Section II
Production

Chapter 5
Appraisal Reports and Market Studies

5.1 General

Appraisal reports are required for all Section 232 applications with the exception of the 232/223(a)(7), 232/223(f)/223(a)(7), 223(d) and 232(i). Market studies must be included in all appraisal reports. The market study may at times be truncated under conditions outlined in Section 5.3.Q. The market study will be authored by the same person(s) who produced the appraisal report and the conclusions carried throughout the appraisal report. In the past, appraisal reports and market studies were required to be separate documents. Now single reports are encouraged.

When an appraisal ~~report~~ assignment involves complex or unusual valuation issues, the appraiser and/or the Lender should consult with the Office of Residential Care Facilities (ORCF) before beginning the assignment.

HUD expressly asserts its role as a regulatory enforcement agency as outlined in the confidentiality provision of the Uniform Standards of Professional Appraisal Practice (USPAP). Appraisers may be required to present their entire work file and fully disclose the identity and source of confidential information should HUD determine a review of the appraiser's work file is in order. All confidential information received either by initial request or by invoking the confidentiality provision of USPAP will be kept confidential by HUD, especially with regard to the "Freedom of Information Act." Any questions regarding the confidential information received will be directed to the originating appraiser for clarification.

When appraisal reports do not meet the program requirements as outlined in this chapter, the following remedies may be invoked:

1. Issuance of a warning letter to the lender or appraiser.
2. Limited Denial of Participation (LDP) of an individual or company.
3. Lender referred to the Mortgagee Review Board.
4. Appraiser referred to the state regulatory agency.

Chapter 2 of Section I – Handbook Introduction, addressing "Lender Relations," discusses remedies against lenders in more detail.

5.2 Selection of Appraisers

The Lender is responsible for the selection and approval of appraisers and familiarizing them with the 232 insurance program guidelines. Lenders must ensure that each appraiser selected is qualified to complete the assignment by reviewing their experience, education, work quality, relevant assignment frequency, and state licenses or certifications.

In order to qualify as the appraiser, the individual must meet all of the following conditions:

1. personally inspect the property being appraised ~~on the date of valuation~~;
2. ~~perform~~develop the analysis, opinions, and conclusions;
3. have the necessary knowledge and experience;
4. sign the appraisal report certification as the appraiser; and
5. be a Certified General Appraiser under the appraiser certification requirements of the State in which the subject property is located, as of the effective date and report date of the appraisal report (temporary certifications are permissible). Lender verification of an appraiser's current standing can be done at http://www.asc.gov.

These requirements do not preclude an appraiser from relying on individuals that are not state-licensed or certified to provide professional assistance (such as an appraiser trainee or an employee doing market data research or data verification) in the development of the appraisal report.

Further, the appraiser must meet all requirements of the competency rule of the USPAP. If more than one appraiser works on the appraisal report, they are each required to sign the report and a certification outlining their involvement. The appraiser's signed certification must acknowledge the roles and extent of the professional assistance provided by others.

The appraiser must be independent of and may not be affiliated with the loan originator, broker, developer, borrower, lender, or any individual or institution involved in any other financial role in the application. The appraisal report must be ordered and paid for by the Lender and not by the originator, broker, developer, or Borrower.

Note: It is acceptable for the borrower to reimburse the lender for the cost of the appraisal fee, as this may be included in the organizational fees (see Appendix 10.2.C.7.a).

The appraisal report must identify HUD as an authorized user of the report. The intended use of the appraisal must be identified as FHA-insured financing. The contract between the lender and appraiser ~~will~~must not contain ~~no~~ language prohibiting contact between ORCF and the appraiser.

5.3 Appraisal Report Requirements (Statement of Work)

A. **USPAP Compliance:** The report must be in compliance with the USPAP. Any data contained in the appraisal report that is not the work of the appraiser and is from an outside source is to be cited. In addition to USPAP-required items, the report will contain the following deliverables:

1. Resume for each appraiser signing the report.

2. Copy of appraisal license or temporary permit for each appraiser signing the report.

3. Adequate photo documentation of the subject to allow a desk reviewer to get a sense of the quality, condition, and adequacy of the physical plant. In the case of new construction or substantial rehabilitation, exhibits such as floor plans, site plans, and elevations are to be included in addition to site photographs. The exhibits should be adequate to give the review appraiser a sense of what is planned. The report exhibits should be clear and readable. Plans may be incorporated into the appraisal report by reference (cite version or date), so long as said plans are supplied alongside the appraisal report.

4. Legible copies of the subject's historical income and expense statements used in the valuation.

5. Legible copies of the subject's rent rolls used in the valuation.

6. Copies of the subject's Medicaid rate letters used in the valuation. When there is no rate letter, provide published methodologies, including historic, current, and published proposed rates need to be factored into the Medicaid rate forecast.

B. **Timing:** The effective date of the opinion of value ~~should be~~is to be the later of the site inspection date or the end-date of the most recent historic financials. Furthermore, the date that the designated appraiser inspected the subject property~~. The date of valuation may not be a future date.~~

~~For 223(f) refinances, the appraisal report is to be submitted to ORCF by the Lender~~ and the end-date of the most recent financials must be within 180 days of the ~~appraisal report's~~ submission date of the application to HUD. Market particulars, such as Medicaid rates, competitive pipeline and new construction activity, and market occupancy need to be contemporaneous with the date of value. The effective date~~.~~ may not be a future date. For expired appraisal reports, a new appraisal report must be submitted or granted a waiver through consultation with the ORCF review appraiser. Consult with ORCF to see if a re-inspection will be required.

For new construction, substantial rehabilitation and 241(a) loans, the appraisal report is to be submitted to ORCF by the Lender within 120 days of the appraisal report's effective date. For expired appraisal reports, a new appraisal report must be submitted or granted a waiver through consultation with the ORCF review appraiser. Consult with ORCF to see if a re-inspection will be required. The appraiser will indicate there is a hypothetical condition that the improvements have been completed and the forecasted occupancy levels have been achieved as of the appraisal report date. In addition, the appraiser must indicate the timeframe necessary to achieve these projected results.

C. **Purpose of the Appraisal Report and Definitions:** The purpose of each appraisal report is to provide the Lender and ORCF an opinion of ~~the fee simple~~Market Value. The value is to be determined for the Fee Simple interest, unless the facility is encumbered by a non-identity of interest lease. In such cases both the fee simple and leased fee values are to be provided. "Market Value of the Total Assets of the Business" (MVTAB) for the subject property. The report will be used by the Lender and ORCF in the underwriting of a FHA-insured mortgage.

The Lender will specifically inform the appraiser if the appraisal report is for another purpose.

D. **Definition of Market Value of the Total Assets of the Business (MVTAB):** "The market value of all the tangible and intangible assets of a business as if sold in aggregate as in a going-concern" *(The Dictionary of Real Estate Appraisal, Fourth Edition, Appraisal Institute).* The appraiser is hereby instructed to exclude any business assets (such as holdings or investments, working capital, accounts receivable, and accounts payable) that are separate from the real estate. Implicit in this definition of the MVTAB is the definition of Market Value which is defined below.

Definition of Market Value: The most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently, knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. buyer and seller are typically motivated;

2. both parties are well informed or well advised, and each acting in what they consider their own best interest;

3. a reasonable time is allowed for exposure in the open market;

4. payment is made in terms of cash in U. S. dollars or in terms of financial arrangements comparable thereto; and

5. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions by anyone associated with the sale.

(Office of the Comptroller of the Currency, 12 CFR Part 34.42g)

The MVTAB differs from a "Going-Concern Value" in that it assumes a sale (see definition of market value above). The appraiser's projection of income and expenses should include any applicable resets of rates that would be triggered by a sale. These resets will vary from one locality to another and may include a tax reassessment, or a reset of the Medicaid reimbursement rates.

In developing the MVTAB, the appraiser is being asked to mimic the processes of the market and estimate the most probable sales price of the going-concern. If the property is currently under contract or has recently sold under normal arm's length market conditions, any departure from that price will be scrutinized. The assumption is that if the property has been adequately exposed to the market, the purchase price is a strong indicator of the price the market will bear.

E. **Extraordinary Assumptions:** Extraordinary Assumptions should be used infrequently and when used, must be prominently outlined in the appraisal report.

F. **Jurisdictional Exceptions:** Jurisdictional exceptions should not be invoked and are not required in order to comply with any instructions contained in this chapter.

