Recommended Practices in the Appraisal of Real Estate for Land-Secured Financings

July 2004

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CDIAC 04-06

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Background
The Mello-Roos Act requires that, as a condition precedent to the sale of bonds (absent certain special findings), the legislative body of a community facilities district (CFD) must determine that the value of real property within the district be at least three times the principal amount of all new debt secured by special taxes and existing debt secured by special taxes or assessments. The Mello-Roos Act further provides that the State Treasurer "may recommend definitions, standards, and assumptions to be used by these appraisals." In 1994, with the input of municipal finance professionals, the California Debt and Investment Advisory Commission (CDIAC), of which the State Treasurer serves as chair, published the *Appraisal Standards for Land-Secured Financings* (*CDIAC Standards*). Since that time, many California issuers have recognized the *CDIAC Standards* as a basis for the conduct of appraisals under the Mello-Roos Act. To a less formal degree, the *CDIAC Standards* also have been used to conduct appraisals intended to value properties within assessment districts.

Since 1994, the practice of appraising properties and issuing bonds secured by Mello-Roos special taxes or assessment district liens has progressed. Some of these changes have led issuers and appraisers across the state to employ differing practices. In addition, the existing *CDIAC Standards* raised uncertainty among market participants with respect to certain concepts and practices. To address the fact that the industry had progressed and that the *CDIAC Standards* were in need of revision, CDIAC held discussions with public finance professionals, including issuers, real estate appraisers, attorneys, financial advisors, special tax consultants, and underwriters. This report, summarizing those discussions, is written as a supplement to the *CDIAC Standards* and provides a basis for the revision of that document. To the extent that this report considers topics not included in the *CDIAC Standards*, it intends to generate conformity among industry professionals in the use of these new concepts or practices.

Recognizing that other market participants, including appraisers and underwriters, are guided by other legal and market standards, the report is directed at issuers. State law specifically requires that issuers adopt standards for the conduct of appraisals in CFDs. But they also may use these standards to guide the appraisal of properties in assessment districts. As a result, the report seeks to guide issuers in the development of their goals and policies for appraising real property securing special tax bonds and assessment bonds.

The report makes the following recommendations regarding specific practices in the field of appraising real properties securing Mello-Roos or assessment bonds:

Definitions of Value for Land-Secured Appraisals
The value of properties reported in an appraisal for both CFDs and assessment districts should be the ***market value*** of the properties. The Uniform Standards of Professional Appraisal Practice (USPAP) defines market value as "a type of value, stated as an opinion, that presumes the transfer of property (i.e., a right of ownership or a bundle of such rights), as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal." Consistent with USPAP, this value should be represented as the most probable price: 1) in terms of financial arrangements equivalent to cash, or 2) in other precisely defined terms, and 3) if the value is to be based on non-market financing or financing with unusual conditions or incentives, the terms of such financing must be clearly identified and the appraiser's opinion of their contributions to or negative influence on value must be developed by analysis of relevant market data.

With respect to raw or undeveloped properties, the reported value should account for and distinguish the use of other value estimates, including retail value and bulk sale value.

Retail value is defined as the price an end user, namely a homeowner or business owner, would pay for a home or completed building under the conditions requisite to a fair sale.

Bulk sale value is the most probable price, in a competitive market, for the sale of all parcels within a tract or development project, to a single purchaser or to multiple buyers, discounted to present value. The bulk sale value reflects the necessary time to sell the land (the absorption period), the cost of developing the land, and the developer's profit from the project.

Value Subject to Lien
The *CDIAC Standards* hold that appraisals for properties in a CFD must be based upon the value of the property taking into consideration the infrastructure improvements that will be funded by the proposed bond issue. The appraiser must also take into account the contributing value of the infrastructure improvements financed by the special tax lien and adjust the price of the subject property accordingly. When conducting a Discounted Cash Flow (DCF) Analysis, the appraiser should include the amount of the special tax paid by the developer during the development or absorption period as a holding cost. Furthermore, the value of comparable sales used to derive a retail lot value should maintain similar lien obligations or they should be adjusted accordingly. The same standard should be applied to properties in an assessment district subject to an assessment lien.

Reporting Value of Real Property Subject to a Special Tax or Assessment Lien
The *CDIAC Standards* recommend that appraisers valuing properties in a CFD or an assessment district report the ***market value*** of these properties. Market value may differ from sales price even though market value is understood to be the same thing as full cash value. To arrive at an opinion of market value, appraisers must adjust the sales price or projected sale price to account for the value of improvements and outstanding debt obligations that will be passed on to buyers.

When valuing real property subject to debt obligations issued to finance improvements under the Mello-Roos Act or various assessment district acts, the contributing value of improvements and the effect or impact of the liens or special taxes associated with outstanding debt obligations must be taken into account in the appraisal process.

Statement of Assumptions, Hypothetical Conditions, and Limiting Conditions
The *CDIAC Standards* defer to USPAP in defining the obligations of appraisers to report the assumptions, hypothetical conditions, and limiting conditions that underlie the appraisal assignment. CDIAC does not approve the use of hypothetical conditions, particularly those related to the value or extent of infrastructure improvements, that would lead the readers of the appraisal report to conclude the value of the property is greater than it is. With respect to hypothetical improvements, CDIAC believes that the appraisal should include only the value of infrastructure improvements to be funded by the special tax bonds or assessment bonds being issued by the CFD or assessment district and those improvements already in place.

Calculating the Value of Overlapping Debt and the Project's Overall Value-to-Lien Ratio
California Government Code Section 53345.8 (Chapter 55, Statutes of 2003) requires that the value-to-lien ratio be based upon the sum of the principal amount of bonds to be sold and the principal amount of outstanding bonds that are secured by a special tax or an assessment district lien on properties within the CFD. In calculating the principal amount of outstanding bonds, Section 53345.8 requires the legislative body to use the maximum allowable special tax or assessment applicable to each parcel of property with the CFD. In practice, a more conservative method for calculating the value of overlapping debt and the project's value-to-lien ratio involves the following steps:

1. Determine the total taxable acreage within the CFD and the development status of that acreage.
2. Identify the maximum amount of special tax or assessment by development status for all land in each district.
3. Multiply the maximum amount of special tax or assessment as determined by development status of the land times the total taxable acreage within the CFD.
4. Divide the result of Step 3 by the total actual special tax or assessment for the most current year for which data is available.

5. Multiply the ratio resulting from Step 4 times the total outstanding bonded indebtedness of any overlapping CFD or assessment district to derive an estimate of the share of total debt outstanding.
6. Add the share of total debt outstanding plus the new debt to be sold to derive an estimate of direct and overlapping debt.
7. Divide the amount derived from Step 6 by the appraised value of the land in the CFD or assessment district to calculate the estimated value-to-lien ratio.

Value Allocation
USPAP Standards Rule 1-4(e) requires an appraiser to analyze the effect on value, if any, of the assemblage of the various estates or component parts of a property and refrain from valuing the whole solely by adding together the individual values of the various estates or component parts.

To the extent that appraisers are valuing projects on undeveloped land composed of subunits or phases, the allocation of the cost of improvements can affect the project's overall value-to-lien ratio. To remove any uncertainty in this process, appraisers, using the DCF Analysis, should use the lien values determined by the special tax consultant responsible for developing the Rate and Method of Apportionment to identify and adjust comparable sales prices. To the extent that a development plan is composed of subunits or phases owned by different parties, the appraiser should seek to determine the value of each such subunit or phase independently. However, to the extent that a project is composed of different subunits or phases owned by a single party, the appraiser should not allocate these different subunits or phases separately, but value the project as a single property.

Having once determined that a development plan is feasible and conforms to the highest and best use of the property, appraisers should seek to determine the value of the project in a manner that reflects that plan. However, differences between subunits or phases within a master development owned by a single owner that might introduce some uncertainty into the development process should not be cause to value these subunits or phases separately. To address these differences the appraiser should support the selection of the discount rate used to value the project as a whole. Finally, appraisers should provide sufficient detail within the appraisal report, particularly information pertaining to differences between subunits or phases that may affect the development process, to allow readers to understand the selection of the discount rate.

Market Absorption Studies
The *CDIAC Standards* recommend that DCF valuations should rely on an absorption or market demand study. As a matter of good practice, issuers should consider commissioning a market absorption study for most projects that require land-secured financing of improvements. Among those projects that a market absorption study can most benefit are:

1. Moderate to large number of residential units (i.e. 500 to 1000+), assuming a diverse mix of product types, or master planned communities.
2. Projects that are not expected to commence escrow closings to homeowners for a year or more.
3. A project that represents a unique market offering.
4. Projects located in rural areas at the fringe of development.

In general, the municipal market professionals recognize minimum and preferred qualifications for individuals conducting market absorption studies whether or not the study is conducted by a market absorption consultant or by an appraiser. They include:

1. Educational Qualifications: The market absorption analysts should possess at least a Bachelors degree but preferably an advanced degree with courses in real estate and economics.
2. Experience with Land-Secured Financings: The market absorption analysts should possess a minimum of five years of experience in performing market studies for land-secured financings. Additionally, they should be well versed in analyzing economic and real estate data that relates to the pricing and absorption of the properties contained within a CFD and

through this experience be capable of addressing issues unique to land-secured financing, including the use of Price Points in the Rate and Method of Apportionment.

3. Avoid Conflicts of Interest: Knowing that issuers, developers, and builders may influence the outcome of a market absorption study with respect to the rate and pattern of absorption of properties in a CFD, market absorption analysts should describe their business relations with developers and builders during the past three years in the market absorption study.

Estimating Development Costs

The *CDIAC Standards* incorporate the cost of developing raw land to finished product or improved lots into the DCF Analysis as a deduction against the sales price to derive cash flows from the project. Appraisers, typically, receive cost information from the developer or builder. Since the value of the project is directly related to the amount of costs deducted from the sales price, costs should be closely evaluated to determine their validity and appropriateness. Appraisers are required to use realistic estimates that are supported by clear and appropriate evidence.

To further support the efforts of appraisers to meet their obligations under USPAP, issuers may wish to consider using a certified civil engineer to verify the cost estimates used to value properties through a DCF Analysis. Issuers also may wish to utilize administrative or financial incentives to encourage developers to provide accurate and timely cost information to appraisers. For example, the cost of hiring a certified civil engineer to provide cost information may be charged to developers should they fail to provide such information. Finally, the cost information provided by the developer or an external engineering consultant to the appraiser should be the same information provided to bankers and attorneys administering the debt issuance process.

Self-Contained vs. Summary Appraisal Reports

CDIAC finds the recommendations and requirements provided by USPAP to appraisers on the format and content of appraisal reports is fully sufficient.

Appraiser Credentials

CDIAC believes that the competency requirements set forth in USPAP are comprehensive and meet the same objectives as the standards set forth in the *CDIAC Standards*. The *CDIAC Standards* recommend that the appraiser should be licensed by the State of California Office of Real Estate Appraisers and be a Member of the Appraisal Institute or have similar training, experience and qualification. If appraisers meet the competency standards set forth in USPAP as well as being an MAI or have similar training, experience, and qualifications, they simultaneously meet the competency standards recommended by the *CDIAC Standards*.

Appraisal Review

Issuers who conduct formal independent reviews of completed appraisal reports can determine that such appraisals meet the *CDIAC Standards* or those adopted by the local agency and were competently performed. Issuers that choose to review appraisal reports should give consideration to the review process in their debt issuance policies, including the selection and minimum qualifications of review appraisers.

Application of *CDIAC Standards* to Financings Secured by a Letter of Credit

The *CDIAC Standards* or locally adopted appraisal definitions, standards, and assumptions must be held as the minimum standards for the preparation and reporting of property values even though the special tax payments may be backed by a letter of credit (LOC). The application of these same standards in assessment districts backed by an LOC should be recognized as good practice by issuers, as well.

