) including improvements when they are to be excluded or excluding them when they are to be included; or
 - (ii) including the value of tenant's fixtures.
- (b) the appraiser has reviewed the provisions of comparable leases for:
 - (i) whether there is a gross up;
 - (ii) whether there are management or administration fees;
 - (iii) additional benefits included in the leased premises such as storage areas, patios, decks, and other amenities;
 - (iv) whether there are restrictions on use or restrictive covenants; and
 - (v) whether there are demolition, termination or relocation clauses;
- (c) the appraiser has inspected the comparable properties for similarities and differences;
- (d) time adjustments made by the appraiser are either not explained or not demonstrated; and
- (e) the appraiser has compared additional rent charges (taxes and operating costs) with the subject lease.

In fee simple appraisals, consider whether:

- (a) the appraiser has inspected comparable properties for similarities and differences;
- (b) the appraiser has commented on the neighbourhood for the comparable or subject properties; and
- (c) the appraiser has considered leases, easements or other impairments to title.

Hindsight evidence is an important issue. Generally an appraiser may not, as a matter of law, rely on evidence that would not have been available at the relevant date unless that evidence is used to show that a trend in the market predicted by the appraiser was correct.⁵ The reason for disregarding hindsight evidence is that values at later dates may be affected by market forces not necessarily operating at the valuation date. In rare cases if there is no other evidence hindsight evidence may be used if it is “logically probative”.⁶

Appraisal reports must comply with CUSPAP. Appraisal Standard Rule 7.6 deals with the timeframe of value opinions. Rule 7.6.2 specifically deals with the use of hindsight evidence in the preparation of retrospective value opinions and makes this comment:

"Data subsequent to the effective date may be considered as confirmation of trends evident at that date. It is up to the appraiser to determine an appropriate cut-off date. In the absence of such data, the effective date is the cut-off date."

CUSPAP Rule 14.35 outlines practice notes for appraisers using a direct comparison approach to valuation and sanctions the use of hindsight evidence, subject to appropriate weight:

"14.35.9 Sales occurring after the effective date of valuation may be useful in the analysis but are subject to appropriate weight."

VI. The Importance of Rebuttal Reports

In valuation cases a rebuttal report can be significant. In practice, parties are usually unable to settle a valuation dispute where the interest to be valued is unique or rare. Often the competing appraisers will take very different approaches to reaching a valuation. A rebuttal report is a useful tool to explore and criticize the approach taken by the other party's appraiser. It will also provide grounds on which to cross-examine the other party's appraiser.

A rebuttal report prepared by an appraiser in response to another appraisal is known as a review report which is subject to CUSPAP standards for review assignments in Rule 8.2. Among other things, those review standards require the review appraiser to:

- 8.2.8 provide an opinion as to the completeness of the report under review,
- 8.2.9 provide an opinion as to the apparent adequacy and relevance of the data and the propriety of any adjustments to the data,
- 8.2.10 provide an opinion as to the appropriateness and proper application of the methods and techniques used,
- 8.2.11 provide an opinion as to whether the analyses, opinions and conclusions in the report under review are appropriate, reasonable and suitable for reliance by the intended user for the intended use, and
- 8.2.12 provide the reasons developed for any disagreement or agreement with the report being reviewed.

5 See: *Rainbow Country Estates Ltd. v. Whistler (Resort Municipality of)*, 2010 BCSC 300; *Cyprus Anvil Mining Corporation v. Dickson* (1983), 40 B.C.L.R. 180; *Amos Investments Ltd. v. Minou Enterprises Ltd.*, 2008 BCSC 332 at paras. 40 to 45: reliance on hindsight evidence is an arbitral error

6 See: *Rainbow Country Estates Ltd. v. Whistler (Resort Municipality of)*, 2010 BCSC 300 at paras. 85 to 91

The review appraiser may or may not include a separate estimate of value. A review report that criticizes the approach taken or adjustments made without suggesting what the better approach or adjustment ought to be, however, may be of limited value. An arbitrator or judge will usually prefer one of two competing methodologies to a difficult valuation problem even when that methodology is subject to significant valid criticism. If no evidence or opinion is put forward to “correct” the conclusion reached using the methodology, the adjudicator may be forced to accept the conclusion without modification even though its inaccuracy is demonstrated because it represents “the less unreliable opinion of value”.