G. **Hypothetical Conditions – 223(f):** ~~Typically, the only Assumptions in a~~Every 223(f) appraisal report should ~~be the completion of~~assume that the proposed repairs/construction~~. On rare occasions, there may need to be other assumptions, such as the execution of a proposed land lease. It is not appropriate to assume~~ have been completed. It is permissible to make the assumption of stabilized operations ~~if the property is not at stabilized, without accounting for the impact on the value associated with~~ as long as the costs of reaching stabilization~~.~~

~~The valuation should not be based on any significant change in occupancy, unit mix, bed configuration, room rate increases, or expense reductions that would require an extended period to implement. The appraised value should reflect the subject's configuration and economics on the date of appraisal report, but with consideration to increases in income, occupancy, or decreases in expenses that could be implemented immediately by a typical buyer (but these changes must be fully supported by the market and discussed in the appraisal report). It is recognized that occupancy levels can vary substantially from day-to-day, so while the occupancy of the facility on the date of inspection should be considered, the focus should be on forecasting achievable occupancy for the 12-months following the date of value based on the subject's historical occupancy, market area dynamics, and anticipated changes in the market.~~

~~In cases where there are proposed~~ have been accounted for as follows: The completion of the repairs~~, the appraisal report will conclude an "as completed" value, making a hypothetical assumption that all proposed repairs are completed~~ might have impacts on the operations,~~. The appraisal report should indicate the dollar amount of the repairs assumed and give a general overview of what items are included. This is to ensure the consistency of the appraisal report with the loan underwriting. The completion of the repairs should be considered in determining~~ rents, ~~vacancy,~~vacancies, census mix (i.e., payor mix), expenses, ~~and~~ depreciation~~;~~, etc.; however~~,~~ these shifts in operations will likely occur over time. ~~The appraisal report should not make the assumption that the new stabilized levels have been~~

~~achieved. Instead, the~~The value should reflect what a typical buyer would pay for the current operations on the valuation date as if the repairs were finished~~.~~

~~ORCF may, at its discretion, allow a Lender to underwrite a 223(f) loan that assumes a shift in operations or~~ and the resulting changes in operations can begin. Keep in mind that market participants generally recognize some value in unrealized operational potential, but not to the same extent as proven operations. When the appraiser concludes the repairs will have an impact on operations or there is a change in the number or type of units ~~(as is done for construction loans). In these cases, the Lender will have the appraiser determine what the stabilized occupancy of the reconfigured project will be once the repairs are completed. A "truncated" market study as outlined in 5.3.Q will not be allowed. The~~ , the appraiser will ~~also~~ supply an analysis of the ~~cost to reach~~costs (in time, expense, lost income, risk, etc.) of reaching the new levels of operation, showing the forecasted monthly cash flows until stabilized occupancy has been achieved. ~~This analysis is required even if the monthly Net Operating Income (NOI) never drops below $0. The appraiser will assume the repairs have been completed and the~~ The concluded costs to reach stabilization must be deducted from the market value based on the hypothetical condition of stabilized operations, to arrive at the current market value. Any of the forecasted operational changes must be fully supported by the market and discussed in the appraisal report. The ORCF Review Appraiser will closely analyze any forecasted shifts in operations that have not yet been achieved. Additionally, the impact of the operational changes need to be accounted for when selecting a capitalization rate and discussed within the capitalization rate analysis in the appraisal report. The appraisal will need to state the hypothetical conditions clearly and specifically. The appraisal report should indicate the dollar amount of the repairs assumed and give a general overview of what items are included. This is to ensure the consistency of the appraisal report with the loan underwriting. ~~stabilized occupancy has been achieved as of the appraisal report date~~When operational changes are expected, a "truncated" market study as outlined in 5.3.Q will not be allowed. The use of other hypothetical conditions should be used with caution.

H. **Hypothetical Conditions – New Construction, Substantial-Rehabilitation and 241(a):** For New Construction, Substantial Rehabilitation and 241(a) loans, the appraisal report is to conclude an "As Completed and Stabilized Value", making a hypothetical assumption that all improvements are completed and the appraiser's forecasted occupancy has been achieved.

For all ORCF appraisal reports, income and expense conclusions are to be as of the effective date of the appraisal report and are not to be trended to the projected date of stabilization.

1. **Operating Deficits:** The ~~Appraiser~~Lender is to perform an operating deficit calculation when the subject property is not currently able to achieve the NOIs forecasted in the appraisal report. The format of the IOD is dictated within the Initial Operating Deficit Escrow Calculation Template (Form HUD- 91128-ORCF). More information on Operating Deficits can be found in Production, Chapter 2 and Appendix 2.1.

2. **Additional Instructions:** When portions of a project already exist (i.e., Section 241(a) and substantial rehabilitation loans), the appraiser will also provide an "As Is"

Market Value of the Total Assets of the Business. The "As Is" MVTAB should not assume repairs are completed. Do not make a hypothetical assumption that the subject is operating at stabilized occupancy if it is not.

I. **Regional Description:** This section should describe the region (typically the U.S. Census-defined Metropolitan Statistical Area- MSA when in urban and suburban areas) relevant to the property, and should include:

1. An overview of recent and forecasted population and household growth;

2. A description of the economic base of the area including recent and forecasted job growth statistics, stability of local industries, major employers, and current and historical unemployment levels.

J. **Neighborhood Description:** In discussing the neighborhood, the appraiser should include the following:

1. A general discussion of the neighborhood's demographics, new development, economic and employment trends, and a summary of the neighborhood's relevant strengths and weaknesses, and their influence on the desirability and remaining economic life of the subject. Note: Only the demographic characteristics not protected by the law are relevant to analyzing the neighborhood. Federal law prohibits discriminating in an appraisal based on certain characteristics such as race, color, religion, national origin, sex (including gender identity and sexual orientation), marital status, familial status, age, receipt of public assistance income, or disability.

2. A description of neighborhood land uses in general, including predominant age, quality, and condition of the properties, and their influence on the subject.

K. **Site Description:** In the analysis and description of the site the appraiser should:

1. Include a reference to the panel number and date of the FEMA map reviewed and if the site is partially or fully within a designated Special Flood Hazard Area~~.~~ (100-year floodplain) or the 500-year floodplain. Be careful to differentiate between Zone X and Shaded Zone X flood hazard areas.

2. Obtain a copy of the land survey (if available) from the lender and discuss the effect of easements, encroachments or encumbrances on the subject site.

3. Identify the immediately adjacent land uses in all directions and indicate if they have a negative impact on the site.

4. Indicate the number and adequacy of parking stalls on site, and if off-site parking is utilized.

L. **Zoning and Conformance**: The appraiser should identify the zoning code. Zoning requirements concerning density, unit size, parking, etc., should be analyzed for the subject property. A statement should be made as to whether the property is a legal-conforming, legal non-conforming, or an illegal use, and include the issues of non-conformance, if applicable. This need not be original research on the part of the appraiser, since the Lender will be supplying their own evidence of zoning compliance with their application.

M. **Improvement Description**: The appraiser is to provide a description of existing and any planned improvements. This section should include the estimate of total building area. Include descriptions of living areas, patient areas, nursing or therapy units, common areas shared by residents and support areas. Include an inventory of room type (private, semi-private and ward) or unit mix as well as a description of their restroom and bathing accommodations.

Color photos should generally include, but not be limited to, site access, common areas, nurse's stations, hallways, rehab space, parking, building exteriors, and interior views of typical units.

Note: Although it is recognized to be outside their area of expertise, the appraiser is encouraged to note any violations of building, health, fire, or safety codes that were suspected at the property. ORCF understands the appraiser is not an accessibility expert; however, if an accessibility issue is obvious, a detailed description (inclusive of pictures) should be provided.

Advisory Note: When analyzing properties that do not have all the necessary facilities or services on-site or that share such functions with an adjoining or affiliated facility, the appraisal report must not assume that the current sharing agreements will continue. By way of example, such shared facilities might provide for dining and food services, laundry, treatment space, management, parking, maintenance, etc. The appraisal report must recognize the property as an operation with deficiencies. For appraisal report purposes a provider of a missing service can be considered an off-site vendor and apply market expenses to that service, not recognizing any below-market expenses granted for existing relationships. The cost of supplying missing services must be clearly defined in the appraisal report. It is noted that off-site costs are typically higher than the costs for similar services with all in-house operations. If the appraisal report assumes an off-site vendor the capitalization rate should also consider the reduced ability to control expenses or other related risks. The appraisal report may hypothetically assume that deficiencies are cured if the cost of renovations and or additions required to provide those services have been accounted for in the valuation. Such assumptions are limited to physical and legal restrictions. Assumptions about construction need to account for any lost income from the change in operations and for time and vacancy needed to implement the change. At that point the expense to operate an in-house good or service should be abstracted from similar facilities with in-house operations.

N. **Remaining Economic Life**: The appraiser will estimate the remaining economic life of the improvements. Remaining Economic Life is defined as: *"The estimated period during which improvements will continue to represent the highest and best use of the property; an estimate* *of the number of years remaining in the economic life of the structure or structural components as of the date of the appraisal report; used in the economic age-life method of estimating depreciation."*[1]

The analysis should discuss the following three types of depreciation: physical deterioration, functional obsolescence, and economic or external obsolescence.

1. **Physical Deterioration.** In determining the remaining economic life, the appraiser will include an estimated economic life and effective age. At a minimum, the economic life estimate from the Marshall & Swift Cost Estimating Manual or equivalent should be quoted. Other published life estimates may also be quoted when available. While HUD will require a reserve account to continually maintain the building, the appraisal report should not assume any specific type of ownership or financing when determining the probable life. Maintenance done in the past may be considered in determining the effective age, but assumptions about future maintenance should be tied to the amount of repairs that can be funded with the "market" reserve expense concluded in the appraiser's income approach.