Introduction

To the degree that those involved in financial transactions maintain and apply different definitions, standards, and assumptions, comparisons of risk will be difficult to achieve. To minimize the economic costs of this outcome, the market seeks, where possible, to establish common definitions, standards, and assumptions. Towards that end, the California Debt and Investment Advisory Commission (CDIAC) published the *Appraisal Standards for Land-Secured Financings (CDIAC Standards)* in 1994. Many California issuers have directly or indirectly incorporated these standards since that time in the development of appraisal reports for transactions carried out under the Mello-Roos Community Facilities Act of 1982, as amended (Mello-Roos Act) (California Government Code Section 53311 et seq.) and various special assessment acts. Nonetheless, CDIAC had learned that appraisers differ with respect to their approach to appraising properties secured or to be secured by special tax bonds and assessment bonds. In addition, the industry has advanced since 1994 to incorporate new practices for appraising these properties.

In an effort to address some of these differences and to identify new practices, CDIAC convened a group of public finance professionals in March 2003 to discuss issues related to the appraisal of real property used to secure Mello-Roos and assessment bonds. The group was composed of issuers, real estate appraisers, attorneys, financial advisors, tax consultants, and underwriters.

This report represents CDIAC's summary of those meetings and highlights topics and issues that underlie differences that may exist between appraisers valuing properties securing special tax bonds and assessment bonds. It also incorporates current practices in so far as they relate to these topics and issues. This report seeks to fill in some of the gaps that exist in the *CDIAC Standards* that may have contributed to the emergence of these differences and provides the basis for supplementing and amending the *CDIAC Standards* in the near future.

This report is directed specifically at issuers who, through the adoption of local goals and policies, establish standards for the conduct of appraisals used to determine the value of real property securing special tax bonds or assessment bonds. It is important that these standards, whether drawn wholly or in part from the *CDIAC Standards*, be rooted in the most current appraisal methods and concepts. To the extent that these locally adopted standards do not conform to the *CDIAC Standards*, they may find this report useful in articulating points of difference. This report, used in conjunction with the *CDIAC Standards*, is intended to move land-secured appraising towards a common ground, circumscribed by generally accepted theories and practices.

Report Structure

In this report, CDIAC uses relevant definitions and professional or administrative protocols to frame each topic and to explain the substance of a concluding position statement. Each position statement represents CDIAC's effort to minimize or eliminate the differences and uncertainty that surround that particular topic. These statements are meant to supplement the *CDIAC Standards* and, as such, are intended for use by those involved in land-secured transactions to assist in better understanding the role and process of real estate appraisals in the financing of CFDs and assessment districts. In the context of this report, each topic is addressed independently. As a result, some materials may appear more than once.

The absence of any topic from this report does not reflect its lack of importance in the field of appraising properties securing special tax bonds or assessment bonds, but rather the content of CDIAC's discussions with industry representatives. Some topics identified here have persisted since the publication of the *CDIAC Standards* and, as a result, represent an opportunity to improve that document. Other topics address disparities within the industry that have defied standardization and warrant consideration by those involved in CFD and assessment district financing.

Public Debt and Real Estate Values

When used in an economic context, an "appraisal" is understood to be the process of estimating the value of specific property as of a stated date of value. The Appraisal Foundation defines an appraisal as "the act or process of developing an opinion of value."[1] The Mello-Roos Act and various statutes authorizing the creation of assessment districts or the issuance of assessment act bonds make reference to real estate appraisals and estimated land values. This language provides a common basis for understanding the purpose behind appraising land secured by bonds issued under these acts.

The Mello-Roos Act

The Mello-Roos Act enables cities, counties, special districts, and school districts to establish CFDs and to levy a special tax to fund a wide variety of facilities and services. The proceeds of a Mello-Roos special tax can be used for direct funding of these facilities and services and, in the case of capital facilities, to pay off bonds issued by a CFD or an assessment district established by the city, county, special district, or school district.

The approval of the Mello-Roos special tax requires a two-thirds affirmative vote. Who votes in the election depends upon the number of registered voters in the proposed CFD. If there are fewer than 12 registered voters within the CFD boundaries, then a vote is held among landowners, with each acre of land or portion of an acre counting as one vote. If there are 12 or more registered voters, the election is held among the registered voters in the proposed CFD. Upon formation of the CFD and levy of the special tax, a special tax lien will be recorded against all properties in the CFD subject to the special tax and continue until satisfied or otherwise removed.

Certain aspects of the Mello-Roos Act make it amenable for use by developers in the development of raw or undeveloped land, including:

1. The Mello-Roos election procedures enable consenting property owners to cast their ballots and approve the special tax if they control two-thirds of the acreage within the CFD and there are less than 12 registered voters within the CFD.
2. The CFD boundaries need not be contiguous, allowing proponents of the CFD to avoid those areas where voters will not support the tax.
3. A CFD can be broken into improvement areas that, subject to their own elections, can contribute to the overall project. The use of improvement areas allows developers to match development plans with economic and market trends.
4. The special tax does not have to be levied by "benefit," allowing property owners more flexibility when establishing the CFD.

The Mello-Roos Act provides that Mello-Roos special tax bonds may be issued to finance infrastructure, but not services.[2] The debt service on these bonds is paid from the proceeds of special taxes and other revenue of the CFD. California Government Code Section 53345.8 requires the legislative body of the issuing agency to determine, prior to the award of sale of bonds, that the "value of the real property that would be subject to the special tax to pay debt service on the bonds will be at least three times the principal amount of the bonds to be sold and the principal amount of all other bonds outstanding that are secured" by a special tax levied or a special assessment. Furthermore, the determination of value is to be "based upon the full cash value as shown on the ad valorem assessment roll or upon an appraisal of the subject property…"[3]

If the legislative body uses an appraisal to determine the value of real property it is to be conducted "in a manner consistent with" the policies adopted by the local agency pursuant to Government Code Section 53312.7(a)(5). Section 53312.7 prohibits local agencies from initiating proceedings to establish a CFD after January 1, 1994 without first adopting local goals and policies concerning the use of the Mello-Roos

[1] *The Appraisal of Real Estate*, 12th edition, The Appraisal Institute, Chicago, 2001, p. 12

[2] The proceeds of Mello-Roos special taxes receipts may be applied to operations and services on a pay-as-you-go basis.

[3] Government Code Section 53345.8(a)

Act. Among the items to be included in these goals and policies is a statement of definitions, standards, and assumptions to be used in the appraisal of real property. Rather than develop definitions, standards, and assumptions on their own, a local agency may adopt the *CDIAC Standards*.

If the legislative body of the issuing agency determines that the proposed bonds do not present "any unusual credit risk due to the availability of credit enhancements or for other reasons specified by the legislative body," it may disregard the requirement to make the aforementioned value determination.[4] It also may disregard the value determination if by a vote of four-fifths of the legislative body it finds and determines that the proposed bond issue should go forward for public policy reasons.

Assessment Districts

With the passage of Proposition 13 in 1978, special assessments gained immediate notice among local agencies as a new source of funding. There were several reasons for the popularity of special assessments. First, the California courts have held they are not ad valorem property taxes. As a result, special assessments are exempt from the taxation limits imposed by Proposition 13. Second, they are not "special taxes," which require a two-thirds affirmative vote prior to being imposed. Third, the proceeds of a special assessment are not "proceeds of taxes" for purposes of the Gann Act.[5] Accordingly, funds received from special assessments do not apply towards a jurisdiction's Gann Act spending limit.

Most of the special assessment acts also provide for the issuance of improvement bonds (more commonly known as assessment bonds) or have another act under which bonds may be issued.[6] These bonds generally are secured by the property within the district and the bonded indebtedness is repaid with the money generated by the assessments.

Landowners are given the opportunity to pay off the assessment immediately, otherwise, the assessments become liens against the property and landowners pay them off in installments. Typically, assessment bonds are sold to provide the capital needed to pay for the immediate construction of the project and are secured by the property liens. The most common assessment acts include the Improvement Act of 1911 (Streets and Highways Code Section 5000 et seq.) (1911 Act), and the Municipal Improvement Act of 1913 (Streets and Highways Code Section 10000 et seq.) (1913 Act). In addition, the Improvement Bond Act of 1915 (Streets and Highways Code Section 8500 et seq.) (1915 Act) provides local agencies the ability to issue bonds secured by property assessments created through one of the assessment acts. Over time and as a consequence of changes in law, including Proposition 218, approved by California voters in November 1996, local governments have popularized the Municipal Improvement Act of 1913 as the favored method for district formation and assessment determination and the 1915 Act for the issuance of assessment bonds.[7]

As with Mello-Roos bonds, the security underlying assessment bonds is the assessed property. Unlike the Mello-Roos Act, however, the 1915 Act does not stipulate a relationship between the value of the underlying property and the value of the bonds outstanding. Nevertheless, an accurate estimate of the value of the underlying property is no less important in assessment district financing since the market prices assessment bonds in relation to the value of that underlying property.

The Importance of Value-to-Lien Ratios

The Security and Exchange Commission (SEC) artfully stated the importance of the value of the property compared to the value of the debt obligation for a land-secured financing in the administrative proceedings

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[4] Government Code Section 53345.8(b)

[5] The Gann Act appears as Section XIIIB of the California Constitution.

[6] For example, the Improvement Bond Act of 1915 (Streets and Highways Code Section 8500 et seq.

[7] Other assessments acts, including the Landscaping and Lighting Act of 1972 (Streets and Highways Code Section 225000 et seq.) and the Parking and Business Improvement Area Law of 1989 (Streets and Highways Code Section 36500 et seq.) provide for the financing of various capital projects and activities by certain types of local governments.

against two financial advisors linked to Mello-Roos bonds issued by the City of Ione Public Financing Authority in 1991.[8] In those proceedings, the SEC stated the following:

> The relationship between the value of the land and the amount of bond debt is referred to as the value-to-lien ratio. The land is not collateral in the sense that a default on the bonds results in the transfer of title to bondholders. Rather, adequate land values offer the best assurance that bondholders will receive principal and interest payments because, if necessary, the issuer can foreclose on the tax lien and the proceeds from the sale of the delinquent properties can be used to bring the bonds current and repay the bondholders. Special tax liens have no intrinsic value without adequate property values to support them.
>
> Because a substantial portion of California land-secured municipal debt is sold without a credit rating, investors have relied on the value-to-lien ratio to measure the creditworthiness of a land-secured financing. The higher the ratio the lower the degree of risk to the investor and the lower the borrowing cost to the issuer in the form of a lower interest rate on the issue. In California, a 3 to 1 value-to-lien ratio served as the informal standard for a number of years. The belief was that a value-to-lien-ratio of 3 to 1 offered a sufficient cushion against declines in land value as well as some protection against the uncertainties of the appraisal process itself.

The Challenge of Appraising Real Properties in CFDs and Assessment Districts

Government Code Section 53345.8 requires, with certain exceptions, that local agencies determine the value of real property that would be subject to a special tax authorized by a CFD. Although these properties are not, by definition, collateral for the special tax, the placement of a lien against the property representing the value of the on-going special tax provides some security that the property owner will have an incentive to pay the special tax. Similarly, the use of liens in assessment districts "secures" payment of the property assessment, in most cases.[9]

CFDs and assessment districts are commonly organized for the purpose of funding public improvements that support new development. Estimating property values of undeveloped or raw land poses different challenges than appraising fully developed properties. In the latter case, appraisers have access to the property's assessed values and to historical sales data that provide a basis for comparison. Appraising undeveloped properties, however, requires appraisers to embrace assumptions and projections that may introduce an element of uncertainty into their calculations. Among the elements that appraisers may need to estimate because the project has not been completed are:

1. Land value based on highest and best use;
2. Number and type of different products (e.g. land uses, floor plans, etc.);
3. Sales price of different products, including cash and non-cash premiums, incentives, or concessions;
4. Market demand for products reflected by the rate of absorption of different products;
5. Discount or capitalization rates that reflect risk conditions at the date of the appraisal report;
6. Economic and demographic drivers, including lending and borrowing rates, population growth, and employment levels.

