

*NEITHER A SCIENCE NOR AN ART, APPRAISAL IS A MYSTERY*

("Things we never really understood...")

Pondered at the

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**ADJUSTMENT CHARTS FOR APPRAISAL REPORTS**

II **Institute Policy**

Canadian Uniform Standards states (line 1585):

*“The appraiser must take reasonable steps to ensure that the information and analyses provided are sufficient for the client and intended users to adequately understand the rationale for the opinion and conclusions.*

*In the process of collecting and verifying relevant information the appraiser must perform this function in a manner consistent with “Reasonable Appraiser” standards. All three approaches require the collection of comparable data. The decision to inspect comparables and the extent of verification of data will be determined by the scope of the assignment, but in all cases the appraiser must conform to “Reasonable Appraiser” standards.”*

II **The “Reasonable Appraiser” is:**

*“One who maintains a level of performance that would be acceptable to the Professional Practice Peer Group. If reasonable appraisers conclude that there is no rational foundation for an analysis or opinion, then such analysis or opinion would not be justified.”*

II No reference in the Standards to a requirement for an adjustment chart.

## II **BC Expropriation Compensation Board**

- no requirement that the report include an adjustment chart
- but it certainly may be of assistance, on one page all the appraiser's judgement is laid out

## II **So include a chart or not?**

### II **The case for inclusion:**

- as expert witnesses, we are here to assist the courts
- a clear chart assists the reader in the thought processes of the appraiser
- each adjustment will test the judgement of the appraiser
- the critical factor in the chart is the appraisers' reasoning and consistency

### II **To exclude – or modify?**

- many rows and columns can lead to inconsistent adjustments. One error, one plus sign instead of a minus can lead to the questioning of accuracy elsewhere in the report
- every cross examiner rubs his hands with glee at the sight of an adjustment chart, there is so much information there!
- can the percentage adjustments be supported? And by what?
- can we as appraisers be expected to have market-derived support for all our adjustments?
- is a modified adjustment chart of any assistance? Does the use of terms such as “superior, inferior or similar” simplify or complicate the issue, or is this just a cop out?

## II **The Ultimate Test**

- be consistent, if you include a chart, then double and triple check the adjustments
- be reasonable, if you include a chart, is there a level of adjustment so high that it would lead the reader to question the use of the comparable?
- an experienced reader, or cross examiner, will know if you are reaching for a value
  - so should you include them or not? Is there a definitive answer? In any event, whether you have a chart in the report or not, you can expect to be thoroughly cross examined on how you arrived at your adjustments!

## **THE IMPACT OF UNUSUAL OFFICIAL COMMUNITY PLAN DESIGNATIONS FOR EXPROPRIATED PROPERTIES**

The basic compensation to an owner's estate or interest in the land subject to an expropriation is the market value.

- Excluding the value of special economic advantages and amounts for disturbance, how does the appraiser deal with an unusual OCP designation?

Part 6 of the *Expropriation Act* sets out the basis for compensation and Section 31 states that "...if the market value is based on a use of the land other than its use at the date of expropriation, the compensation payable is the greater of:

- (a) the market value of the land based on its use at the date of expropriation plus reasonable damages under section 34, and
  - (b) the market value of the land based on its highest and best use at the date of expropriation."
- Before developing the estimate of market value the appraiser must consider the various land use controls which might impact the optimum use of the site.
  - What if the OCP was out of step with the existing use and identified the use simply as park or a school site?
  - What would be the correct methodology to be employed?
  - What about a future road link shown on the OCP?

Check Sec. 33(g) exclusions from market value:

- "(g) any increase or decrease in value of the land that results from the enactment or amendment of a zoning bylaw, official community plan or analogous enactment made with a view to the development in respect of which the expropriation is made."