2. **Functional Obsolescence.** Lives can be extended or shortened based on the presence or absence of functional obsolescence as compared to other facilities in the subject's market. For nursing facilities, these comparisons may include the number of private rooms compared to semi-private or wards, shared toilets/showers, quality and location of therapy space, size of common areas, corridor width, etc. For assisted living facilities, the comparisons alternately might focus on building amenities, common space, and room configurations.

3. **External or Economic Obsolescence.** Again, lives can be extended or shortened based external factors. Items to consider here may include but are not limited to long term population trends, stage of neighborhood life cycle, type of license and certifications, the likelihood of new competition, whether supply is controlled by State Certificates of Need (CON), the subject's relative competitive position in the market, hospital referrals, Medicaid reimbursement issues, alternate highest and best uses, etc.

O. **On-Site Services.** The appraiser is to provide a detailed description of the services and personal care levels to be provided by the subject project, including but not limited to the number of meals, housekeeping, laundry facilities, transportation, activities, therapies, assistance with activities of daily living (ADLs), etc. For multiple use facilities, the services offered or available for each resident group (e.g., board and care, assisted living, dementia, skilled nursing) should be segregated in the narrative.

P. **Highest and Best Use.** The Highest and Best Use is to be developed according to USPAP. It is to include both the highest and best use "as vacant" and "as improved." Properties are to be appraised based on their highest and best use. Usually this use will be the same as the intended use of the property; however, when there is a conflict between the two the Lender or

[1] The Dictionary of Real Estate Appraisal, 5th Edition, Appraisal Institute

appraiser should approach ORCF for guidance on how to approach the valuation for their particular circumstances.

Q. **Market Analysis.** For New Construction, Sub-Rehabilitation and 241(a), a complete market study must be part of the appraisal report. Appraisal reports for 223(f) refinances may supply a "truncated market analysis" if the project meets specific criteria. The case for submitting a truncated analysis should be presented in sufficient detail for the ORCF reviewer to arrive at the same conclusions.

1. A truncated market study is allowed if:
    a. The property is not adding beds/units and no substantial shift in the subject's census mix has been assumed.
    At the time of the appraisal report, the property is operating at and is expected to continue operating at its estimated stabilized occupancy into the foreseeable future.
    b. There are no anticipated or foreseeable increases in supply that will significantly alter the subject's competitive position or performance.
    c. There are no anticipated decreases in demand in the foreseeable future for the type of services offered at the subject.

2. With a truncated analysis it is not necessary to quantify (put a number to) the current demand level or "unmet need" in the primary market area. A truncated market analysis will include the following:
    a. A definition of who is the subject's target market(s).
    b. A definition and explanation of the Primary Market Area (PMA) including a discussion of geographic, demographic, and economic influences on and characteristics of the target market. Include a map showing the boundaries of the PMA. Note: Only the demographic characteristics not protected by the law are relevant to analyzing the neighborhood. Federal law prohibits discriminating in an appraisal based on certain characteristics such as race, color, religion, national origin, sex (including gender identity and sexual orientation), marital status, familial status, age, receipt of public assistance income, or disability.
    c. A description of the primary competition within the market area. Report each competitor's name, location, year built, and number of units/beds. If available, also report on unit type/sizes, payor mix, private pay bed/room rates, any significant shift in rates within the recent past, vacancy, recreational facilities and other amenities, condition of improvements, additional fees for personal care levels and/or second occupants, etc.
    d. A description of the local research into proposed construction or expansion of competitive facilities. For States that require certificates of need (CON), or its equivalent, the state agency should be contacted to determine the current and future intentions for granting additional beds or units in the primary market area that would represent additional competition. The appraisal is to identify the person(s) contacted regarding new supply.

3. Whenever truncated studies are not appropriate, a complete market analysis that conforms to the following rules must be included in the appraisal report.

   a. **Define the Primary Market Area (PMA).** PMA in this document is defined as "the area that a majority of the project's demand will be drawn from considering physical barriers, psychological barriers, density of population, linkages, and the location of competing facilities.

      Advisory ~~note~~Note: The need to be nearby friends, family, physician, ~~church~~houses of worship, among other familiar services is a primary determinant for the selection of most senior housing and nursing facilities. Typically, 60 to 80 percent of the demand for senior housing and / or a nursing facility will come from the PMA. The analyst should study the market and determine natural boundaries, ~~social or economic boundaries~~ as well as other factors that generally define the PMA. The analyst should also determine if nearby areas have sufficient supply and would be a significant area to draw potential patients. Certain services that the subject may offer may also extend the PMA due to the lack of services in that area, therefore, the services the subject may offer should also be considered.

      Market area analysis for long term care and seniors housing should focus not only on seniors but also on adult children who may be caregivers for an elderly person residing outside the market area." When defining the boundary of a market area, the analyst must include:

      i. A description and map of the geographic boundaries of the subject's market area and a discussion of any physical or psychological barriers of the primary market area.
      ii. The locations and a map showing all facilities (supply) that offer the same care as the subject facility (IL, AL, MC, SN, etc.) must be provided for the primary market area as well as for adjacent secondary market areas where a competitor's PMA overlaps the subject's PMA (existing, under construction, and planned).
      iii. A general description of the localities from which the occupants in competing projects originate, if available. If the subject is an existing project with a proposed addition or a replacement project, a resident origin analysis should be performed.
      iv. Location of significant referral sources.

   b. **Define the Target Resident.** The report must include a qualitative description of the target resident and the type of housing and care offered by the subject. Include the ~~economic and demographic~~ characteristics of the target market (subject residents): income levels, wealth and assets, age, physical and/or mental limitations~~, and other similar factors~~.

      Advisory Note – The economic and demographic focus for the target market may be different for assisted living than for memory care or skilled nursing facility. For example, income, wealth and assets are more important for private pay assisted living than for skilled nursing for which Medicare and/or Medicaid are the primary payor.

c. **Describe the Current Inventory and Supply Count.** While all facilities offering the same type of care as the subject will be mapped as described above, only those competing for the same Target Resident as the subject facility need to be identified as competitive supply. These direct competitors are to be used in forecasting unmet or displaced demand, rates, occupancy, resident/patient mix etc. Any beds/units identified in the PMA, but not included in the competitive supply must describe the reasons why they will not compete directly with the subject facility for the same Target Resident.

i. A datasheet for each of the subject's primary competitors is to include the following information:
   1. Project name, location, number of unit/beds.
   2. Operated beds versus licensed beds. Operated beds are those beds that are actually available and set up for immediate occupancy. Many nursing homes and assisted living facilities do not operate all of their licensed beds. A description of why the number of operated beds varies from the number of licensed beds should be provided,
   3. Private pay rates by unit type, and level of services. Provide information on the base rate and any added costs for optional services, as applicable.
   4. Typical census mix by payor source (i.e. private pay, Medicare, Medicaid, HMO, VA, etc.).
   5. Age and condition of the competing project, with consideration of aspects that may be substandard or obsolete in terms of physical plant, services, amenities, etc.
   6. Occupancy rates – indicate if the occupancy percentage is for a point in time or the average for the year.
   7. Existence or extent of concessions.
   8. The level of competitiveness in comparison to the subject should be discussed.
   9. Photographs should be provided.
   10. Contact information for the person who supplied the data. The administrator/executive director/marketing director should be interviewed for each primary competitor as part of the confirmation process.

ii. In addition to the datasheets presented for the primary competitors, the following information is to be presented.
   1. Describe any off-line product.
   2. Give the total number of beds/units (of the types housed within the subject) in the PMA, by type of care.

3. Description of turnover rates (length of resident stays) within the PMA.
4. Supply an occupancy survey for the PMA of the product type offered by the subject. Include an explanation of any vacancy or absorption problems in the market. Supply any information gathered on waiting lists.
5. Describe the absorption experience of any recently completed projects, discussing the level and extent of pre-sales, move-ins, move-outs, and net absorption.

d. **Rate Determination.** This may be done within the market analysis section or the income approach section. The analysis should contain a determination of the appropriate rates for the subject. Differences in pricing strategies should be accounted for. For example, some facilities may charge lower base shelter fees with higher care fees, while others will quote higher shelter fees with lower care fees. The rate conclusions for the subject must show a consistent pricing strategy between shelter and care charges.

The report should also include, as applicable, a discussion of the current levels of public payments by the State relative to the typical "private pay" rate for the same level of shelter, care, and services.

e. **Alternative Care and Service Systems.** The demand analysis should discuss the impact of other care and housing options that cater to the same target populations as the subject. These may include: home healthcare, continuing care retirement communities (CCRCs), assisted living facilities (ALFs), board and care facilities, congregate care facilities, retirement service centers, independent living facilities, nursing facilities, etc.

f. **Characteristics of Pipeline Activity.** The following information should be provided in the report for each project in the construction pipeline or planning process:
   i. Total number of beds currently under construction or proposed, by unit size or type of accommodation. Provide the projected rates if known. If proposed, what is the likelihood of being developed.
   ii. Typical types of services to be offered.
   iii. Provide contact information for data source.

g. **Licensing and Certificate of Need.** For intermediate and skilled nursing facilities, provide a narrative discussion and description of the licensing and Certificate of Need requirements and processes or any moratoriums imposed by the State in which the project is to be located. The discussion should focus on any required or recommended demand or need models and any other specific licensing requirements that would impact demand for the proposed project. Where CON requirements significantly curtail the building of new facilities, the appraiser will describe the state's rules relating to "transfer" of

CON beds (e.g., must the transfer be within the same county? Must the transfer be from an over-bedded county to an under-bedded county? If data is discoverable, what are typical arms-length unit prices for these transactions?).