The greater the uncertainty incorporated by estimates or projections of these different elements, the greater the possible variance of estimated land values. In other words, the accuracy of the appraisal is dependent upon the accuracy of the data used to determine a value as well as the analytical skills and diligence of the appraiser. Because appraisers are expected to predict market demand and other future conditions of sale, appraisals are treated as an opinion of value by a professional based on certain assumptions.

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[8] United States of America before the Securities and Exchange Commission. Administrative Proceeding File No. 3-9429 and Administrative Proceeding File No. 3-9430

[9] In the case of 1911 Act assessment districts, parcel assessments exactly match the amount of the bond issued on behalf of that parcel. Nonetheless, the appraisal seeks to establish a district-wide or aggregate value regardless of the link between individual parcels and assessments.

The market has generally accepted the 3-to-1 value-to-lien ratio as a cushion designed to mitigate differences in projections in all but a small number of cases. In addition, the market uses background information disclosed by the appraiser to assess the likelihood that the appraisal does include some risk of error. The market's dependency upon this information requires appraisers to fully detail the methods, principles, and assumptions underlying their valuation of these properties, including:

1. A definition of market value provided by the appraisal;
2. Alternative definitions of value and the difference between these and the value cited by the appraisal;
3. Basis for discount or capitalization rates used to derive values;
4. A definition and conclusion of highest and best use as applied to the subject properties;
5. The development process, including phases of development and financing;
6. The assumptions and limiting conditions concerning the absorption process and the appraised value of the project;
7. The assumptions and limiting conditions concerning market, demographic, and economic data and the appraised value of the project;
8. The method(s) used to estimate value and a description of the factors used in this method(s);
9. A definition of lien and a detailed calculation of the aggregate amount of all liens associated with special taxes and assessments;
10. The basis and reliability of development costs and future product prices;
11. The relationship between "other value-producing enhancements" and the appraised value of the project.

Appraisals and Municipal Securities Market Disclosures

While Congress exempted municipal securities offerings from the registration requirements and civil liability provisions of the Securities Act of 1933 (Securities Act), and a mandated system of reporting under the Securities Exchange Act of 1934 (Exchange Act), it did not exempt municipal securities transactions from the antifraud provisions of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5 enacted to implement Section 10(b). These antifraud provisions prohibit any person, including municipal issuers, brokers, and dealers from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with an offer, purchase, or sale of any security.

Disclosure in the municipal market has been guided by the market's demand for information and by these antifraud prohibitions. In 1989, the SEC adopted Rule 15c2-12 under the Exchange Act to enhance the quality and timeliness of disclosure to municipal investors. Rule 15c2-12 requires that underwriters of primary offerings of municipal securities with an aggregate amount of $1,000,000 or more obtain and distribute to their customers the issuers' Official Statement (OS) for the offerings. The SEC amended Rule 15c2-12 in 1994 to prohibit a broker or dealer from purchasing or selling municipal securities with an aggregate principal amount of $1,000,000 or more unless the "participating underwriter" has reasonably determined that the issuer or its designated agent has agreed to continually disclose to the market certain information concerning the transaction.

In 1996, CDIAC published *Disclosure Guidelines for Land-Based Securities* to "assist public officials in developing disclosure documents that fulfill their requirements under law and minimize their exposure to fraud liabilities."[10] In that document, CDIAC affirms the recommendations made by the Government Finance Officers Association that a bond offering's OS should disclose complete information regarding its purposes, the plan of financing, the sources of payment, and other security for the bonds.[11] Among the information to be provided with respect to security features of land-secured financings is the value of the

[10] *Disclosure Guidelines for Land-Based Securities*. California Debt and Investment Advisory Commission, Sacramento, 1996, p. i.

[11] See Section III: Securities Being Offered, in *Disclosure for State and Local Government Securities*. Government Finance Officers Association, Chicago, 1991.

land and improvements in a CFD or assessment district. CDIAC recommends that the OS should "state the appraised value of the property and describe the appraisal methodology on which it was based." It should also "state the value-to-lien ratio of the bond issue."[12]

In 2000, the National Federation of Municipal Analysts (NFMA) published its recommended disclosure practices for land-secured debt. The NFMA recommends that the initial disclosure documents include appraisal and absorption studies. Furthermore, the appraisal studies should discuss clearly:

1. The approaches used to determine the valuation (and, if appropriate, why certain approaches were omitted);
2. The assumptions and, if applicable, the discount rates used in the valuation approaches;
3. How expenses over and above the debt proceeds necessary to complete the development were taken into account in the valuation; and
4. How the assessment or special tax lien is treated in determining the value.[13]

The enforcement of securities laws in land-secured transactions has increased since 1989. In California, the SEC's actions against the County of Nevada, the City of Ione, the Wasco Public Financing Authority and other participating parties centered on misrepresentations and omissions in offering materials. The courts found in imposing cease and desist orders against the defendants that the defendants' OSs had overstated the value of the property, among other things.[14] In its action against William McKay, an appraiser, the SEC stated that:

> "…the value of the underlying property is the key measure of the creditworthiness of a land-secured financing. The lower the value the greater the risk inherent in the bonds. In both the Nevada and Ione CFD-1 offerings, McKay's appraisals led bond holders to falsely believe that their investments were adequately secured by the value of the real estate securing the bonds."[15]

More recently, the SEC sued a Los Angeles developer and appraiser for fraud in the issuance of more than $83 million in Mello-Roos bonds in San Bernardino County. The SEC's complaint recognized that the appraiser

> "…had a duty to competently perform appraisal services. His duties…included, but were not limited to, understanding the intended use of the appraisal, accurately describing the methods used for appraising the subject property, performing the appraisal in accordance with the described methodology and standards adopted by the Appraisal Institute, accurately identifying any underlying assumptions, and presenting the appraisal in a written report that was not misleading."[16]

The SEC alleges that the appraiser committed fraud by falsely stating that the appraisal report had been prepared in conformity with the professional standards of the Appraisal Foundation and the Appraisal Institute. Having failed to do so, the appraiser did not state the intended use of the appraisal, did not include extraordinary assumptions, and failed to perform a proper feasibility analysis to determine the highest and best use of the property. The outcome of this action is pending.

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[12] *Disclosure Guidelines for Land-Based Securities*, p. 19

[13] *Recommended Best Practices in Disclosure for Land Secured Debt Transactions*, National Federation of Municipal Analysts, 2000, p. 8

[14] See Securities Act Releases No.33-7535, 33 -7536, and 33-7537 (May 5, 1998) and Securities and Exchange Commission Litigation Release No. 15423 (July 28, 1997).

[15] *Ibid.*, p. 6

[16] Securities and Exchange Commission v. Manoucher Sarbaz, Pacific Golf Community Development, LLC and Lee Andrew Hill, Case No. 03-1310 JSL (February 27, 2003)

The Concept of Appraisal Standards

The Mello-Roos Act requires that, as a condition precedent to the sale of bonds (absent certain special findings), the legislative body must determine that the value of real property within the district be at least three times the principal amount of all debt secured by special taxes. Section 53345.8, which provides for the value-to-lien criteria referred to above, also provides that the State Treasurer "may recommend definitions, standards, and assumptions to be used by these appraisals." In 1994, with the input of industry professionals, CDIAC published the *CDIAC Standards* to meet that legislative mandate.

The Mello-Roos Act gives importance to this document by prohibiting a local agency from initiating proceedings to form a Mello-Roos CFD without having first adopted appraisal standards. The local agency may adopt the *CDIAC Standards* in whole or part to comply with this requirement. Since 1994, the *CDIAC Standards* have stood as the benchmark, either by adoption or reference, for appraising properties secured by Mello-Roos bonds or assessment bonds.

CDIAC's mandate led it to produce a set of standards that were specific to land-secured transactions. In doing so, it relied on the more encompassing Uniform Standards of Professional Appraisal Practice (USPAP), which forms the core of the appraisal practices used by the industry in the United States. USPAP, published by the Appraisal Foundation, was adopted in 1994 by the State of California as the "minimum standard of conduct and performance for a licensee."[17] Appraisers must comply with USPAP in all cases and conform to the *CDIAC Standards* or those adopted by the local agency when appraising properties subject to Mello-Roos bonds. Conversely, USPAP requires appraisers to determine the overlap between other standards and USPAP.[18] These other standards "prepared for specific purposes or property types may be issued (i.e. published) by government agencies, government sponsored enterprises, or other entities that establish public policy."[19]

The statutes providing for the issuance of special assessment bonds do not contain a similar requirement with respect to the definitions, standards, and assumptions to be used in appraising properties secured by a special assessment lien. In practice, however, most issuers apply the same appraisal standards required under the Mello-Roos Act to special assessment bonds. In the absence of specific statutory language, these standards are commonly expressed in the local agency debt policies.

The value-to-lien ratio, though widely accepted as an analytical tool, conveys meaningful information only if it is derived from a reasonably accurate appraisal. Indeed, the appraisal profession itself is not of one mind when it comes to valuing tracts of raw or undeveloped land and investors should be attentive to the appraisal. Conventional valuation methods are not well suited to this task. Appraisers often blend a variety of methods together to reflect the availability of data and differences in ownership and end-use. Among these methods is the Discounted Cash Flow (DCF) Analysis that requires the appraiser to make assumptions about the allocation of values to different owners and product-types, the distribution of development costs, and the risk represented by different products and owners. The margin of error involved in these assumptions can vary with their complexity. In the end, an opinion of value given by an appraiser is dependent upon their understanding of these assumptions.

The *CDIAC Standards* recognize that appraisals of undeveloped land within CFDs and assessment districts inherently include varying degrees of risk, but the approaches and major assumptions used in estimating values within districts can be consistent. Investors who are given the same market data, methods of analysis, assumptions and limiting conditions that an appraiser used to arrive at his or her value opinion can interpret the level of risk presented by a particular development project. Towards that end, the *CDIAC Standards* attempt to provide a common approach to the appraisal of properties located in CFDs and assessment districts where USPAP and other standards are not sufficient. In particular, the *CDIAC Standards* attempt to provide a standardized approach to the analysis of discounted cash flows, the derivation of discount rates, and the determination of value for properties subject to special tax or assessment liens.

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[17] California Business and Professions Code Section 11319

[18] *Uniform Standards for Professional Appraisal Practice*, 2003, Supplemental Standards Rule

[19] *Ibid.*

Definitions of Terms Used in the Appraisal of Properties in CFDs and Assessment Districts
The following definitions may vary due to local ordinances and other agency, land development, and entitlement requirements. Furthermore, the development community may assign a different meaning to these terms.

Finished Lot – A parcel which has legal entitlements created by a recorded subdivision map, whose physical characteristics are a finished, graded level pad with infrastructure contiguous to each individual lot, asphalt paved road, and the necessary utilities. This term assumes the payment of all applicable development fees with the exception of building permit and other fees due at the issuance or a building permit.

Mass Graded or Superpad – A parcel which has legal entitlements created by a recorded subdivision map. The physical condition being a mass graded pad only. Internal streets have not been cut nor has lot terracing been completed. Utilities have been supplied to the property line only.

Blue Top Lots- – A parcel which has legal entitlements created by a recorded subdivision map, whose physical characteristics are graded pads with streets cut in and utilities to the perimeter property line.

RECOMMENDED PRACTICES

1. Definitions of Value for Land-Secured Appraisals

The Appraisal Foundation defines "value" within the context of real estate appraising as the monetary relationship between properties and those who buy, sell, or use those properties.[20] *The Dictionary of Real Estate Appraisal* defines value in a general sense as "the monetary worth of a property, goods, or service to buyers and sellers at a given time."[21] Some economists declare value to be the consequence of material or immaterial things, defined as a good, possessing four requisite traits: 1) utility; 2) scarcity; 3) capacity for private ownership, and 4) demand or effective purchasing power.