References: *Kliman v S.D. No. 63, Saanich*  
*286684 BC Ltd. v Cohwood*

## CAN COST EVER EQUAL MARKET?

Market value is usually estimated by applying one or more of the three 'classic' valuation techniques:-

- The Direct Comparison Approach (DCA)
- The Income Capitalization Approach
- The Depreciated Replacement Cost Approach (DRC)

Is DRC a legitimate technique for estimating market value?

### **Standards of The Appraisal Institute of Canada**

Canadian Uniform Standards state (at Line 1604) that when a Cost Approach is "applicable" an appraiser must:-

- develop an opinion of site value by an appropriate appraisal method or technique;*
- analyze such comparable cost data as are available to estimate the cost new of the improvements (if any); and*
- analyze such comparable data as are available to estimate the difference between cost new and the present worth of the improvements (accrued depreciation).*

Interestingly, the leading appraisal textbook in Canada adds a further element

*...to apply the Cost Approach, an appraiser estimates the cost to construct a new reproduction of, or replacement for, the subject property, then deducts all accrued depreciation and adds site value and entrepreneurial profit. This profit is defined as the difference between the costs of development and the value of the completed property.*

### **International Valuation Standards**

These Standards, adopted ostensibly for purposes of financial reporting, state that

*In the absence of market evidence, DRC (depreciated replacement cost) is regarded as an acceptable method/basis to arrive at a surrogate for the Market Value of specialized and limited market properties. Nonetheless, DRC methodology incorporates market observations by the Valuer with regard to land value, current cost, and depreciation rates.*

## **The Expropriation Act (BC)**

Of the three classic techniques available for an appraiser to estimate market value, the only one that is featured in our Expropriation Act is found in s.35.

*“Where there is no general demand or market, the market value is deemed to be the reasonable cost of equivalent reinstatement.”*

If not included in the market value, s. 31 hints of the cost approach by providing for the addition of

*the value of improvements made by an owner occupying a residence located on the land*

## **Current practice**

Typically, an appraiser will turn to valuation manuals for the essential components of the cost approach, such as costs per square foot, time and location adjustments and additional items such as garages, pools etc., and for age/life and depreciation tables. Whereas contractor's profit is contained within rates in the manuals, entrepreneurial profit is not and is seldom considered.

## **The Question**

This current practice begs the question...can cost ever equal market?

## **The two fundamental flaws**

Profit is market determined, not the other way round.

*(“An entrepreneurial profit (or loss) is the difference between the cost of development and the value of the completed property” – The Appraisal of Real Estate, Can. ed. p.313)*

Accrued depreciation is market determined, not the other way round.

*(“Depreciation...is the difference between reproduction or replacement cost of an improvement and its market value...”-ibid, p.352)*

## **Cases**

Sisters of Charity 3 DLR 358

Laidlaw 15 LCR 24

Branscombe 51 LCR 285

Reti 68 LCR 317

Glendale 70 LCR 253,256

## CAN THE APPRAISER REALLY DEAL WITH THE EFFECTS OF THE SCHEME?

II The BC Expropriation Act under Sec. 33 states

*“In determining the market value of land, account must not be taken of*

- (d) an increase or decrease in the value of the land resulting from the development or prospect of the development in respect of which the expropriation is made,*
- (e) an increase or decrease in the value of the land resulting from any expropriation or prospect of expropriation, and*
- (f) an increase or decrease in the value of the land due to development of other land that forms part of the development for which the expropriated land is taken.”*

II But when does “the prospect of the development” begin? Denning MR in *Wilson v. Liverpool Corporation* rejected the argument that the Pointe Gourde principle applied only from the date the scheme became precise, definite and known to all the world, and states in 40 LCR Page 62 as follows:

*“I do not accept counsel’s submission. A scheme is a progressive thing. It starts vague and known to few. It becomes more precise and better known as time goes on. Eventually it becomes precise and definite, and known to all. Correspondingly, its impact has a progressive effect on values. At first it has little effect because it is so vague and uncertain. As it becomes more precise and better known, so its impact increases until it has an important effect. It is this increase, whether big or small, which is to be*



*disregarded as at the time when the value is to be assessed.”*

Π This seems fairly straightforward. It appears that it is only when the scheme becomes “precise and better known” and it has “an important effect” that any increase or decrease in value is to be disregarded.