Certificate of Need restrictions, moratoriums on new development, and in particular licensed supply versus operated supply, must be considered when forecasting unmet or displaced demand in the PMA.

h. **Demand Estimate and Analysis.** The market study report should:

   i. Estimate the unmet demand, or oversupply for the unit type(s) offered by the subject.

      Rather than only comparing the subject's saturation rate to the rates of other markets, the market study should quantify the demand in numbers of units/beds. The unmet demand should be determined for the current market and include a forecasted demand for five years in the future. The demand estimate should show the number of units/beds by payor source (private pay, Medicare, Medicaid, etc.). For independent living, assisted living or memory care, the demand estimate must be based on the number of prospective Target Residents/Patients meeting the ~~relevant economic and demographic criteria (sufficient incomes, age, etc.) that~~income and age requirementsthat reasonably would be expected to require the level of care provided at the subject. As discussed subsequently, a demand estimate for nursing homes would rarely be based on ~~demographic~~ criteria such as sufficient incomes~~,~~ and age,~~ etc.,~~ but would be based on need by type of insurance such as Medicare, Medicaid managed care or commercial insurance. Supply or a portion of a unit at a competitor that does not compete for the Target Resident/Patient population should be excluded as competitive units as part of the unmet or displaced demand calculation.

      1. The demand analysis and forecast for senior housing (assisted living, memory care, group homes, independent living etc.) should include:
         a. Current and forecasted population of the target group(s) by age cohort and the proportion of the population each group comprises.
         b. Current and forecasted estimates for the Target Resident group of social, physiological, psychological limitations that require intermediate or skilled care.
         c. Current income band of prospective Target Residents demand segment, including rent to income ratio analysis, if necessary. Note: the monthly rents used in the target income calculations should be based on average monthly rents, not minimum rents. In addition, the anticipated care fees should be included in the

monthly rent determinations for the target income calculations.

d. Discuss the impact of anticipated population changes on the demand for this project.
e. Discuss changes in the population (including migration patterns) of adult children of the frail elderly, if applicable.
f. Indicate the proportion of secondary demand expected to come from outside of the PMA. Secondary demand should not be confused with the impact on demand tied to the influence of adult children or family members. Secondary demand is the portion of the demand that cannot be directly tied to the influence of primary market area. Do not double count in-migration tied to the influence of adult children with the percentage coming from outside the PMA, as those residents/patients are usually accounted for in the population estimates used in the primary demand calculation.
g. Include demographic data sheets in the addendum.

2. The demand analysis and forecast for nursing facilities should include:
   a. Current and forecasted population of the target group(s) by age cohort and the proportion of the population each group comprises.
   b. Current and forecasted estimates for the Target Resident/patient group of social, physiological, psychological limitations that require intermediate or skilled care.
   c. If a significant portion of the Target Resident/patient census mix is private pay or Medicaid, include an income range for the prospective Target Resident/patient demand segment, including rent to income ratio analysis.
   d. Discuss the impact of anticipated population changes on the demand for this project.
   e. Discuss changes in the population (including migration patterns) of adult children of the frail elderly, if applicable.
   f. The demand forecast for specialized residential medical services may need to be based on the number of skilled nursing discharges from those hospitals serving the primary market area.

ii. Include an estimate of the absorption period needed for the project to reach sustaining occupancy. The absorption estimate should be tied to the analysis of demand, not just the historical experience of comparable buildings.

iii. When the supply is compared to demand it is acceptable to account for enough vacancy for the market to operate fluidly. Since the point of a supply analysis is to quantify the capacity of the existing inventory; it is not appropriate to discount the supply count for vacancies beyond a basic frictional vacancy. Frictional vacancy is defined as the minimum vacancy needed for a market to operate in an orderly fashion.

iv. Because the focus of the supply count should be on capacity, the market study will discuss the existence and impact of any off-line product in the PMA. An off-line unit is one that is not being operated because of lack of market demand for the unit. Facilities that are licensed for more beds than they operate may or may not count as off-line units, depending on the reason for operating fewer beds.

i. **Data, Estimates, and Forecasts.** The analysis should document the methods and techniques used to develop all estimates and forecasts; and provide adequate citations on the sources of all data, estimates, and forecasts. The data and estimates provided should be relevant and current.

The demand model utilized by the appraiser or market analyst must be supported by the case studies demonstrating the relevance of the demand model for estimating unmet or displaced demand regardless if the demand methodology is based on a published model or it was independently developed by the appraiser or market study analyst.

j. **Subsidized or Restricted Rents.** For projects with subsidized or restricted rent, such as Low Income Housing Tax Credits (LIHTC~~). For LIHTC projects,~~), the market study is to provide an estimate of net demand, based on potential income-eligible resident. In many states income eligibility is satisfied when a resident is defined as income-eligible under Medicaid. Otherwise, an income-eligible resident is one whose income does not exceed the maximum permitted by the affordability restrictions but who has sufficient minimum income to pay the ~~LIHTC~~ subsidized or restricted rent without being overburdened ~~by the amount of the restricted rent.~~. Some ~~LIHTC~~ restricted rent projects have other forms of assistance (such as Section 8 rental assistance or soft subordinate financing) to further reduce rents and thus expand the number of income-eligible tenants.

R. **Valuation.** The appraisal report should establish the subject's market value supported by the reconciliation of the income approach, the sales comparison approach, and cost approach (if applicable).

Advisory Note: Special consideration will need to be given to properties (whether the subject or the comparable sales) located within an incentive zone, such as an Opportunity

Zone. These might offer benefits to an owner of a property without changing the facility's Net Operating Income. It is up to the appraiser to determine if the market recognizes the benefits and if special adjustments are warranted within each approach.

1. **Land Valuation**. In cases where no cost approach is developed, the appraiser is not required to estimate the value of the land.

   The appraiser will base their land value on the highest and best use as if vacant. A minimum of three comparable sales should be used. The appraiser should ensure that the comparable transactions were arm's-length between buyer and seller and indicate how the sales data was verified. An explanation of the adjustments should be given in the narrative. If there is a recent or pending sale of the subject land, the sales price must be analyzed. This is a USPAP requirement.

   For guidance on appraising properties involving ground leases, refer to Section 5.4.

   For New Construction, Substantial-Rehabilitation and 241(a) loans, the appraiser will also supply the "Market Value of the Site Fully Improved". This is a HUD-specific value that is defined in HUD Handbook 4465.1. The "Market Value of the Site Fully Improved" essentially assumes the site is ready for development and specifically that:

   a. All necessary utilities are available to the site.
   b. Any environmental conditions needing to be corrected prior to construction have been resolved.
   c. Any required demolition has occurred.
   d. There are no unusual site costs or that the conditions leading to such costs have been corrected.
   e. All off-site improvements have been completed.

   The extra costs associated with these site conditions need to be kept separate from the land value for correct loan sizing on Form HUD-92264a-ORCF. The "Market Value of the Site Fully Improved" is a HUD-specific value used in the derivation of the HUD replacement cost of the project. A conventional market value of the site as if vacant must also be derived by the appraiser when developing a cost approach, in order to keep that value strictly a market value, not a HUD-specific value. In cases where all of the above stated assumptions are already true, there may be no difference between the "Market Value of the Site Fully Improved" and the site value as if vacant prepared in the normal non-HUD way.

2. **Cost Approach to Valuation**. The Cost Approach is typically more relevant in the case of new construction or recently completed properties. This approach may be eliminated with older properties when not a reliable indicator of value; however, ~~a~~not at the request of the Lender. A narrative justification of its elimination is required. ORCF requires this approach when the actual or effective age of the facility is 5 years or less and whenever the appraiser believes this approach is applicable and relevant to producing a credible appraisal report.

ORCF will expect to see a fully developed cost approach in cases where there is little depreciation or in cases where the undepreciated replacement cost new would be expected to be lower than the conclusions of the Sales Comparison or Income Capitalization Approaches. For that reason, base costs of new facilities will need to be carefully discussed in the narrative justification for excluding the approach. If the appraisal does not include a complete Cost Approach to Value and there are no barriers to entry for a similar business enterprise to be constructed in the market area, the appraisal must include the un-depreciated cost. The un-depreciated cost includes the improvement and major moveable replacement cost, the estimated land value, and the associated intangible costs. If there are barriers to entry that would prohibit the development of a similar business enterprise in the market area, then the appraisal must include a brief explanation of the barrier(s) to entry. When the un-depreciated cost is near or above the appraised value, the appraisal must explain why an investor would not build new rather than purchase the subject facility at the appraised value.

When developing a Cost Approach, the appraiser will prepare an independent estimate using comparable data and industry publications (e.g., Marshall and Swift) and conclude to the total cost for all improvements and major movable equipment. In order to arrive at the MVTAB, absorption, staffing costs, other intangible start-up operating costs, occupancy costs, and entrepreneurial profit should be considered and identified. The entrepreneurial profit should be an amount sufficient to attract a typical owner/investor to develop a project versus purchasing a stabilized project. Disparity between the conclusions of the cost approach and the other approaches should be discussed and reconciled as it relates to the principle of substitution.