With respect to appraisal value, the *CDIAC Standards* recommend that the operative definition of value be market value as of the date of the appraisal.

> Appraisals undertaken to establish value-to-lien ratios in CFDs and assessment districts should estimate the Market Value of the subject property. Since two distinct "markets" may be at work in a CFD or assessment district, the estimate of Market Value should be refined to reflect the Retail Value of fully improved and occupied properties and the Bulk Sale Value of all vacant properties, including both unimproved properties and improved or partially improved but unoccupied properties.[22]

Use of the market value as the basis of value is premised on the fact that the property owner has recourse to sell the property to settle unpaid liabilities, including special taxes and assessments. The default value of the property, or the value of the property based upon a foreclosure sale, is assumed to approach its liquidation value or the value of outstanding notes and liens. Since the property owner is unlikely to settle for the liquidation value when he has the opportunity to sell the property at a market price and receive some benefit once he has paid off notes and liens, CDIAC believes that the market value of the property should be the operative definition of value.

Some economists define market value, also known as "value in exchange," as the power of a commodity to command other commodities in exchange. Value in exchange means that the purchasing power of a commodity can be expressed in terms of other commodities. Sellers in a barter economy, therefore, may calibrate the value of their goods, say tomatoes, in terms of other goods, say chickens. In an industrial economy, goods are measured in terms of money. Market value is determined by the utility of the good, as manifest in the purchasing power of those who are interested in acquiring it and in the relative scarcity of the goods and the ability to overcome this scarcity. In other words, value, in a free market society, is determined by supply and demand. Supply and demand interact in a competitive market to determine the price and availability of traded goods. The *Assessor's Handbook on Basic Appraisal* explains the importance of a market upon value in this way:

> The essence of market value is that it is derived from a market, subject to the actions of buyer seeking goods and sellers offering goods. A perfectly competitive market requires: 1) many buyers and sellers, none of who can affect market price through their own singular efforts; 2) a standardized product; 3) no artificial restrictions; 4) easy entry and exit into the market by buyers and sellers; 5) complete knowledge and information regarding bids and offers; and 6) the mobility to take immediate action.[23]

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[20] *Uniform Standards of Professional Appraisal Practice*, "Definitions" section

[21] *The Dictionary of Real Estate Appraisal*, 3rd edition, The Appraisal Institute, Chicago, 1993

[22] *Appraisal Standards for Land-Secured Financings*, California Debt and Investment Advisory Commission, Sacramento, 1994 (revised 2004), p. 9

[23] Quoted from *Assessor's Handbook, Basic Appraisal*, California State Board of Equalization, January 2002. p. 4

Market value is distinguished from "use" value or "value in use".[24] In the context of real estate, the concept of use value addresses the value of a property based upon its use by a particular set of owners or prospective owners. The Appraisal Institute defines use value as:

> The value of a property as it is currently used, not its value considering alternative uses; may be used where legislation has been enacted to preserve farmland, timberland, or other open space land on urban fringes; also known as value in use.[25]

Efforts to define the economic concept of value have led to the application of the concept of full cash value. Section 110 of the California Revenue and Taxation Code defines both "full cash value" and "fair market value," synonymously, as:

> The amount of cash or its equivalent that property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other, and both the buyer and the seller have knowledge of all of the uses and purposes to which the property is adapted and for which it is capable of being used, and of the enforceable restrictions upon those uses and purposes.[26]

Subdivision (b) of Section 110 establishes a rebuttable presumption that full cash value or fair market value shall be the actual purchase price if the terms of the transaction were completed as an "open market transaction."[27]

The California Board of Equalization's (BOE) Rule 2 interprets market value as:

> In addition to the meaning ascribed to them in the Revenue and Taxation Code, the words "full value," "full cash value," "cash value," "actual value," and "fair market value" mean the price at which a property, if exposed for sale in the open market with a reasonable time for the seller to find a purchaser, would transfer for cash or its equivalent under prevailing market conditions between parties who have knowledge of the uses to which the property may be put, both seeking to maximize their gains and neither being in a position to take advantage of the exigencies of the other.[28]

USPAP defines market value as:

> (A) type of value, stated as an opinion, that presumes the transfer of a property (i.e., a right of ownership or a bundle of such rights), as a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal.[29]

The most widely accepted components of market value are incorporated in the following definition:

> The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and

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[24] The "investment" value of a property is a variant of use value and is understood to be the value of an investment to a particular investor or group of investors. It may be more or less than the market value of the property given market conditions for real properties and for real estate investments. The investment value of property is usually calculated as the present value of revenues derived from a property, using a specified or expected rate of return to the investors.

[25] *The Appraisal of Real Estate, 12th edition*, The Appraisal Institute, Chicago, 2001, p. 25

[26] California Revenue and Taxation Code Section 110

[27] Namely, if the terms of the transaction "were negotiated at arms length between a knowledgeable transferor and transferee either of which could take advantage of the exigencies of the other."

[28] *Rule 2. The Value Concept*, State of California, Board of Equalization. Adopted June 21, 1967, effective July 23, 1967

[29] *Uniform Standards of Professional Appraisal Practice*, "Definitions" section

seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.

CDIAC defines "market" value as:

> The most probable price in cash or in terms equivalent to cash for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.[30]

This definition conforms to the definition of market value used by the Appraisal Institute:

> (T)he most probable price which 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 and 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 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 United States dollars or in terms of financial arrangements comparable thereto;
> 5. and the price represents the normal consideration for property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale. [31]

The fact that CFDs and assessment districts often include undeveloped parcels led CDIAC to further distinguish market value by subcategories: retail value and bulk sale value. Retail value is applicable to completed and occupied buildings or homes and is defined, conceptually, as the price "an end user would pay for a finished property under the conditions requisite to a fair sale."[32] Bulk sale value should be applied to both unimproved properties and improved or partially improved but unoccupied properties. Specifically, the bulk sale value of a development project is:

> The most probable price, in a sale of all parcels within a tract or development project, to a single purchaser or sales to multiple buyers, over a reasonable absorption period discounted to present value, as of a specified date, in cash, or in terms equivalent to cash, for which the property rights should sell after reasonable exposure, in a competitive market under all conditions requisite to a fair sale, with buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue stress.[33]

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[30] *Appraisal Standards for Land-Secured Financings*, p. 10

[31] This definition derives from the efforts of Congress to reform the savings and loan industry, resulting in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. It appears in the Code of Federal Regulations (12 C.F.R. part 34.42(g)).

[32] *Appraisal Standards for Land-Secured Financings*, p. 10

[33] *Ibid.*

Recommended Practices – Definitions of Value for Land-Secured Appraisals

The value of properties reported in an appraisal for both CFDs and assessment districts should be the ***market value*** of the properties. The *CDIAC Standards* define market value as "the most probable price in cash or in terms equivalent to cash for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress." Consistent with USPAP, this value should be represented as the most probable price 1) in terms of financial arrangements equivalent to cash; or 2) in other precisely defined terms; and 3) if the value is to be based on non-market financing or financing with unusual conditions or incentives, the terms of such financing must be clearly identified and the appraiser's opinion of their contributions to or negative influence on value must be developed by analysis of relevant market data.

With respect to raw or undeveloped properties, the reported value should account for and distinguish the use of other value estimates, including retail value and bulk sale value.

Retail value is defined as the price an end user, namely a homebuyer or business owner, would pay for a home or completed building under the conditions requisite to a fair sale.

Bulk sale value is the most probable price, in a competitive market, for the sale of all parcels within a tract or development project, to a single purchaser or to multiple buyers, discounted to present value. The bulk sale value reflects the necessary time to sell the land (the absorption period), the cost of developing the land, and the developer's profit from the project.

2. Value Subject to Lien

The *CDIAC Standards* recognize several approaches or methods for determining the value of real property: the Sales Comparison Approach, the Cost Approach, the Income Capitalization Approach, and the Discounted Cash Flow (DCF) Analysis. The Cost and Income Capitalization Approaches are most appropriately applied to improved real property and are, as a result, less well suited to the valuation of unimproved land. For that purpose, the *CDIAC Standards* promote the use of the Sales Comparison Approach and the DCF Analysis.[34] The Sales Comparison Approach is often used when valuing properties, ranging in size from 50 to 250 lots, which is being bought by a residential builder. In this case, comparable sales data likely exists. A DCF Analysis typically is applied to large development projects (250 units or more) where comparable market data does not exist. DCF Analysis values the property in present terms by discounting future cash flows using a market determined discount rate, that generally includes profit, taken to be the cost of capital and the expected return on investment.

When discussing each of these methods, the *CDIAC Standards* apply procedures that incorporate the value of the lien in the estimate of property value. For example, the *CDIAC Standards* include in the Sales Comparison Approach a step that requires the appraiser to adjust the value of the subject property to reflect special tax and assessment liens if the comparables do not have a similar special tax or assessment lien. Specifically, the *CDIAC Standards* state that appraisals using this approach "should be adjusted to reflect the differences between the subject of the appraisal and the comparable properties which affect value."[35] CDIAC's rationale for doing so is based upon evidence from market research that indicates that these tax differences, if not matched by equally valuable differences in service levels, are capitalized into lower and higher prices.[36] That is, buyers take into consideration special tax rates or assessments when buying a home.

The *CDIAC Standards* commit substantial effort to the calculation of the lien, representing the burden assumed by the homeowner to pay the special tax or assessment. An appraiser using the Sales Comparison Approach should adjust the value of subject property by an amount representing what the market considers to be the difference in value between a property with a special tax or assessment lien and one without a special tax or assessment lien.

Since land cannot be reproduced or replaced, the Cost Approach is unable to provide a value for undeveloped land.[37] To be consistent with the Sales Comparison Approach in valuing improved properties, however, the Cost Approach also should account for the special tax or assessment lien by including the value of the lien as a cost.

The discussion of the Income Capitalization Approach in the *CDIAC Standards* recognizes that the approach is suited to income generating properties and not to unimproved properties. Nevertheless, this approach, which discounts net operating income by a market-determined capitalization rate, incorporates the cost of the infrastructure improvements in the calculation of income and the lien in the calculation of operating expenses subtracted from gross or operating income.

The *CDIAC Standards* recommend the DCF Analysis as the best method for large, undeveloped land parcels in a CFD or assessment district. DCF Analysis bases present property values on projected cash flows derived from the development and sale of those properties. This cash flow is based upon an analysis of demand or the rate at which buyers absorb properties within the development. Revenues generated by the sale of properties throughout this absorption period are discounted back to a present value using an appropriate discount rate.

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[34] DCF Analysis is also referred to as the Subdivision Development or Land Development approach.
[35] *Appraisal Standards for Land-Secured Financings*, p. 23
[36] *Ibid.*
[37] The *CDIAC Standards* suggest that the Cost Approach may be better suited to adjusting values determined through other methods for differences in infrastructure improvements. Using this approach, for example, two properties may be compared if their sale prices are adjusted for differences in the value of infrastructure improvements assumed by the two properties.

The *CDIAC Standards* state that "DCF Analysis values unimproved land as if it were subdivided, developed, and sold."[38] The infrastructure improvements that are being funded with the proposed bond proceeds, therefore, are assumed to be completed. In order not to double count the developer's costs for infrastructure, the improvements being funded by the special tax or assessment bonds could either be represented in the DCF Analysis as: (1) a "credit" to the revenue stream, or (2) deducted from the Total Costs of the project. Special tax and assessment payments are treated as expenses to be deducted from the gross cash flow received by the developer over the course of the development. It should be recognized, however, that as the properties are sold the developer's obligation declines.