When the review appraiser does not include his or her own estimate of value, the review may include a statement of the opinion that:

- (a) the value conclusions stated in the appraisal report is (or is not) supported;
- (b) the value conclusion is (or is not) appropriate and reasonable given the data and analyses presented;
- (c) the value conclusions stated in the report was (or was not) developed in compliance with applicable standards and requirements;
- (d) the content, analyses and conclusions stated in the report under review are (or are not) in compliance with applicable standards and requirements; and/or
- (e) the value conclusion stated in the report is rejected as being unreliable due to the errors and/or inconsistencies found.

When the review appraiser includes his or her own estimate of value, the review appraiser should state:

- (a) whether or not he or she concurs or agrees with the value;
- (b) whether the value is incorrect, too high or too low; and
- (c) provide an opinion on value.

VII. Cross examining an appraiser

As with the cross-examination of any expert witness, the cross-examination of an appraiser requires careful preparation. The input and advice of the cross-examining party’s own appraiser will be invaluable.

A useful starting point for cross-examination is CUSPAP. The current edition was published April 1, 2014 but, depending on the effective date of the appraisal you are reviewing, it may be appropriate to refer to an earlier edition.

CUSPAP prescribes certain rules which specify the minimum content necessary to produce a credible report that will not be misleading. A misleading report can be caused by omission or commission and may result from a single large error or a series of small errors that, when taken in aggregate, lead to a report that is deemed to be misleading. Rule 6.2 of the Appraisal Standard Rules stipulates that, in the report, the appraiser must:

- 6.2.1 identify the client by name and intended users,
- 6.2.2 identify the intended use of the appraiser's opinions and conclusions,
- 6.2.3 identify the purpose of the assignment,

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- 6.2.5 identify whether the appraisal is current, retrospective, prospective or an update,
- 6.2.7 identify the effective date of the appraiser's opinions and conclusions,
- 6.2.9 identify the location and characteristics of the property and the interest appraised,
- 6.2.12 identify land-use controls,
- 6.2.13 state the existing use and the use reflected in the appraisal,
- 6.2.4 define and resolve the highest and best use,
- 6.2.16 describe and apply the appraisal procedures relevant to the assignment and support the reason for the exclusion of any of the usual valuation procedures,
- 6.2.17 detail the reasoning supporting the analyses, opinions and conclusions of each valuation approach,
- 6.2.18 analyze the effect on value, if any, of the terms and conditions of the lease when developing an opinion of the value of a leasehold estate,
- 6.2.19 analyze the effect on value of an assemblage,
- 6.2.20 analyze the effect on value of anticipated public or private improvements,
- 6.2.23 review and reconcile the data, analyses and conclusions of each valuation approach into a final value estimate.

Keep in mind that, unlike almost all other experts, appraisers rely on hearsay evidence that is rarely proven. If there is a discrepancy it can be explored in cross. However both appraisers will have similar problems with data – for lease rates much of the data comes from conversations and often the leases are not available.

The key areas for exploration in cross examination are:

- (a) the nature of the interest the appraiser is appraising;
- (b) the assumptions the appraiser has made or been asked to make;
- (c) the selection and rejection of comparables;
- (d) the date of the valuation;
- (e) the adjustments made to the comparables for:
 - (i) time;
 - (ii) location;
 - (iii) size;
 - (iv) improvements;
 - (v) use;
 - (vi) restrictions on use; and
- (f) the items set out in Part 5 above.

8.1.10

Appraisers are sometimes careless and use boilerplate language, cut and pasted from another report which valued a different interest. For example, a rent valuation may use boiler plate language taken from a fee simple appraisal.

The choice of comparables is one of the most important steps in conducting an appraisal. If the appraiser has not used the same comparables used by the other appraiser it may be fruitful to explore why. Generally there are two explanations. Either:

- (a) the appraiser was not aware of the comparable; or
- (b) the appraiser was aware of it but rejected it as not being appropriate.

Each of these answers provides fertile cross examination material.

The effective date of the valuation is critical as the wrong date can result in an arbitrator or a judge rejecting the report in its entirety. An error in the effective valuation date can be corrected by an amendment or a supplementary report either redoing the analysis to correct the date or showing how the market changed between the two dates and adjusting the conclusion.

Many appraisers make global adjustments by commenting that various features require an “upward adjustment” and others a “downward adjustment” resulting in an overall adjustment of X. If the adjustments are not quantified, however, then the appraiser will usually have difficulty explaining how the final figure was arrived at. If the appraiser is able to explain and even quantify the adjustments the obvious question is: “why weren’t these adjustments included in your report?”

Adjustments should be explained and quantified if possible. This allows a report to be understood and critiqued. A useful practice is to plot the data from comparable properties in a chart or table, and then apply upward, downward or no adjustments based on a comparison with the data from the subject property. An expert appraiser should be able to explain, quantify and defend each adjustment.