All applicable forms of depreciation (also applies to major movable equipment) are to be considered. The final cost approach estimate is to assume completion of all required and proposed repairs included in the financing.

Advisory Note: There are sometimes costs associated with acquiring bed licenses when the number of beds is controlled by the State, as with Certificates of Need (CON). When the appraiser determines it is appropriate, the cost/value of acquiring the license may be included in the Cost Approach. This is not the case for the "HUD Replacement Cost" used in underwriting, see Production, Chapter 3.3.M

3. **Sales Comparison Approach to Valuation.** In obtaining sales data for the Sales Comparison Approach, the appraiser should verify the data with a party involved in the transaction (this source should be cited) and confirm that the transactions were arm's-length between buyer and seller. The appraiser should visit all improved sale comparables when in the subject's statistical market area. Photographs should be provided of the comparables that were inspected. For those comparables which the appraiser was not able to visit, inclusion of second party or published photos is permitted, and preferred to omitting a photo entirely. The source of the second party photographs should be cited.

The sales comparison should be formulated based upon those sales which are most relevant and meaningful. The scope of the appraisal report should include a complete description of the comparable search. If the sales that are utilized require substantial adjustments the appraiser must provide an explanation why the sales utilized are appropriate. Although the market for the property type appraised may be regional or national in scope, if there have been recent sales in the area and those sales were not utilized for comparative purposes, an explanation of why the more proximate sales were not utilized is needed. All adjustments of the sales should be justified in the narrative report. The value of any excess land should be deducted from the comparable transaction sales price (if applicable). Contact information for sales comparable data should be given.

When economic indicators such as income, expense, vacancy, cap rate, etc., are quoted from a sales comparable, the source of the data, whether it be from the buyer, seller, the appraiser's estimate, third-party estimate, etc., should be stated. Whether the income was historical or prospective in nature should also be disclosed. Also, state if the expense information is inclusive of management fees and reserve for replacement deposits, to be consistent with the subject's income forecasts.

If the sales price includes consideration for accounts receivable, retained earnings, or intangible assets that may be sold off by the buyer without affecting the going concern, then the value of those assets should be deducted from the purchase price.

Sales of leased fee and partial interests should not be used as comparables in the Sales Comparison Approach unless they can be reasonably adjusted for differences in the interest being sold, nor should they be used in the derivation of market-extracted capitalization rates.

Sales that are part of a small group transaction or portfolio are discouraged but may be used if:

a. At least one of the facilities in the portfolio is within the same state as the subject,
b. Adjustments are made for premiums or discounts associated with the "bulk" sale, and
c. The price allocation of each facility is verified. Details of the aggregate sale, with unit price indicators should also be given.

   The larger the portfolio the less the sale can be relied on for comparison to a single project. Reliance on a majority of portfolio comparables will not be acceptable.

If the appraiser wishes to use an NOI adjustment in the sales comparison approach, the guidance in this paragraph is to be followed. Using an NOI adjustment in the Sales Comparison Approach is a way to adjust for all differences between properties with one adjustment. In theory, all differences between two properties will be reflected in the different NOIs the projects can generate. The use of an NOI adjustment exclusively will largely replicate the results of the income approach in the sales comparison approach. The danger is that the sales comparison approach cannot function as a check, as any mistakes in the income approach will be passed through to the sales comparison approach. In order to preserve the independence of the sales comparison approach, an NOI adjustment can be utilized as additional support for the conclusion but not to the exclusion of a fundamental analysis of the unit price.

The price per bed is a common unit of comparison utilized in the sales comparison of skilled nursing facilities. In addition to the price per bed comparison, the appraiser should consider, where appropriate, analyzing the sales on a per room basis. The price per bed can be misleading at times because the rooms can be shared or private, depending on the marketing strategy of the Borrower. This requirement is meant to prevent a bed value derived from private rooms being applied to semi-private or ward beds, resulting in an incorrect valuation.

~~If there is a recent or pending sale of the subject, the sales price must be analyzed. If the property has sold within 3 years, or within the date range of the comparable sales, the price per unit/bed, capitalization rate, marketing time and market exposure must be provided.~~

If the appraised property has been involved in a transaction within three years of the effective date of the appraisal, within the date range of the comparable sales, the transaction(s) must be analyzed. Transactions include listings, sales, pending sales, options, leases, offers to purchase, or similar transactions. The transaction analysis should include the price per unit/bed, capitalization rate, marketing time, exposure time, and be reconciled to the appraisal's estimated value. Depending on the details of the transaction it may also be necessary to comment on how the property was marketed, the volume of market interest, which assets were included/excluded from the transaction, and if there were any special conditions or terms. Many appraisals report the subject's most recent sale but fail to include all sales, agreements of sale, options, listings, within a three-year period. If the required information is not available, the efforts made to obtain the information must be presented. When the information is irrelevant, its lack of relevance must be explained.

4. **Income Approach to Value.** The income capitalization approach to value is often the most significant indicator of value for properties purchased for their cash flow.

   The scope of the appraisal report should include a complete description of the comparable search and data gathering process. The appraiser is to inspect and provide a photo of all comparables utilized to forecast rents, census mix or occupancy for the subject facility.

   The appraisal report will provide a detailed description of the subject's reimbursement structure or payment sources. In projecting all sources of income for the subject property, consideration should be given to foreseeable changes in competitive market conditions that will affect current occupancy, payer mix, and rate levels. Examples include changes in: the condition of state finances, state laws offering alternative forms of housing types, reimbursement structures, and competitors in the marketplace.

For existing operations, an analysis of the subject's income, expense, and census mix (by payer source) for the year-to-date and the last three fiscal years should be provided and analyzed.

The analysis should provide a discussion of any foreseeable changes in reimbursement.

Advisory Note 1: For example, if the capital cost component of a project's Medicaid reimbursement will diminish over a 10-year period as the capital is depreciated, this would need to be considered when setting the reimbursement rate and accounted for in the capitalization processes of that income. This may also lead to the inclusion of a sinking fund. See Production, Chapter 2.5 GG.

Advisory Note 2: Revenue and expenses should always be estimated based on market expectations as a stand-alone facility of that particular asset type and class. For example, if an operator owns several small facilities in a market sharing an administrator between two or more facilities, this expense should be adjusted to market as a stand-alone facility, which means one administrator to one building. However, this does not mean that if the subject is a regional or national asset class that economies of scale such as purchasing power or marketing cannot be considered.

ORCF does not have a minimum threshold of acceptability for the percentage for occupancy. However, if the property in question has a lower occupancy rate than comparables, it may be that the property is inferior in the marketplace. The lender narrative will need to explain why this is occurring and what steps the Borrower is taking to make the project more competitive. Also, ORCF does not put a limit on the maximum occupancy rate that can be used in the appraisal report. Appraisal reports must be based on market values. Appraisers may use whatever occupancy a typical market participant would use. The appraiser's burden of demonstrating the market's action ~~grows~~increases the more they depart from market norms. At the same time, ORCF expects the lender to present a loan sizing that is conservative. In cases where the appraiser has assumed unusually high occupancies, ORCF expects the lender to implement a more conservative assumption. The loan sizing would then be based on the lender's lower value.

a. **Private-Pay Rates.** Facilities with private pay as a payor source need to include an analysis of the current rent roll, and how achieved rents differ from asking rents. This should be taken into consideration in the rate conclusions. For independent living, assisted living and memory care a comparison and adjustment grid should be provided for each private-pay unit type. For skilled nursing facilities, an adjustment grid is not required but the appraiser/analyst must provide an analysis with a rate comparison chart to determine if the private-pay nursing rates are at market levels. Use of fewer than 3 similar comparables requires an explanation. At a minimum, the rent comparison will discuss building ages, unit types, unit sizes, amenities, services, location, and rental concessions. The narrative should provide the rationale behind the adjustments and offer support in the form of market data and/or pairing analysis, when available.

Advisory Note: Many private-pay patients in nursing homes are patients with short-term assets and often will convert to Medicaid later. The forecasted private-pay rate must also consider the private-pay mix or census at the facility. As the private-pay rate increases, the average length of stay of the private pay patient may decrease due to limitations on their private assets.

b. **Medicaid Reimbursement – 223(f).** For 223(f) refinances, the appraisal report will include an outline of the State's reimbursement system, discussing how reimbursement rates are set, or any local peculiarities. Medicaid reimbursement ~~rates~~rate conclusions should ~~be based on the project's current rate, with~~take into account the following~~ exceptions~~:

~~i. If a firm rate change has been published and the change will occur within 6 months of the date of the appraisal report, the new rate can be used. The appraiser should acknowledge any foreseeable drop in rates.~~

i. Published methodologies and rates, including historic, current, and published proposed rates need to be factored into the Medicaid rate forecast.

ii. If the reimbursement rate includes a capital and/or financing component from which a new rate can be calculated based on the proposed/required repairs to be completed as part of this financing, the prospective rate can be calculated and used. A Certified Public Accountant should be used to determine the new reimbursement rates. This would also lead to the inclusion of a sinking fund. See Production, Chapter 2.5 GG.

iii. Determination of the MVTAB assumes a market sale, and if the state resets rates upon sale, then a new rate must be estimated. The ways these rates are calculated vary from state to state. If the appraiser is not experienced in making these rate determinations, they should work with an accountant experienced with long-term care reimbursements within the state in which the subject is located to determine the new reimbursement rates. The "reset" Medicaid reimbursement rate(s) must tie back to the appraiser's forecasted operating expenses when the reimbursement system is facility-specific and not cost based.