Recommended Practices – Value Subject to Lien

The *CDIAC Standards* hold that appraisals for properties in a CFD must be based upon the value of the property taking into consideration the infrastructure improvements that will be funded by the proposed bond issue. The appraiser must also take into account the contributing value of the infrastructure improvements financed by the special tax lien and adjust the price of the subject property accordingly. When using the DCF Analysis, the appraiser should include the amount of the special tax paid by the developer during the development or absorption period as a holding cost. Furthermore, the value of comparable sales used to derive a retail lot value should maintain similar lien obligations or they should be adjusted accordingly. The same standard should be applied to properties in an assessment district subject to an assessment lien.

[38] *Ibid.*, p. 14

3. Reporting Value of Real Property Subject to a Special Tax or Assessment Lien

Government Code Section 53345.8 provides that any determination of value made pursuant to the Mello-Roos Act "shall be based upon the full cash value as shown on the ad valorem assessment roll or upon an appraisal of the subject property made in a manner consistent with the policies adopted pursuant to paragraph (5) of subdivision (a) of (Government Code) Section 53312.7 by a state certified real estate appraiser, and defined in subdivision (c) of Section 11340 of the Business and Professions Code." At the same time, the *CDIAC Standards* recommend that appraisals conducted for CFDs and assessment districts report market value.

Market value, then, is the value in exchange under certain stipulated conditions. The appraiser must account for these conditions, representing market and economic conditions, by adjusting comparable sales prices. Adjustments may be made to reflect cash or financing incentives, non-cash considerations, or developer financed improvements.

When dealing with improvements, the contributing value of improvements financed with Mello-Roos and assessment bonds and an adjustment for the value of the lien associated with outstanding debt obligations should be taken into account in the appraisal. That is, in the absence of comparable sales that maintain an equal special tax obligation or benefits, the appraiser should adjust the sales price of comparables to account for the effect of those differences on the value of the subject property.

This approach is reflected in the method promoted by the Board of Equalization (BOE) for the Sales Comparison approach in the *Assessor's Handbook*.

> "According to subdivision (b) of section 110 '(t)here is a rebuttable presumption that the value of improvements financed by the proceeds of an improvement bond resulting in a lien imposed on the property by a public entity is reflected in the total consideration, exclusive of that lien amount, involved in the transaction. This presumption may be overcome if the assessor establishes by a preponderance of the evidence that all or a portion of the value of those improvements is not reflected in that consideration.' For example, otherwise similar properties may sell for the same sale price regardless of the existence or nonexistence of 1911, 1913 (sic), or 1915 Act bonds. If this is the case, the appraiser may conclude that the fair market value of the subject property encumbered with a 1911, 1913, or 1915 Act bond is equal to its nominal sale price and not its adjusted price that includes the fair market value of the 1911, 1913, or 1915 Act bond."[39]

Because California Revenue and Taxation Code Section 110 defines the purchase price as "the total consideration provided by the purchaser or on the purchaser's behalf, valued in money, whether paid in money or otherwise…" the purchase price is understood to include the fair market value of any outstanding improvement bond.[40] When using the Sales Comparison Approach, then, the appraiser must adjust the sale price of a property encumbered by a 1911 or 1915 Act bond to reflect the fair market value of the outstanding bond. The fair market value of the bond may be determined by the following methods: 1) reference to sales of comparable properties; or 2) by discounting the bonds to a cash equivalent amount. The adjusted sales price is the sum of the market value of the improvement bonds and the sales price of the property. The adjusted sales price is then equivalent to the market value per the definition set forth in the Revenue and Taxation Code.[41]

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[39] *Assessor's Handbook, Basic Appraisal*, p. 70

[40] California Revenue and Taxation Code Section 110(b)

[41] When appraising properties subject to Mello-Roos obligations, however, the BOE does not include the value of the obligations when valuing land subject to the Mello-Roos encumbrances. The BOE finds that Mello-Roos debt differs from improvement bonds in significant ways that make the "consideration paid" by a buyer (in the form of an assumed property lien) difficult to assess. In particular, Mello-Roos bonds are not tied to a specific parcel, they may be issued in amounts that exceed the fractional benefits received by a parcel, and the purposes to which a Mello-Roos bond may be used does not conform to the notion of direct benefit as do projects financed with assessment obligations.

The following discussion presents one approach among others to adjusting sales values to account for difference in special tax or assessment liens. Its use or the use of other methods may be at the discretion of the appraiser and based upon conditions existing at the time of the analysis.

Discounting Retail Values to Reflect Future Special Tax Payments[42]

1. From the special tax consultant, obtain the Rate and Method of Apportionment (for developed and undeveloped land, and by various product types).

2. At the time the property is expected to be sold, either as a finished product to a homeowner or an improved lot to a merchant builder (based upon the appropriate lead-time according to the demand by end-users estimated in the Market Absorption Study), the present value of the remaining Special Tax payments should be computed (using the projected bond True Interest Cost as the discount rate).[43]

3. In adjusting the retail value of the finished property or improved lot to reflect the present value of future special tax payments, the appraiser should consider the extent to which the comparable property sales were encumbered by such liens, and the impact that such liens may have upon the price that the homeowner or merchant builder would be willing to pay for the property. The impact that the special tax lien may have on the price of property may vary by location and product type, and may be equal to all of or only a portion of the present value.

Table 1 illustrates how the estimated retail values of finished units scheduled for completion in a new development project are discounted to reflect future special tax payments. The retail values may be used in a DCF Analysis to estimate bulk sale value. To establish comparable prices for each year of the absorption period, the appraiser relies on recent sales data for units in a nearby development project that is virtually identical, save for the fact that the infrastructure in the new development project is to be financed through Mello-Roos special tax bonds. Because the special tax represents the only discernible difference between the two development projects, the appraiser may adjust the retail values of units in the new development to reflect the full amount of their special tax liabilities.

In this example, the special tax will be levied at an annual rate of $10,000/acre on undeveloped land and $2,000/unit on developed land to support a bond issue that will be paid off over 25 years. (The undeveloped land tax is not relevant for purposes of this discounting exercise, however, since the entire development project will be sold as a finished product to end users). The bond issue will be structured to include a capitalized interest account (to pay debt service in Year 1) and a reserve fund (which, along with its interest earnings, will pay debt service in Year 25). As a result, no special taxes will be collected in Year 1, during which grading and other preliminary construction work will take place, or Year 25. The units in the new development project will be constructed and absorbed over a five-year period (Year 2 through Year 6).

[42] When discounting retail values to reflect future assessments, begin with the Engineer's Report attributing assessments to each parcel. Assessments, though potentially different for each parcel, can be discounted over the absorption period using the True Interest Rate on the assessment bonds as the discount rate.

[43] The True Interest Cost is defined as a measure of the interest cost of debt that includes the time value of money. The True Interest Cost is also referred to as the internal rate of return or the net effective interest rate.

Presently, the comparable units (without the special tax) are selling for an average price $238,095, and have been increasing in value at an annual rate of 5 percent in recent years (assuming the appropriate deductions for accrued depreciation). The appraiser therefore increases the value estimates of these units by 5 percent annually over the absorption period for comparison purposes (Column B). To estimate the retail values of the units scheduled for completion in the new development project, the appraiser subtracts the present value of the remaining special tax payments from the comparable sales prices for each year of the absorption period. For the initial units absorbed in Year 2, for example, the present value of the $2,000 special tax payment due that year is $2,000; for each remaining year, this amount is discounted at an annual rate of 7 percent (the expected True Interest Cost of the bond issue). The present value total of the remaining special tax payments, $23,188, is then deducted from the comparable sales price of $250,000 to arrive at an estimated retail value of $225,878 for each new unit absorbed in Year 2. The same discounting procedure is applied for the units absorbed in each of the remaining years in the absorption schedule, Years 3 through 6.

In discounting the retail values of finished units to reflect their future special tax payments, the appraiser is attempting to establish the retail values of those units in each year of the absorption period. At this juncture, the appraiser is not interested in determining the *present* value of those units (unless they are being absorbed in the current year). For each year of the absorption period, consequently, the appraiser discounts the remaining special tax payments to determine the *present* value of those payments *for that year*. For units absorbed in Year 3, for example, the present value of the $2,000 special tax payment in Year 3 is $2,000 — even though the present value of the Year 3 special tax payment is only $1,869 for units absorbed in Year 2. Estimating the retail values of units during the absorption period in this manner allows the appraiser to project the cash flow generated by the project, which then can be discounted to present value to estimate bulk sale value.

Before leaving this example, a few concluding comments are in order. First, the appraisal should maintain the linkage between the *level* of the special tax and the *value* of the infrastructure financed through the tax. In the example above, the special tax is levied at a flat rate to finance infrastructure improvements comparable to those in the nearby development project. Because the infrastructure improvements are comparable, the estimated retail values of the newly completed units do not need to be adjusted to reflect discrepancies in the quality of public facilities. Some special tax formulas, however, allow for an increase of 2 percent annually. Whether or not the appraiser should increase the special tax payment at this rate prior to discounting again depends on the disposition of these proceeds. If the escalating special tax is needed to finance comparable infrastructure improvements, the appraiser would increase the special tax payment by 2 percent annually prior to discounting – which, of course, would result in a larger retail value discount in each year of the absorption period than in Table 1. If, instead, the annually increasing special tax will finance infrastructure superior to that in the comparable development, the appraiser would again escalate the special tax at this rate prior to discounting, but also adjust the retail values in the new development upward to reflect its superior amenities.

Table 1

DISCOUNTING RETAIL VALUES TO REFLECT FUTURE SPECIAL TAX PAYMENTS

A	B	C	D	E	F	G	H	I	J	K	L
Year	PV Comp Price (no tax)	Discounted Special Tax (Year 2)	PV Value (Year 2)	Discounted Special Tax (Year 3)	PV Value (Year 3)	Discounted Special Tax (Year 4)	PV Value (Year 4)	Discounted Special Tax (Year 5)	PV Value (Year 5)	Discounted Special Tax (Year 6)	Value (Year 6)
1	$238,095	--	--	--	--	--	--	--	--	--	--
2	250,000	$2,000	**$225,878**	--	--	--	--	--	--	--	--
3	262,500	1,869	--	$2,000	**$238,829**	--	--	--	--	--	--
4	275,625	1,747	--	1,869	--	$2,000	**$252,437**	--	--	--	--
5	289,406	1,633	--	1,747	--	1,869	--	$2,000	**$266,735**	--	--
6	303,877	1,526	--	1,633	--	1,747	--	1,869	--	$2,000	**$281,759**
7	--	1,426	--	1,526	--	1,633	--	1,747	--	1,869	--
8	--	1,333	--	1,426	--	1,526	--	1,633	--	1,747	--
9	--	1,245	--	1,333	--	1,426	--	1,526	--	1,633	--
10	--	1,164	--	1,245	--	1,333	--	1,426	--	1,526	--
11	--	1,088	--	1,164	--	1,245	--	1,333	--	1,426	--
12	--	1,017	--	1,088	--	1,164	--	1,245	--	1,333	--
13	--	950	--	1,017	--	1,088	--	1,164	--	1,245	--
14	--	888	--	950	--	1,017	--	1,088	--	1,164	--
15	--	830	--	888	--	950	--	1,017	--	1,088	--
16	--	776	--	830	--	888	--	950	--	1,017	--
17	--	725	--	776	--	830	--	888	--	950	--
18	--	677	--	725	--	776	--	830	--	888	--
19	--	633	--	677	--	725	--	776	--	830	--
20	--	592	--	633	--	677	--	725	--	776	--
21	--	553	--	592	--	633	--	677	--	725	--
22	--	517	--	553	--	592	--	633	--	677	--
23	--	483	--	517	--	553	--	592	--	633	--
24	--	451	--	483	--	517-	--	553	--	592	--
25	--	--	--	--	--	--	--	--	--	--	--
Totals	--	$24,122	--	$23,671	--	$23,188	--	$22,671	--	$22,118	--

--debt service paid from capitalized interest in year 1
--debt service paid from reserve in final 3 years
--discount rate = 7 percent (bond TIC)

Recommended Practices – Reporting Value of Real Property Subject to a Special Tax or Assessment Lien

The *CDIAC Standards* recommend that appraisers valuing properties in a CFD or an assessment district report the market value of these properties. Market value may differ from sales price even though market value is understood to be the same thing as full cash value. To arrive at an opinion of market value, appraisers must adjust the sales price or projected sales prices to account for the value of improvements and outstanding debt obligations that will be passed on to buyers.