Π Denning found no fault with the Lands Tribunal decision adopting the relevant date which:

*“...a purchaser would have known enough about the...scheme to have been able to allow for its effect in deciding what price he would pay for the subject land.”*

- II So, is it only when the scheme has an “important effect” on values that we must ignore any increase or decrease after that date, rather than when it becomes “precise and definite”? If so, how does the appraiser pick that moment in time?
- II Professor Todd advises that appraisers should “*make a determination of the value of the subject property before any public notice or discussion of the development is made known and then provide an adjustment for time. This at least provides a check as to the total effect of the development...*”
- II In any event, how then does the appraiser sift through sales evidence, and attempt to differentiate between normal market forces and the effects of the scheme?
- talk to the market participants and find out what premium, if any, was paid for the property in anticipation of the scheme?
  - what if the scheme is five years in the “planning stage”, without final approval, yet the market participants are already bidding up the property values? Does the appraiser ignore this market activity?
- II Ultimately, appraisers are put in an untenable position, to assess and isolate one factor from a myriad of factors that make up market value.

**THE DIVISION OF INTERESTS**  
**AN ENTIRELY DIFFERENT VALUATION PROCESS**

Sec. 30(i) “Every owner of land that is expropriated is entitled to compensation”

“owner”, in relation to land, means

- (a) a person who has an estate, interest, right or title in or to the land including a person who holds a subsisting judgment or builder’s lien,
- (b) a committee appointed under the *Patients Property Act* as guardian, executor, administrator or trustee in whom land is vested, or
- (c) a person who is in legal possession or occupation of land, other than a person who leases residential premises under an agreement that has a term of less than one year;

Sec. 31(3) goes on to say “If there is more than one interest in the land expropriated, the value of each interest must, if practical, be established separately.”

- When do we encounter multiple categories of interests?

In general, it is not uncommon to have:

- leasehold interest
  - operating businesses
  - divided partial interests such as fractional interests
  - interests in resources on the property trees, gravel, etc.
- How does the appraiser go about estimating the market value of interests that are less than fee simple?
    - Sections 36 and 39 of the *Expropriation Act* deal with the frustration of leases and the manner in which disturbance damages are to be determined by the board.
    - Of course when the expropriating authority or board has the issue before them, the total compensation for the property must be divisible and equal 100% of the unencumbered market value. Section 31 (3) outlined earlier requires the appraiser to render an opinion of the value of the various interests.

- When valuing the separate interests do they, or should they add up to the unencumbered fee? How would the appraiser treat the varied interests?
    - There are pertinent court cases dealing with decisions impacting partial interests related to real estate matters. Our findings note three which are of particular interest:
      - o *Patricia Edmonds v Her Majesty The Queen*
      - o *J. Hewitt v Her Majesty The Queen*
- Todd v Freeman* (2003 BCSC 1155)

## WHAT'S UP WITH INTEREST RATES?

### (1) Do cap rates and interest rates have an inverse relationship?

*With the end of cheap money in sight... inflation is a 'ghost from the past, haunting financial markets around the world', says the Economist...*

#### Guiding principles

“The value of money influences real estate prices”

“When money becomes plentiful, the price of money declines”

“When the demand for money is high ...interest rates increase”

“Appraisers consult...money market activity for indications of  
changing monetary values”

( The Appraisal of Real Estate, Can. ed. P.85, 94)

#### What are Interest Rates?

Nominal rates comprise the 'real' interest rate plus a premium for inflation.  
Economists suggest that the 'real' interest rate has remained steady at around 3%.

Hence a 7% bond would indicate a 3% real interest rate plus a 4% hedge against inflation.