Advisory Note: The Medicaid rate may not always be the current rate. For example, some states issue quarterly rates and they may change significantly quarter by quarter depending on the case mix index. If the most recent quarter is used and that rate is the highest it has been in the last 4 quarters, the rate may be overestimated.

c. **Medicaid Reimbursement – New Construction, Substantial Rehabilitation and 241(a)**. For New Construction, Substantial Rehabilitation and 241(a) loans, the estimated Medicaid rate must incorporate the rate-setting methodologies used by the respective state. For rates that are developed from cost-based, facility-specific systems, the Medicaid rate must be reconciled to the forecasted "Medicaid-allowable" operating expenses of the subject. It is not permissible to apply an un-reconciled rate to the appraiser's forecasted expenses where cost-based, project specific systems are used. Facility specific, cost-based Medicaid rates developed or provided by third party experts (e.g. developer, operator, or management company) must be reconciled to the appraiser's forecasted "Medicaid-allowable" operating expenses.

d. **Medicare Reimbursement – 223(f)**. For 223(f) refinances the analysis of the Medicare reimbursement rates should be based on ~~the project's weighted average rate based on~~ an analysis of the historic average ~~Resource Utilization Group (RUG) census over~~per resident day reimbursements under the ~~preceding 6 to 12 months of operations~~Patient-Driven Payment Model (PDPM) , and any published rate changes. If a firm rate increase has been published and the increase will occur within 6 months of the date of the appraisal report, the published rate can be used when the appraiser feels this outcome is expected and supported.

e. **Medicare Reimbursement – New Construction, Substantial Rehabilitation and 241(a).** For New Construction, Substantial Rehabilitation and 241(a) loans, the analysis of the Medicare reimbursement rates should be based on weighted market reimbursement rates for the proposed care type, and supported by an analysis of average ~~RUG census~~per resident day reimbursements under PDPM of comparables offering the same type of care ~~over the preceding 6 to 12 months~~. The appraiser should make a concerted effort to show that the expenses forecasted for the subject, match the level of care in the reimbursement rate. For projects with preexisting units, the rate should be reconciled with the facility's historical weighted average rate.

Advisory Note: ~~RUG data is provided in Medicare cost reports.~~ Although local market comparable data needs to be provided, when the subject is ~~new~~newly constructed it may be appropriate to use other newly construction facilities in similar markets rather than using ~~older~~only local comparables.

f. **Other Reimbursement (HMO, VA, etc.).** For other forms of reimbursement, the appraisal report will base the rate conclusion on an appropriate analysis of comparable market data, published rates, provider agreements, and/or the subject's historical data, as applicable.

g. **Other Income:** Other income should be estimated based on market data. Significant components, such as personal care/ancillary services, second occupant charges, beauty shop, day care services, and other miscellaneous sources, should be supported by historical or comparable market data and presented individually in the report. Interest income is not to be included as it is not considered to be tied to the real estate.

Fundraising revenue cannot be included in the NOI. This would not be a dependable source of income and would not be available to a purchaser in the event of sale of the property.

Income and expenses from off-site activities, such as adult day care or home care, must be excluded from the valuation. See also Chapter 2.5.K

h. **Commercial Income.** If the subject contains commercial space, the forecasted income from that space is to be estimated based on property history (when existing) and market data. Use of fewer than three comparable commercial leases requires an explanation. Small spaces, such as those leased for beauty/barber shops and therapist's rooms are not considered commercial space. In cases where a commercial lease would be severed in the event of a sale, such as with an Identity of Interest lease, the appraiser will use a hypothetical assumption that there is no lease in place, but uses instead market rates for the commercial space.

i. **Vacancy and Collection Loss (Economic Vacancy).** HUD requires that the appraiser forecast a vacancy factor for the subject. Consider both a physical vacancy and a collection loss allowance. These components should be separately identified and supported in the report.

Advisory Note: Collection loss in healthcare properties is primarily listed as bad debt.

If the physical vacancy in the market exceeds the factor selected for the subject property, the appraiser must explain why the Property's performance is expected to be stronger than the market. The appraiser should also address the trends that would indicate a change from the current vacancy in the near future. The discussion of trends should generally include:

- i. Recent vacancy patterns, including any seasonal variations at the property and in the market.
- ii. Turnover rates.
- iii. Economic factors (e.g., employment, supply of comparable units) that may have a long-term impact.
- iv. Changes in the supply of competitive facilities and/or units.

j. **Expenses.** The appraiser's expense estimate should conform to the following rules: All projects should stand alone and must not reflect shared expenses from nearby projects under the same management.

- i. Categorize and provide commentary as needed to support each item. A suggested chart of accounts (expense categories) is included in the Lender Narrative Template, but this is not a mandate on how the expenses should be categorized. The goal should be to record the expenses of the subject and the comparables in a way consistent with one another and in a way that requires the least amount of subjective re-categorization from the source reports.

ii. For existing properties, the appraisal report will analyze the subject's historical operating statements. If any expense estimate used by the appraiser is lower than the historical expense, the appraiser should be particularly diligent in providing information concerning that expense estimate. The appraisal report should contain legible copies of the subject's historical income and expense statements used in the valuation.

The financial history summarized in the appraisal must balance with the detailed income and expense statements certified by the owner to be correct. For the two to balance, expense add-backs are sometimes needed. Examples of add-backs are, interest income, interest expense, depreciation, amortization, property rent, lawsuits, fund raising activities, and major capital improvements. This reconciliation should be explained in the lender narrative in sufficient detail for a reviewer to understand how the appraiser arrived at the historical NOI summary. The lender can speed the balancing process by describing the add-backs using the specific name or accounting code used in the certified financials. It is inappropriate to make adjustments to the history to normalize peculiarities of corporate structure. Such "normalizations" will be reflected in the appraisal's forecast, but the history will reflect actual operations without adjustment. This financial history without normalization will be important for underwriters to gauge the adequacy of the debt coverage. Any income or expense considered by the appraisal or underwriter to be atypical should be adequately described and supported in the lender narrative.

Advisory Note: Appraisers and lenders should use caution if moving expenses into the management fee category. Since the management fee is typically normalized to market levels, there is a danger that necessary market expenses will be erased from the history by the normalization process. Itemize and explain any expenses that were recategorized into the management fee.

iii. At least three expense comparable properties will be considered. The expense comparables must not all be from the same operator/owner. The expense comparables should be included in the report and strive to:

a. contain approximately the same payer mix (Medicaid, Medicare, Private Pay, etc.),
b. have similar unit/bed capacities,
c. be located in a market similar to the subject,
d. represent the same licensed level of care (skilled nursing, assisted living, memory care, etc.).

In cases where comparables with similar care mixes cannot be found, at least three expense comparables for each care type should be used.

Advisory note 1: The size as well as the census mix of a senior housing and/or nursing home must be considered in the selection of expense comparables. These two factors have the largest impact on variations in expenses from facility to facility. For example, it is not relevant or appropriate to forecast the expenses for an assisted living facility with an assisted living facility that is 50 percent smaller in size. It is not relevant or appropriate to compare a nursing facility with a substantial Medicare and managed care census mix to a nursing facility with substantially less Medicare and managed care patients.

Advisory Note 2: When estimating the expense of Professional Liability Insurance (PLI), do not simply select an average market expense for an average user. Market PLI expenses are property specific. The rate going forward for a given property for any owner is dependent on the actual history of claims, as well as the care/star rating. Therefore, the going-concern of a low rated property with a history of high claim rates would have a higher conclusion for market PLI expense than a highly rated property with a low rate of claims. For portfolios, ORCF implements this rule on a property by property basis, rather than applying the same PLI expense per bed across the entire portfolio.

Advisory Note 3: "ORCF considers flood insurance to be a market expense that other lenders would also require, therefore, the cost of flood insurance when applicable should be included in the appraisal's expense estimate.

iv. The appraiser must indicate from which period/fiscal year the expense comparables were taken. The appraiser will adjust or trend the comparables for changes in the market over time to the effective date of the appraisal report. The appraiser will describe how the adjustments were applied.

v. For properties with commercial space, the expenses associated with that space must be discussed and supported at least three additional expense comparables will be analyzed and considered, unless the lease is on an absolute/triple net basis whereby the tenant pays all expenses. Commercial expenses should be reflected separately from the residential expenses. The conclusion should reflect any special conditions indicated in the commercial leases that would reduce the net income of the property.

vi. Regarding confidential expense comparables, the appraiser may only use confidential expense comparables that are supportive and consistent with the fully disclosed comparable(s) used in the analysis.