When valuing real property subject to debt obligations issued to finance improvements under the Mello-Roos Act or various assessment district acts, the contributing value of improvements and the effect or impact of the liens or special taxes associated with outstanding debt obligations must be taken into account in the appraisal process. The method used to adjust values to reflect differences in liens may be at the discretion of the appraiser, but should reflect conditions present at the time of the analysis, including the nature of improvements and the structure of the financing.

4. Statement of Assumptions, Hypothetical Conditions, and Limiting Conditions

Appraising real property constitutes a form of analysis with the goal of estimating or presenting an opinion on the economic value of real property. That value often forms the basis of financial and legal decisions associated with the assessment, transfer, improvement, or collateralization of the property. For this reason, property owners, investors, and tax-revenue supported organizations are highly concerned with the validity and accuracy of the appraisal process.

As with any research project, the scope of an appraisal is an essential step in defining the applications of the appraisal report. With respect to real property appraisal, USPAP's Standards Rule 1-2(f) requires appraisers to:

> "(i)dentify the scope of work necessary to complete the assignment"[44]

In the 'comment' section under this rule, USPAP states that:

> The scope of work is acceptable when it is consistent with:
> - the expectations of participants in the market for the same or similar appraisal services; and
> - what the appraiser's peers' actions would be in performing the same or a similar assignment in compliance with USPAP[45]

Furthermore,

> An appraiser must have sound reasons in support of the scope-of-work decision and must be prepared to support the decision to exclude any information or procedure that would appear to be relevant to the client, an intended user, or the appraiser's peers in the same or similar assignment.
>
> An appraiser must not allow assignment conditions or other factors to limit the extent of research or analysis to such a degree that the resulting opinions and conclusions developed in an assignment are not credible in the context of the intended use of the appraisal.[46]

USPAP Standards Rule 2-2 requires that:

> Each written real property appraisal report must be prepared under one of the following three options and prominently state which option is used: Self-Contained Appraisal Report, Summary Appraisal Report, or Restricted Use Appraisal Report.[47]

With respect to which report is appropriate, USPAP states that:

> When the intended users include parties other than the client, either a Self-Contained Appraisal Report or a Summary Appraisal Report must be provided. When the intended users do not include parties other than the client, a Restricted Use Appraisal Report may be provided. The essential difference among these three options is in the content and level of information provided.[48]

The appraiser's decision to limit the scope of the appraisal must be stated in all report types, including the Self-Contained Appraisal Report and Summary Appraisal Report. Specifically, Rule 2-2(a)(vii) and Rule

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[44] *Uniform Standards of Professional Appraisal Practice*, Standards Rule 1-2(f)
[45] *Ibid.*
[46] *Ibid.*
[47] *Uniform Standards of Professional Appraisal Practice*, Standards Rule 2-2
[48] Ibid.

2-2(b)(vii) require that these reports describe or summarize "sufficient information to disclose to the client and any intended users of the appraisal the scope of work used to develop the appraisal…"

USPAP's Standards Rules 1-2(g) and (h) require an appraiser to:

> (i)dentify any extraordinary assumptions" and "hypothetical conditions" necessary in the assignment. An extraordinary assumption may be used only if:
>
> - it is required to properly develop credible opinions and conclusions;
> - the appraiser has a reasonable basis for the extraordinary assumption;
> - the use of the extraordinary assumption results in a credible analysis; and
> - the appraiser complies with the disclosure requirements set forth in USPAP for extraordinary assumptions.
>
> An appraiser may use a hypothetical condition in an appraisal only if:
>
> - use of the hypothetical condition is clearly required for legal purposes, for purposes of reasonable analysis, or for purposes of comparison;
> - use of the hypothetical conditions results in a credible analysis; and
> - the appraiser complies with the disclosure requirements set forth in USPAP for hypothetical conditions.

USPAP Standards Rules 2-2(a)(viii) and 2-2(b)(viii) require appraisers to "state all assumptions, hypothetical conditions, and limiting conditions that affected the analyses, opinions, and conclusions."

The *CDIAC Standards* do not address the reporting of assumptions, hypothetical conditions, and limiting conditions that apply to the appraisal. In effect, CDIAC defers to USPAP's guidance on this subject. USPAP Ethics Rule states that "(A)n appraiser must not communicate assignment results in a misleading or fraudulent manner." However, CDIAC acknowledges that an appraisal of property within a CFD or assessment district incorporates the hypothetical condition that the infrastructure to be financed with special tax bonds and assessment bonds exists on the effective date of the valuation. CDIAC does not approve the use of hypothetical conditions, such as the value or extent of infrastructure improvements over and above those funded by the special tax bonds or assessment bonds being issued by the CFD or assessment district, which would render a higher "finished lot" valuation if installed.[49] However, if such improvements have been funded and installed as of the date of the valuation opinion, they may be included.

Recommended Practices – Statement of Assumptions, Hypothetical Conditions, and Limiting Conditions

The *CDIAC Standards* defer to USPAP in defining the obligations of appraisers to report the assumptions, hypothetical conditions, and limiting conditions that underlie the appraisal assignment. CDIAC does not approve the use of hypothetical conditions, particularly those related to the value or extent of infrastructure improvements, that would lead the readers of the appraisal report to conclude the value of the property is greater than it is. With respect to hypothetical improvements, CDIAC believes that the appraisal should include only the value of infrastructure improvements to be funded by the special tax bonds or assessment bonds being issued by the CFD or assessment district and those improvements already in place.

[49] This statement incorporates the possibility that a CFD or assessment district may authorize multiple improvement bonds, but sell them in a series of offerings in order to fund incrementally the authorized improvements.

5. Calculating the Value of Overlapping Land-Secured Debt and the Overall Value-to-Lien Ratio
Government Code Section 53345.8 requires that before selling bonds, the legislative body of a CFD must determine, with some exceptions, that the value of the real property subject to a special tax established to pay the debt service on the bonds will be at least three times the value of the principal amount of the bonds sold and all other bonds outstanding that are secured by special taxes on these properties. While the market value of the project represents the "value" component of the value-to-lien ratio, the lien is taken to be the principal amount of proposed and outstanding special tax and assessment bonds secured by the subject properties.

Within a CFD's boundaries other local agencies may provide public services, some of which may have outstanding bonds or other forms of indebtedness. To determine whether the appraised value of the project is three (or more) times greater than the principal amount of bonds, issuers, typically, add the amount of the proposed bonds to the proportion of the principal amount of all outstanding bonds secured by special tax payments that is applicable to properties within the district. Tax and revenue anticipation notes and revenue, mortgage revenue, and tax allocation bonds and non-bonded capital lease obligations bonds often are excluded from the calculation.[50] Also excluded, typically, are annual levies used to pay for services.

California Government Code Section 53345.8 (Chapter 55, Statutes of 2003) requires that the value-to-lien ratio be based upon the sum of the principal amount of bonds to be sold and the principal amount of outstanding bonds that are secured by a special tax or an assessment district lien on properties within the CFD. In calculating the principal amount of outstanding bonds, Section 53345.8 requires the legislative body to use the maximum allowable tax or assessment applicable to each parcel of property with the CFD. In practice, a more conservative method for calculating the value of overlapping debt and the project's value-to-lien ratio involves the following steps:

1. Determine the total taxable acreage within the CFD and the development status of that acreage.
2. Identify the maximum amount of special tax by development status for all land in each district.
3. Multiply the maximum amount of special tax as determined by development status of the land times the total taxable acreage with the CFD.
4. Divide the result of Step 3 by the total actual special tax for the most current year for which data is available.
5. Multiply the ratio resulting from Step 4 times the total outstanding bonded indebtedness of any overlapping CFD or assessment district to derive an estimate of the share of total debt outstanding.
6. Add the share of total debt outstanding plus the new debt to be sold to derive an estimate of direct and overlapping debt.
7. Divide the amount derived from Step 6 by the appraised value of the land in the CFD district to calculate the estimated value-to-lien ratio.

What follows is an example of the steps discussed above.

[50] Leasehold mortgage revenue bonds are typically included in the calculation of overlapping debt.

Property Information CFD 04-01

FY 03-04 Taxable Acreage	151.45
FY 03-04 Development status	Undeveloped Property

Overlapping CFD No 98-02

FY 03-04 Actual Special Tax on Undeveloped Property		$1,059.50/acre
FY 03-04 Maximum Special Tax on Undeveloped Property		$10, 554.34/acre
FY 03-04 Actual CFD 98-02 Special Tax		$5,579,656
FY 03-04 Maximum CFD 98-02 Special Tax		$13,548,894
Total Acreage		2,059
Outstanding Bonded Indebtedness		$120,569,238

Allocation of CFD Overlapping Debt

Overlapping District	Maximum Special Tax on Property in CFD 04-01		Total Actual FY 03-04 Levy		Percent Allocated
CFD-1	$1,598,455	/	$5,579,656	=	28.65%

Percent Allocated	(times)	Total Debt Outstanding		CFD 04-01 Share of Total Debt Outstanding
28.65%	X	$120,569,238	=	$34,543,087

Value-to-Lien Calculation

CFD 98-02	$34,543,087
New Bonds	$50,000,000
Total Direct and Overlapping Debt	$84,543,087
Appraised Value	$250,000,000
Estimated Value-to-Lien	2.96

It is important to note that the calculation of the value-to-lien ratio incorporating overlapping special tax and assessment debt is distinct from the direct and overlapping debt summary that is often included in an OS. An OS may include such a summary to compare the amount of direct and overlapping special tax and assessment debt and general fund obligation debt to the assessed value of properties within the district. The assessed values are different from and, typically for properties included in CFDs or assessment districts that are undeveloped or in early stages of development, less than market values. As a result, comparing overlapping debt to assessed values provides investors a limited description of the security for the project.

Recommended Practices – Calculating the Value of Overlapping Land-Secured Debt and the Project's Overall Value-to-Lien Ratio

California Government Code Section 53345.8 (Chapter 55, Statutes of 2003) requires that the value-to-lien ratio be based upon the sum of the principal amount of bonds to be sold and the principal amount of outstanding bonds that are secured by a special tax or an assessment district lien on properties within the CFD. In calculating the principal amount of outstanding bonds, Section 53345.8 requires the legislative body to use the maximum allowable tax or assessment applicable to each parcel of property with the CFD. In practice, a more conservative method for calculating the value of overlapping debt and the project's value-to-lien ratio involves the following steps:

1. Determine the total taxable acreage within the CFD and the development status of that acreage.
2. Identify the maximum amount of special tax or assessment by development status for all land in each district.
3. Multiply the maximum amount of special tax or assessment as determined by development status of the land times the total taxable acreage with the CFD.
4. Divide the result of Step 3 by the total actual special tax or assessment district levy for the most current year for which data is available.
5. Multiply the ratio resulting from Step 4 times the total outstanding bonded indebtedness of any overlapping CFD or assessment district to derive an estimate of the share of total debt outstanding.
6. Add the share of total debt outstanding plus the new debt to be sold to derive an estimate of direct and overlapping debt.
7. Divide the amount derived from Step 6 by the appraised value of the land in the CFD or assessment district to calculate the estimated value-to-lien ratio.

6. Value Allocation and Assignment of Lien Values within the Project

Government Code Section 53345.8 requires that before selling bonds, the legislative body of a CFD must determine, with some exceptions, that the value of the real property subject to a special tax to pay the debt service on the bonds will be at least three times the value of the principal amount of the bonds sold and all other bonds outstanding that are secured by special taxes on these properties. This three-to-one value-to-lien ratio has become the standard for land-secured transactions under the assumption that property owners will have a financial interest in honoring their special tax or assessment obligations if the property is worth significantly more than the lien.