Thus nominal interest rates and inflation generally move together in the same direction..

#### Capitalization rates

Capital invested in real estate usually comprises debt and equity.

A capitalization rate is a mysterious blend of the interest rates on these two components, but is most often simply derived from net operating income absent the debt payments. The mystery lies in the rate that does not appear, reflecting the expectation that values will increase.

#### The Question

As our interest rates rise, should capitalization rates follow?

#### A Proposition

Higher interest rates could be the result of higher inflation rates

Higher inflation means the anticipation of higher prices

Higher prices mean lower cap rates.

Hence higher interest rates could mean lower cap rates.

It would seem that an increase in interest rates does not necessarily usher in an increase in capitalization rates. Does the possibility exist that the reverse could be true?

## **(2) How come reported cases show discount rates from 3% to 20%?**

*“The anticipation of receiving future benefits creates value, but the possibility of losing benefits detracts from value. Higher rewards are required in return for higher risk”.*

*“In market value appraisals, the appraiser’s objective is to simulate the expectations of a typical investor, not necessarily to make the most reliable prediction of yield and inflation rates.”*

### **Discount rates**

A discount rate is a yield rate that converts future lump sum or periodic income into present value. It is essentially a time-sensitive interest rate, an internal rate of return in an all-cash transaction.

In the BC *Law and Equity Act*, it is defined as the rate, expressed as a percentage, used in calculating the present value of future damages. It is deemed to represent the future difference between the investment rate of interest and...inflation.

The inflation rate is stripped away to reveal the real rate of return. The lower the rate applied, the higher the amount.

(While economists predict the rate of inflation, the unknown variable in this equation is the investment rate of interest.)

Nonetheless, s.51 of the Law and Equity Act is not intended to govern the discount rate in administrative proceedings. (see 54 LCR 218)

### **The reported cases**

A fruitful discussion of discount rates is found in the Cokato Dairy and Jones decisions of this Board where the elements of risk and inflation were canvassed. Rates were not widely divergent. The claimant sought to apply 5.85%, lowering to 3.5%, whereas the respondent argued for no less than 5.32%. The Board awarded a rate of 5% over 50 years, giving considerable credibility to the evidence of a resource economist and expert in agricultural economics.

In a recently reported case decided by the Court of Queen’s Bench of New Brunswick, gravel from lands expropriated were used for highway construction. The claimant sought the undiscounted value of the gravel, but the court awarded the present value of the prospective earnings at a discount rate of 12%. Four experts had arrived at rates that varied from 8.33% to 15%. The decision goes to some length to detail their reasoning. While the court acknowledged the importance of applying a proper rate, the derivation of the 12% appears to include a 2% premium for inflation, rather than a deduction.

## The Question

Discount rates in the reported cases display a puzzling if not disconcerting range of numbers. With the interest rate regime apparently now on the move, experts will be even more hard pressed to explain their analyses. And what if an increase in interest rates is found not to herald an increase in discount rates?

### Cases

#### BC

Corner's Pride...52 LCR 59...10% p.a. discount for increased farm expenses over 15 years

Cokato ...54 LCR 219...5% p.a. discount for increased farm expenses over 50 years.

Kliman...54 LCR 242,266 ...15% discount applied to back-date a contract price.

Mayfair...61 LCR 220...11% discount for risk and delay

#### Other

Bauer (Ontario)...52 LCR 140...3% p.a. in perpetuity for increased costs (hydro towers).

Malmberg (Alberta)...57 LCR 91...3% p.a. discount for increased costs over 10 years

Stierle (Alberta)...63 LCR 171, 186...3% p.a. discount for travel costs over 10 years.

McLeod (N.B.)...69 LCR 92,104...20% discount for projected crop loss in new venture.

Moffett (N.B.)...81 LCR 161,177...12% p.a. discount for annual gravel revenue.

Bodner (Man.)...83 LCR 71,79...5% p.a. for 10 years for increased travel costs