~~Using only confidential comparables is not allowed~~Identify the locality of confidential expense comparables as much as possible without revealing the identity, e.g. MSA, State, or City. It must be noted when any of the expense comparables have a shared identity of interest, confidential or not. If an expense comparable is known to have FHA financing, it cannot remain confidential.

k. **Reserve for Replacement Reserve.** The appraiser should reflect a reserve for replacement that is supported by the market and/or historical levels. HUD has a programmatic requirement to require a reserve for replacement; however, in order to preserve the integrity of the "Market Value" called for, if the amount required by HUD differs from what the market demands, the appraiser will use the market-based amount and the Lender will revise the amount in their underwriting to meet HUD's requirements. The Lender is not required to recapitalize the value conclusion for this revision of expenses. The Lender will however use their altered net income conclusions in the calculation of the Debt Service Criterion used for loan sizing.

l. **Real Estate Taxes.** The appraiser must consider current assessed value, trends, and levy rates of the local jurisdiction taxing the subject property. In cases that involve new construction, at least three comparable tax properties should be considered and analyzed. The current taxes (for the immediate tax year) should be clearly stated. The appraiser should discuss how the appraised value compares to the current assessment. If a jurisdiction resets the tax assessment after a sale, the appraiser's expense conclusions should implement the hypothetical reassessment.

For properties subject to tax abatement or tax exemptions, the appraisal report will follow the procedures outlined in 7.5.

m. **Capitalization Rate.** Under the direct capitalization method, the appraiser extracts the over-all capitalization rate from sales comparables. When deriving a capitalization rate from the sales comparables, the analysis of the comparables should be the same as is used for the subject. It is inappropriate to apply a retrospective capitalization rate to prospective income. There may be important sales that have only provided retrospective income. If the appraiser wishes to use those sales in a cap rate discussion or an NOI adjustment, they must estimate the buyer's prospective income. If there is insufficient information to support capitalization rates from the sales comparables, additional capitalization rate comparables should be added. The methodology for estimating the comparable's NOI should match the methodology used in developing the subject's NOI. That is to say, if the subject's income is prospective in nature, so the comparable's should be; if the subject included a management fee, so should the comparable; if the subject's expenses included reserve deposits, so should the comparable's, etc. When extracting market capitalization rates from sale comparables, the appraiser should attempt to interview the buyer, seller, and brokers to learn their expectations of income and expenses. This is to ensure agreement between the subject's projected income/expenses and the sale comparable capitalization rates.

The appraisal report must explain the adjustments to a comparable's NOI when deriving a capitalization rate. The appraiser should comment on the relative quality, reliability, or appropriateness of comparable's capitalization rate. The narrative is to provide pertinent discussion as to how the subject's final capitalization rate-was determined.

n. **Discounted Cash Flow (DCF).** The appraisal report may use a discounted cash flow analysis or Yield Capitalization as an additional check against the direct capitalization approach above. This method can be a useful and valid analysis in situations where incomes will vary over time in a predictable way. However, due to the subjective nature of the DCF and the potential for misuse of cash flow estimates, discount rates, terminal rates, etc., ORCF will only permit this methodology to be utilized as an indicator of value in addition to other valuation methodologies. With rare exceptions, the Income Approach conclusion should not be weighted to the results of a Discounted Cash Flow Analysis.

o. **Special Appraisal Report Considerations.** The appraiser should be aware of the following program restrictions:

   i. **Continuum of Care Retirement Communities (CCRC's).** HUD does not insure facilities that require upfront fees or substantial down payments for occupancy. For facilities that offer services to more than one type of resident (e.g., assisted living, dementia, skilled nursing) the appraisal report will need to adequately evaluate each group in terms of income, expense, and sales comparable data. If comparable data from projects of a similar resident mix is not available, the appraisal report will need to include a separate analysis for each resident type. Likewise, for the income and expense comparables.

   ii. **Day Care.** An eligible health care facility may provide nonresidential (outpatient) care for elderly individuals and others (e.g., persons with physical or mental disabilities) who require care during the day. To be eligible for the program, non-resident day care space may not exceed 20% of the gross floor area of the facility and non-resident day care income may not exceed 20% of gross income.

   iii. **Clinics, Medical Offices, and Similar Related Services.** Clinics, medical offices, and similar related services included in a residential care facility are to be treated as commercial space in accordance with the current ORCF instructions and limitations.

   iv. **Rent Restrictions/Rent Subsidies.** In some cases~~, assisted living~~ facilities may receive subsidies and be tied to restrictions. If the property's rental rates are restricted or subsidized, the appraisal report will discuss the particulars of the restriction/subsidy, including how the rates are determined, the duration of the restriction/subsidy, identify the entity responsible for monitoring the restriction/subsidy, and identify the effect on marketability~~ of the non-restricted/non-subsidized units.~~. For unit- or project-based restrictions/subsidies, the appraisal report should use the lower of the market rent conclusion and the restricted/subsidized rent in determining value, unless otherwise instructed. This may require the appraiser to cite a hypothetical condition.

Payments from Medicare, Medicaid, HMO's and Private Insurance are not considered subsidized rents. Subsidized properties cannot be used as comparables for non-subsidized properties with respect to sales, expense, or rent comparability.

v. **Contradiction.** In the event that this appraisal report guideline contradicts the provisions of the HUD/FHA Regulations or does not comply with USPAP (and a jurisdictional exception cannot be made), the appraiser will immediately bring the issue to the attention of the Lender's underwriter.

5.4 Ground Leases

~~A. **Lease Duration:** To be eligible, the lease term may be at any stage of a 99-year lease, so long as the lease is renewable, or have at least 10 years remaining after the maturity date of the proposed mortgage.~~

A. **Eligibility and Lease Duration:** For guidance on the eligibility of ground leases, see Production Chapter 2.

B. **Mortgage Amount Limitation:** HUD regulations state, "In the event the mortgage is secured by a leasehold estate rather than a fee simple estate, the value of the property described in the mortgage shall be the value of the leasehold estate (as determined by the Commissioner) which shall in all cases be less than the value of the property in fee simple" (24 CFR 232.903(a)). Compliance with this regulation will be met through the following steps:

1. The appraiser is asked to develop the Hypothetical Fee Simple Value of the Going Concern as if unencumbered by the ground lease. The lender will enter this amount on Form HUD-92264a-ORCF, (Tab MILC Page 1 – Line D.a).

2. Next the lender will enter the option to purchase price from the Lease Addendum (Form HUD-92070-ORCF), on the line that calls for the "Value of the Leased Fee" - Line C.b.(1) and Line D.b). Only government entities can request waivers to not name a purchase price. In the rare cases where the Lease Addendum does not specify a purchase price, the hypothetical fee simple value of the land will be entered on line C.b.(1). Cases where there is a single up-front ground lease payment or where the lease payment is a token $1, will be treated more like fee simple land ownership in that $0 will be entered on line C.b.1. ~~Only government entities can request waivers to not name a purchase price.~~

The form will automatically deduct the option to purchase price from the fee simple value before applying the prescribed loan to value percentage limitation. This procedure assumes parity between the Leased Fee Value and the option to purchase price. Even when there is not parity, HUD's interest is covered as the loan size decreases based on how costly it will be to purchase the land.

For the Debt Service criterion on Form HUD-92264a-ORCF, the lender will include the annual ground rent under the "Land Calc" tab on the line item that says "Annual Ground Rent".

The land value should not be included on Form HUD-92264a-ORCF. Likewise, when leased land contains pre-existing buildings that are to receive substantial rehabilitation, the contributory value of the pre-existing improvements is not to be included. The value of these items is assumed to be paid for annually by the lease payments; therefore, their value should not be included in the overall costs.

In cases where there is a single up-front ground lease payment that covers the ground rent through loan maturity, the amount of the payment may be entered in the "Land Calc" tab of Form HUD-92264a-ORCF, under additional cost. Include a note explaining what the additional cost is for. Otherwise, the processing is the same as with other ground leases.

C. **ORCF Appraisal Report Review:** The ORCF review appraiser will perform a review of the ground lease that examines the following:

1. The review appraiser will analyze the lease parameters and the ground rent payment amounts. Although certain kinds of annual increases may be allowed, variable lease payments are not acceptable because they raise the risk that future payments may be too burdensome and may cause a potential default in the mortgage payments. Examples of unacceptable methods of determining variable ground rents are:
    a. A graduated schedule of future increases on a lump sum year-by-year basis.
    b. Cost of Living increases (waivers of this restriction will be considered if there is a cap in place to the amount of increase).
    c. Increases based on the results of future appraisal reports.

~~2.1.Annual increases are acceptable when computed using any of the following three methods:~~
    d. A fixed percentage of effective gross income. The percentage must remain the same throughout the term of the lease. Effective gross income shall mean the annual amount collected from all sources, less refunds.

2. Annual increases are acceptable when computed using any of the following three methods:

e. A fixed percentage of net cash flow. The percentage must remain the same throughout the term of the lease. Net cash flow shall be the annual amount remaining after debt service payments are subtracted from net income.

f. A stated dollar amount per year which must remain fixed for at least 10 years more than the term of the insured mortgage.

D. **Acceptability of Lease Payments:** The lease payments may not exceed market levels. The appraisal report is to determine the amount of the "market" ground rent by first determining the fee simple value of the land, then presenting comparable data on ground lease returns. The market ground rent is then to be compared to the proposed ground rent. When local comparables are not available, data from comparable markets will be acceptable. The review appraiser will ensure that the ground rent amounts do not exceed market levels.