The use of the three-to-one value-to-lien ratio predates its appearance in Government Code Section 53345.8 as an industry standard. Underwriters and investors generally had maintained that the sufficient security needed to issue debt secured by payments from property owners was roughly three times the value of the property subject to these payments. In this sense, the value-to-lien ratio is understood to be a measure of risk. Prior to Government Code Section 53345.8, however, underwriters and investors were free to adjust this ratio to reflect the project's assessed risks. Financings that included developed properties, for example, may have been suited to a lower value-to-lien ratio because some of the risk inherent in the development process had been removed by prior development activities. That is, for at least a portion of the project special tax revenues were assured.

Within a CFD, individual parcels may be foreclosed upon only to pay delinquent special taxes levied against that parcel. The special tax formula provides that the special tax may not be levied on any parcel within the CFD for the purpose of covering a delinquency of any other parcel within the CFD.[51] This fact raises the level of significance of value-to-lien ratios that represent an aggregate level of risk for a project. These aggregate risk values mask differences between the risk levels associated with different planning units or phases of development within a project. As a result, investors may not fully understand the relationship between the project's risk and the risk presented by a unique planning unit by reviewing the project's value-to-lien estimate only.

USPAP Standards Rule 1-4, however, advises appraisers against aggregating the value of individual properties or units of properties to derive the project's value. Instead, appraisers are required to "analyze the effect on value, if any, of the assemblage of the various estates or component parts of a property…"[52] The apparent conflict between the *CDIAC Stan*dards and USPAP raises two questions:

1. When should appraisers allocate value to subunits within the project? and;
2. How should appraisers inform investors reading the appraisal report of the potential differences in value between subunits?

When using the DCF Analysis on undeveloped land on which the project is composed of more than one planning unit, the appraiser should seek to determine the value of each separately owned unit and phase. To derive the sales price of properties when applying the DCF Analysis, the appraiser should seek to use comparable sales of properties maintaining equivalent special tax or assessment liens. The appraiser can compare the value of liens on different properties by using the Rate and Method of Apportionment developed by the special tax consultant.

If the project is a master-planned development owned in whole by the master developer, an appraiser applying the DCF Analysis should value the different planning areas. However, after taking into consideration appropriate costs and the rate of absorption to arrive at a single value, the appraiser should

[51] The special tax formula may provide for maximum tax payments from all parcels in order to account for delinquencies on individual parcels within a district. Furthermore, Government Code Section 53321(d) places certain limits on the amount special taxes on parcels used for private residential purposes may increase, including the fact that they may not be increased more than 10 percent as a consequence of delinquencies or defaults.

[52] *Uniform Standards of Professional Appraisal Practice*, Standards Rule 1-4(e)

not attempt to allocate values to each planning area. Doing so would violate USPAP's prohibitions against using partial values to derive the value of the whole.

Differing conditions within the project as well as the development process create differences in the risk represented by different subunits within a project. For example, a project that includes a commercial phase built on a slope and a phase of residential units built on the flat represent different risk levels to investors who depend upon the project being developed in such a way as to ensure that special tax or assessment payments are made as promised. Appraisers should seek to value the project in a manner that reflects the development plan assuming that the appraiser has determined that the proposed project is feasible and represents the highest and best use of the property.

Allocating costs in line with the development process by assigning the largest burden of the improvement costs to the first developed properties is one way to address the risk that the project may not be completed. Because of the potential to manipulate the project's value-to-lien ratio, CDIAC recommends that risk should be handled in another fashion. The most correct way to account for risk is to modify the discount rates used to value the project – the more complex the project or uncertain the development process, the higher the risk of non-completion and, therefore, the higher the discount rate. To assist investors to understand the selection of the discount rate, appraisers should provide sufficient detail within the appraisal report to describe different units of production or phases and the development process.

Recommended Practices – Value Allocation and the Assignment of Lien Values within the Project

USPAP Standards Rule 1-4(e) requires an appraiser to analyze the effect on value, if any, of the assemblage of the various estates or component parts of a property and refrain from valuing the whole solely by adding together the individual values of the various estates or component parts. At the same time, the *CDIAC Standards* recommend that appraisers report values by ownerships or assessor parcel numbers in developed or partially developed projects.

To the extent that appraisers are valuing projects on undeveloped land composed of subunits or phases, the allocation of the cost of improvements can affect the project's overall value-to-lien ratio. To remove any uncertainty in this process, appraisers, using the DCF Analysis, should use the lien values determined by the special tax consultant responsible for developing the Rate and Method of Apportionment to identify and adjust comparable sales prices. To the extent that the development plan is composed of subunits or phases owned by different parties, the appraiser should seek to determine the value of each such subunit or phase independently. However, to the extent that the project is composed of different subunits or phases owned by a single party, the appraiser should not allocate these different subunits or phases separately, but value the project as a single property.

Having once determined that the development plan is feasible and conforms to the highest and best use of the property, appraisers should seek to determine the value of the project in a manner that reflects that plan. However, differences between subunits or phases within a master development owned by a single owner that might introduce some uncertainty into the development process should not be cause to value these subunits or phases separately. To address these differences the appraiser should support the selection of the discount rate used to value the project as a whole. Finally, appraisers should provide sufficient detail within the appraisal report, particularly information pertaining to differences between subunits or phases that may affect the development process, to allow readers to understand the selection of the discount rate.

7. Market Absorption Studies

The *CDIAC Standards* state that "(I)t should be considered good practice for issuers to have an absorption or market demand study performed to estimate the dates of sale of finished properties to homeowners and improved lots to merchant builders."[53]

Market absorption studies consider conditions in the regional and national economy to arrive at an absorption schedule for properties in a project. Absorption rates are projected over time to be a function of current and future economic conditions. Using economic and demographic data, an appraiser or market absorption consultant estimates the rate at which lots or finished properties will be sold to final users, such as homeowners. The date of sale (or absorption) provides the basis for discounting cash flows from sales to derive the present value of the project.

USPAP Standards Rule 1-4(h) requires realistic forecasts in the appraisal of proposed improvements and development projects. Standards Rule 1-4(c)(iv) requires that projections of anticipated future revenue or rent and expenses be based on reasonably clear and appropriate evidence. It is the responsibility of the appraiser to ensure that the market demand data used in the analysis is consistent with such evidence and the market forces prevailing at the time.[54] Furthermore, Standards Rule 1-1(b) states that the appraiser must not commit a substantial error of omission or commission that significantly affects the appraisal. Appraisers must report on the information analyzed to make an opinion of value and the extent to which information was not available and, thus, not included. In the appraisal report, appraisers often include a disclosure pertaining to the market information obtained from market absorption consultants. An example of this statement is:

> It is not the scope of this appraisal assignment for the appraiser to conduct an extensive independent market study/absorption analysis, but it is the appraiser's responsibility to address the reasonableness of the conclusions of any market study that has been prepared by outside firms for the subject property.

Market absorption studies are most appropriate when applied to the following projects:

1. *Moderate to large number of residential units (i.e. 500 to 1000+) or master planned communities*. Large projects require more time to sell out and are, consequently, more subject to future changes in economic and demographic forces that drive sales. Given market conditions at the time of the appraisal, however, it is likely that an independent market absorption study may be warranted on projects of fewer units. For example, projects composed of 300 to 500 units of the same product type may have an absorption time, assuming four units per month, of six to 10 years. A 300- to 500-unit project composed of four non-competing products is likely to sell out in two to three years.
2. *Projects that are not expected to commence escrow closings to homeowners for a year or more*. The longer the time to market-entry, the more significant future economic and demographic changes are likely to be.
3. *A project that represents a unique market offering*. Niche products, such as condominiums in an area that favors single-family homes, may require longer absorption horizons.
4. *Projects located in rural areas at the fringe of development*. In the event of an economic recession or slowdown, projects located in rural areas at the fringe of development are typically impacted to a greater degree as compared to projects situated in established urbanized areas.

[53] *Appraisal Standards for Land-Secured Financings,* p. 14

[54] *Uniform Standards of Professional Appraisal Practice*, Statement of Appraisal Standards No. 2, July 8, 1991

Market absorption studies also contain analyses of competitive prices for product types within projects, also known as "Price Points," that can be used to set appropriate special tax rates.[55] The Rate and Method of Apportionment used to establish a special tax in a CFD should use "base prices" instead of prices that include appreciation, premiums, or options and upgrades.

A market absorption study also can be used to identify the amount of special tax that a developer or builder is likely to pay. These taxes will be different from those that homeowners will pay. In this way, the market absorption study can be used as part of the appraisers DCF Analysis and the developer's pro forma. Both costs and sales revenues can be estimated and scheduled using market absorption data. Finally, a market absorption study is a useful tool for prospective bondholders. The study can provide some measure of comfort that the debt service payments will be made from the future projected property owners, as expected.

While no professional or educational credentials guarantee the ability of individuals to competently and efficiently perform the duties of a market absorption consultant, the industry expects certain minimum and preferred qualifications. These minimum qualifications apply regardless of whether the absorption analysis is conducted by a market absorption consultant or by an appraiser. They include:

1. *Educational Qualifications*: The market absorption analysts should possess at least a Bachelors degree but preferably an advanced degrees with courses in real estate and economics.

2. *Experience with Land Secured Financings*: The market absorption analysts should have a minimum of five years of experience in performing Market Studies for land-secured financings. (The Appraisal Institute requires appraisers to have five years of experience prior to receiving a MAI (Member of the Appraisal Institute) designation.) Additionally, they should be well versed in analyzing economic and real estate data that relates to the pricing and absorption of the properties contained within a CFD. This experience should allow them to address issues unique to land-secured financing, including:

    a. How the Price Points are utilized in the Rate and Method of Apportionment to ensure that the issuer's Policy for Maximum Tax Burden is met.

    b. How the estimated absorption schedule is utilized in the appraisal to complete a DCF Analysis to estimate the market value of the subject property.

    c. How to summarize the market absorption study for inclusion in the OS so that prospective bondholders understand the projected rate and pattern of absorption of lots within the CFD, including any special risk factors that may adversely impact the expected absorption schedules.

3. *Avoid Potential Conflicts of Interest*: Market absorption analysts should avoid potential conflicts of interest that may occur in providing consulting services for both the issuer (a public entity) and developers and builders that own property within the CFD. For instance, with respect to Price Points and Absorption Schedules, the issuer's interests typically run counter to the interests of the developer/builders. That is, developers are likely to prefer higher Price Points and faster absorption schedules than the issuer may accept. Accordingly,

[55] By definition, Price Points represent the current base prices for the forthcoming products in a CFD, excluding potential appreciation or premiums, options, or upgrades, based upon their expected characteristics, such as living area and lot size.

if the market absorption analyst has provided consulting services on behalf of the developer or one or more builders in the CFD during the past three years, with regards to either the subject CFD or another property under their ownership or control, then it is appropriate to disclosure the existence of such a relationship in the market absorption report.

Recommended Practices – Market Absorption Studies

The *CDIAC Standards* recommend that DCF valuations should rely on an absorption or market demand study. As a matter of good practice, issuers should consider commissioning a market absorption study for most projects that require land-secured financing of improvements. Among those projects that a market absorption study can most benefit are:

1. Moderate to large number of residential units (i.e. 500 to 1000+), assuming a diverse mix of product types, or master planned communities.
2. Projects that are not expected to commence escrow closings to homeowners for a year or more.
3. Projects that represent a unique market offering.
4. Projects located in rural areas at the fringe of development.

In general, the municipal market professionals recognize minimum and preferred qualifications for individuals conducting market absorption studies whether or not the study is conducted by a market absorption consultant or by an appraiser. They include:

1. Educational Qualifications: The market absorption analysts should possess at least a Bachelors degree but preferably an advanced degree with courses in real estate and economics.