E. **Lease Provisions:** The review appraiser must review other provisions of the lease to determine that they will not restrict the successful operation of the project, keeping in mind that the provisions of the Lease Addendum, must be included in, or legally appended to, the lease. If the above conditions are met and the annual lease payments required under the lease meet the test for acceptability, the appraiser may recommend that the lease be accepted.

F. **Ground Rent during Construction:** For proposed construction under all sections of the Act, normal monthly lease payments during construction may be included in the estimated replacement cost of the project and in the certified cost, subject to the following conditions:

1. The period for which ground rent is estimated must be the same as that for which interest and other related charges are calculated, or, the estimated construction time plus two months.

2. Ground rent during construction may be entered in the replacement cost tab of Form HUD-92264a-ORCF (labeled "Warranted Price of Land"). A remark should be entered indicating that the amount includes ground rent during construction.

~~3. Ground rent must not be included in the base on which profit (AMPO – allowable for making non-profit projects operational) is calculated.~~

5.5 Tax Abatement Procedures

Tax abatement/exemption herein shall mean a reduction of property taxes by the taxing authority, whether in the form of forgiveness or refund. The appraiser will investigate how long the abatement will last and whether or not the abatement will be passed on to a new owner when there is a sale. For purposes of Section 232 underwriting abatements will be classified as one of the following three types:

1. **Type A:** Abatements that will not be inherited by a typical buyer, and abatements where there are less than 5 years of abatement remaining.

2. **Type B:** Abatements that would be inherited by a typical buyer, where the abatement amount is level, or the exemption is complete, and lasts the term of the mortgage.

3. **Type C:** Abatements that would be inherited by a typical buyer, but are variable in amount and/or shorter than the term of the mortgage.

A. **Type A Abatements:** Properties that have real estate tax abatements that would not be passed onto a typical buyer or where there are less than 5 years of abatement remaining are to be appraised and underwritten assuming full market-level tax as an expense. It will not be necessary for the appraiser to invoke a hypothetical condition for this assumption, as they will already be assuming a sale. Deciding whether or not abatements can be inherited will require an analysis of the rules that govern the abatement. These rules could show that some buyers, such as non-profit organizations, could inherit the abatement, whereas for-profit organizations could not.

When determining who a typical buyer of the property would be, it is inappropriate to assume a non-profit organization would be the next buyer simply because the current Borrower is a non-profit. This is not to say that there are not cases where another non-profit would be the most likely buyer.

While the appraised value will recognize full market taxes, the lender can recognize the tax abatement in sizing the mortgage by debt coverage, so long as the abatement lasts more than 5 years.

B. **Type B Abatements:** For properties that have tax abatements that would be passed onto a typical buyer, AND where the abatement amount is constant or there is forgiveness of the complete amount, AND lasts the term of the mortgage, the appraiser and lender may recognize the savings in their expense conclusions both in market value and in debt coverage calculations.

C. **Type C Abatements:** For properties that have tax abatements that would be passed onto a typical buyer where the tax abatement is variable in amount, and/or shorter than the term of the mortgage (but longer than 5 years), the value of the abatement may be considered as follows: The appraiser will first determine the values produced by all applicable approaches, assuming full market taxes in their expense calculations. Next, the appraiser will estimate the Net Present Value (NPV) of the tax savings. The discount rate used in this calculation is to be determined by the appraiser. Below is an example of a 6-year variable tax abatement and the concluded NPV. In this example seven years have been shown for illustrative purposes but there is no tax savings in year seven.

Year	2012	2013	2014	2015	2016	2017	2018
Forecasted Market Taxes	$115,387	$117,118	$118,875	$120,658	$122,468	$124,305	$129,983
Actual Taxes with Abatement	$0	$5,856	$11,888	$18,099	$24,494	$31,076	$129,983
Tax Savings	$115,387	$111,262	$106,988	$102,559	$97,974	$93,229	$0
Discount Rate	13.0%						
NPV of Abatement	$424,252						

The NPV can then be added to value conclusions from each approach before concluding a final rounded value.

Type C tax abatements can be recognized in Debt Service criterion on the Form HUD-92264a-ORCF (maximum mortgage amount based on debt service ratio).

5.6 Restricted Rents

For loan applications that involve rent restriction from Low Income Housing Tax Credits (LIHTC) or Tax Exempt Bonds, the income and expenses are to be evaluated under two scenarios, namely with and without the rent restrictions. The two scenarios will be used as follows for loan sizing on the Form HUD-92264a-ORCF:

1. Loan-to-Value Criterion: ~~-~~In the Loan-to-Value criterion of the Form HUD-92264a-ORCF, the lender is allowed to use either the market value as encumbered by the rent restriction or the hypothetical market value as if unencumbered by the rent restrictions. ~~The~~ Regardless of which value is used to size the loan, the appraisal ~~report statement of work (Section 5.3) always calls for a Market Value that incorporates all the applicable~~ will supply both the market value as encumbered by the rent restriction and the hypothetical market value as if unencumbered by the rent restrictions~~, therefore, whenever the Lender wishes to use an unencumbered value, they will need to expand the appraiser's assignment to provide the second value (unencumbered) value. The appraiser will then make a hypothetical assumption that the rent restrictions do not apply. Market rent levels will be established using the normal procedures outlined in the statement~~. All components of ~~work. Expenses will also need to be reanalyzed based on the hypothetical census shift. The market~~ the analysis ~~requirements always call for an analysis that recognizes all rent restrictions that will be in place. In order for the appraiser to produce a hypothetical unencumbered value, they will need to revisit the demand calculations to determine how well the proposed units will be received when~~must be analyzed separately for each scenario including but not limited to ~~restricted~~differences in rent, expenses, marketability, income ~~residents. The comparable selection and the adjustments made in the~~qualifications, sales ~~comparison approach will also need to be revisited~~and rent comparables, census mix, capitalization rate, etc.
~~If the lender is requesting a loan amount that is less than the Loan-to-Value criterion limit, the lender may simply use the Market Value that recognizes the rent restrictions and not provide the second hypothetical value as if unencumbered. This will make the appraisal report assignment less complex and generally less costly.~~

1. Debt Service Criterion – Debt Service Analysis: In calculating the NOI the lender uses for the Debt Service criterion, rent restrictions must be observed.

A. **Expenses/Fees:** Properties with LIHTC restricted units will commonly have a higher operating expense ratio per unit than market rate properties, which may be due to increased administrative costs for tax credit compliance monitoring, and due to performing tenant income certifications and staffing to provide on-site resident services.

C. **Audit Fee No Longer Recognized:** With the elimination of the requirement for an audited cost certification for mortgage insurance transactions with LIHTC, assuming the ratio of loan proceeds to the actual cost of the project is less than 80 percent, the audit fee will no longer be recognized as an allowable cost in the Total Estimated Replacement Cost of Project, replacement cost tab of the Form HUD-92264a-ORCF.

5.7 Non-Profit Operations

ORCF is seeking the as-is market value based on the hypothetical condition that all repairs are complete as of the effective date of value. The as-is market value is what a facility would sell for as of the effective date of the appraisal hypothetical. It is not always the mission of non-profit organizations to maximize cash flows. Potential for-profit buyers would likely modify the operations with the goal of improving cash flows in mind. Potential differences between non-profit and for-profit operators include but are not limited to staffing ratios, employee benefits packages, higher level food service, even potentially higher occupancy rates, reputational differences, etc. It is appropriate for an appraiser to adjust these and other revenues and expenses to reflect a true market operation (both on the revenue and expense side) in determining the value. If the appraiser believes that the operations would materially change with a market sale, the appraiser must factor into their analysis the additional costs and risks associated with converting a facility from the current non-profit operation to a for-profit operation (see Production, Chapter 5.3.G Hypothetical Conditions). The method for factoring in the additional costs and risks is up to the appraiser but could conceivably take the form of an increased cap rate or a reduction to value based on a discounted cash flow analysis to support the value or other methods as the appraiser deems appropriate.

When considering modifications to the current operations, the following additional standards must be met. The appraiser must separately discuss the market income and support any changes from the original operating statements.

- The income capitalization analysis of the appraisal report must first analyze the project's actual non-profit operations, with no market-based adjustments being made. No valuation analysis is considered in regard to this income.
- A market based reconstructed income statement to be used for capitalization purposes will also be required. The market income must separately discuss and support any changes from the original operating statements.

- Many non-profit organizations have established and consistent fundraising income. This may be considered as an underwriting strength however that income is not to be considered for valuation or debt coverage purposes.
- The market's reaction to a hypothetical shift from non-profit to for-profit and the timing of the shift should be analyzed and discussed.
- A hypothetical condition needs to be included if the valuation assumes a transition to for-profit operations.

Lenders need to pay particular attention to the debt coverage limits to loan sizing when working with non-profits. While the net income operating income used in valuation includes market income and expenses, the NOI for the debt cover assumes the performance of the subject's own specific operator. The lender should not introduce adjustments to NOI used in the debt coverage test for any items besides reserves for replacement. The subject's historical NOI, not the appraiser's conclusion, will be relied on by HUD to determine the reasonability of the NOI proposed by the lender in the debt coverage test.