2. Experience with Land-Secured Financings: The market absorption analysts should possess a minimum of five years of experience in performing market studies for land-secured financings. Additionally, they should be well versed in analyzing economic and real estate data that relates to the pricing and absorption of properties contained with a CFD and through this experience be capable of addressing issues unique to land-secured financing, including the use of Price Points in the Rate and Method of Apportionment.

3. Avoid Conflicts of Interest: Knowing that developers and builders may influence the outcome of a market absorption study with respect to the rate and pattern of absorption of properties in a CFD, market absorption analysts should describe their business relations with developers and builders during the past three years in the market absorption study.

8. Verification of Cost Information

The DCF Analysis described in the *CDIAC Standards* adjusts the projected sales price by the cost of converting raw land to finished products or improved lots in order to derive cash flows from the project. The lower the costs, the higher the cash flow and, consequently, the higher the value of the project derived from the DCF Analysis. The *CDIAC Standards* recommends that both direct and soft costs be deducted from the sales price. Direct costs, or hard costs, include labor and materials, developer profit while soft costs include administrative overhead, taxes, and insurance. Many, if not all, of these costs are obtained from the developer or builder.

USPAP Standards Rule 1-4(h) requires realistic forecasts in the appraisal of proposed improvements and development projects. Standards Rule 1-4(c)(iv) requires that projections of anticipated future rent and expenses be based on reasonably clear and appropriate evidence. Appraisers may comply with USPAP even though they lack the expertise to determine whether the cost information provided by the developer or builder is valid and appropriate by disclosing this fact in the appraisal report. Alternatively, appraisers may seek to evaluate the validity and appropriateness of developer- or builder-provided costs and the timing of those costs by consulting a certified civil engineer or other expert.

Issuers should support the efforts of appraisers or third-party consultants to obtain cost information and may do so through the development and implementation of administrative measures, including statements in the local agency's debt policies requiring developers to provide cost information with sufficiently detailed documentation to support the provided costs. Furthermore, an issuer may chose to hire a consultant to obtain cost information in the event that a developer fails to provide it. The issuer may choose to recover the cost of the consultant's services directly from the developer. Finally, the issuer's debt policies should stress that the information provided by the developer or a external consultant to the appraiser be the same information provided to bankers and attorneys involved in the debt issuance.

Recommended Practices – Verification of Cost Information

The *CDIAC Standards* incorporate the cost of developing raw land to finished product or improved lots into the DCF Analysis as a deduction against the sales price to derive cash flows from the project. Appraisers, typically, receive cost information from the developer or builder. Since the value of the project is directly related to the amount and timing of costs deducted from the sales price, costs should be closely evaluated to determine their validity and appropriateness. Appraisers are required to use realistic estimates that are supported by clear and appropriate evidence.

To further support the efforts of appraisers to meet their obligations under USPAP, issuers may wish to consider using a certified civil engineer to verify the cost estimates used to value properties through a DCF Analysis. Issuers also may wish to utilize administrative or financial incentives to encourage developers to provide accurate and timely cost information to appraisers. For example, the cost of hiring a certified civil engineer to provide cost information may be charged to the developer should they fail to provide such information. Finally, the cost information provided by the developer or an external engineering consultant to the appraiser should be the same information provided to bankers and attorneys administering the debt issuance process.

9. Self-Contained vs. Summary Appraisal Reports

USPAP Standard 2 addresses real property appraisal reports and requires that "an appraiser must communicate each analysis, opinion, and conclusion in a manner that is not misleading." USPAP Standards Rule 2-1 requires that each written or oral real property appraisal report must:

1. Clearly and accurately set forth the appraisal in a manner that will not be misleading;
2. Contain sufficient information to enable the intended users of the appraisal to understand the report properly; and
3. Clearly and accurately disclose any extraordinary assumption, hypothetical condition, or limiting condition that directly affects the appraisal and indicate its impact on value.[56]

Standards Rule 2-2 provides that a written real property appraisal report must be prepared under one of three options: Self-Contained Appraisal Report, Summary Appraisal Report, or Restricted Use Appraisal Report. The essential differences between these three options are to be found in the content and level of information provided. "When the intended users include parties other than the client, either a Self-Contained Appraisal Report or a Summary Appraisal Report must be provided. A Self-Contained Appraisal Report includes all data, analysis, and supporting documentation used by the appraiser in presenting an opinion of value. A Summary Report summarizes all data, analysis, and supporting documentation used by the appraiser in presenting an opinion of value. When the intended users do not include parties other than the client, a Restricted Use Appraisal Report may be provided."[57]

Appraisal reports may be further defined as "limited" appraisal reports. USPAP defines a limited appraisal as the act or process of estimating value or an estimate of value performed under and resulting from invoking the Departure Rule. The Departure Rule of USPAP provides that "(A)n appraiser may enter into an agreement to perform an assignment in which the scope of work is less than, or different from, the work that would otherwise be required by the specific requirements, provided that prior to entering into such an agreement, the appraiser has determined the appraisal will be credible, the appraiser has advised the client and the client has agreed the limited appraisal service is appropriate.[58] USPAP Appraisal Opinion AO-15 more specifically addresses the use of the Departure Rule in developing a limited appraisal.

The *CDIAC Standards* do not address the form of the appraisal report, but rather its content. CDIAC feels that because of the USPAP reporting requirements no additional consideration in the *CDIAC Standards* is necessary at this time.

Recommended Practices – Self-Contained vs. Summary Appraisal Reports

CDIAC finds the recommendations and requirements provided to appraisers on the format and content of appraisal reports by USPAP is fully sufficient.

[56] *Uniform Standards of Professional Appraisal Practice*, Standards Rule 2-1
[57] *Ibid.*, Standards Rule 2-2, "Comment" section
[58] *Ibid.*, Departure Rule

10. Appraiser Credentials

The *CDIAC Standards* recommend that appraisers valuing properties in a CFD for the purpose of calculating the project's value-to-lien ratio "should be licensed by the State of California Office of Real Estate Appraisers and be a Member of the Appraisal Institute (MAI) or have similar training, experience and qualifications."[59]

USPAP addresses the appraiser credentials indirectly by establishing minimum performance standards and expectations. To begin with, USPAP defines an appraiser as "one who is expected to perform valuation services competently and in a manner that is independent, impartial, and objective."[60] Furthermore, USPAP sets forth in its Ethics Rule the standards by which an appraiser must perform an assignment, including performing an appraisal ethically and competently.[61] Finally, in USPAP's Competency Rule, appraisers are required to identify the appraisal problem and to have the knowledge and the experience to complete the assignment competently prior to accepting an assignment or entering into an agreement to perform an assignment. If the appraiser lacks the necessary knowledge, he or she must

1. Disclose the lack of knowledge and/or experience to the client before accepting the assignment;
2. Take all steps necessary or appropriate to complete the assignment competently; and
3. Describe the lack of knowledge and/or experience and the steps taken to complete the assignment competently in the report.[62]

In elaborating on the competency requirements of appraisers, USPAP notes that "competency applies to factors such as, but not limited to, an appraiser's familiarity with a specific type of property, a market, a geographic area, or an analytical method. If such a factor is necessary for an appraiser to develop credible assignment results, the appraiser is responsible for having the competency to address the factor or for following the steps outlined" in the Competency Rule."[63]

CDIAC believes that the competency requirements set forth in USPAP are comprehensive and meet the same objectives as the standards set forth in the *CDIAC Standards*. If appraisers meet the competency standards set forth in USPAP as well as being an MAI or possess similar training, experience, and qualifications, they simultaneously meet the competency standards recommended by the *CDIAC Standards.*

Recommended Practices – Appraiser Credentials

CDIAC believes that the competency requirements set forth in USPAP are comprehensive and meet the same objectives as the standards set forth in the *CDIAC Standards*. The *CDIAC Standards* recommend that the appraiser should be licensed by the State of California Office of Real Estate Appraisers and be a Member of the Appraisal Institute or have similar training, experience, and qualification. If appraisers meet the competency standards set forth in USPAP as well as being an MAI or possess similar training, experience, and qualifications, they simultaneously meet the competency standards recommended by the *CDIAC Standards*.

[59] *Appraisal Standards for Land-Secured Financings,* p. 6
[60] *Uniform Standards of Professional Appraisal Practice*, Definitions
[61] *Ibid.*, Ethics Rule
[62] *Ibid.*, Competency Rule
[63] *Ibid.*, Competency Rule, "Comment" section

11. Appraisal Review

The *CDIAC Standards* suggest that issuers might benefit by reviewing completed appraisal reports. Reviews can be used to determine whether the appraisals comply with the *CDIAC Standards* or those adopted by the local agency and were competently performed. If an issuer carries out formal independent reviews of completed appraisal reports it should set forth the process for these reviews in its debt issuance policies. Among the items to be considered there are the selection and minimum qualification of review appraisers. Issuers may benefit from USPAP's Standard Rule 3, which focuses on the standards of practice and qualifications of review appraisers.

Recommended Practices – Appraisal Review

Issuers who conduct formal independent reviews of completed appraisal reports can determine that such appraisals meet these *Appraisal Standards* and were competently performed. Issuers that choose to review appraisal reports should give consideration to the review process in their debt issuance policies, including the selection and minimum qualifications of review appraisers.

12. Application of *CDIAC Standards* to Financings Secured by a Letter of Credit

Government Code Section 53345.8 requires, with certain exceptions, that local agencies determine the value of real property that would be subject to a special tax authorized by a CFD. This value must be at least three times the value of the lien created by the proposed debt and all outstanding special tax and assessment debt secured by the subject properties. Sometimes a Letter of Credit (LOC) is provided that can give investors additional security against default by guaranteeing that a third party institution will make payments of special tax should certain property owners fail to do so. LOCs are sometimes used in land-secured transactions and are kept in place as long as the payment obligation remains in the hands of a limited number of property owners. Once significant amounts of the property subject to the special tax of assessment lien have been sold to individual owners or a larger number of developer/landowners, the LOC often is removed.

While the presence of the LOC offers investors security, it does not mitigate the legislative requirements of Government Code Section 53345.8. As a result, in CFDs, the *CDIAC Standards* or locally adopted appraisal definitions, standards, and assumptions must be held as the minimum standards for the preparation and reporting of value-to-lien ratios. The application of these same standards in assessment districts backed by an LOC should be recognized as good practice by issuers, as well.

Recommended Practices – Application of *CDIAC Standards* to Land-Secured Financings Secured by a Letter of Credit (LOC)

The *CDIAC Standards* or locally adopted appraisal definitions, standards, and assumptions must be held as the minimum standards for the preparation and reporting of property values even though the special tax payments may be backed by a letter of credit (LOC). The application of these same standards in assessment districts backed by an LOC should be recognized as good practice by issuers, as well.

ACKNOWLEDGEMENTS

This report was written by Mark B. Campbell, a Senior Policy Analyst with the California Debt and Investment Advisory Commission (CDIAC). The opinions and findings cited here are solely those of CDIAC. CDIAC is indebted to the many people who assisted in the development and review of this report, including: Larry Rolapp, Fieldman, Rolapp & Associates; Sam Sperry, Orrick, Herrington & Suttcliffe LLP; John Murphy, Stradling Yocca Carlson & Rauth; John Gibson, UBS; Bruce Hull and Kitty Sino, Bruce Hull & Associates; Jim Harris and Berri Cannon, Harris Realty Appraisal; Jeff Ridolfi, Clark Wolcott Company; Ursula Hyman, Latham & Watkins LLP; Don Hunt, Fulbright & Jaworski LLP; Scott Ferguson, Jones Hall; Diane Schooler, The Schooler Company; Kevin Ziegenmeyer, Seevers Jordan Ziegenmeyer; Deborah Schulte and Bill Sinclair, City of Sacramento; Joe Janczyk, Empire Economics; and Bob Williams, RBC Dain Rauscher.