U.S. Department of Housing and Urban Development
Office of Multifamily Housing
Region X Multifamily HUB

Region X

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TO: FHA Multifamily Lenders

FROM: Renée D. Greenman, Director, Region X Multifamily Hub, OAH

SUBJECT: Clarification of Section 232 and Section 232/223(f) Appraisal Guidelines

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The purpose of this memo is to provide clarification of the Region X Hub's interpretation and understanding of the Multifamily Accelerated Processing (MAP) Section 232 and Section 232/223(f) appraisal and underwriting requirements in Section 7.12 of the MAP Guide.

From discussions with participant's at Region X's recent Western Mortgagees Planning Meeting on January 23, 2006, it is clear that an inordinate amount of time is spent in Section 232[1] valuation and underwriting. This appears to be the result of misunderstanding of HUD's directions on valuation of Section 232 "going concern" and "realty only" values. We believe these resulting delays can and should be avoided, if a few steps are taken.

In the valuation process of health care facilities under Section 232, caution must be exercised to prevent Section 232 appraisals from erroneously concluding "Real Estate" only (i.e. HUD Adjusted) values higher than, or equal to, Going Concern value due to improper treatment of proprietary earnings deductions and related calculations.

Most errors and erroneous valuation conclusions, which we have noted, can be avoided by following the sequential steps outlined below. You will find that they are consistent with the MAP Guide. The first step and most critical is to establish the Going Concern value of the subject facility. Its value should include a management fee, as with a standard, commercial appraisal, without regard to special HUD Adjusted rules, if supported by the market. This appears to be the case in most markets within the region. The Going Concern value sets the upper value limit. The HUD Adjusted value (i.e. "realty only" value) is then calculated *after* Going Concern is established and should be lower to account for deduction of the estimated business value, unless there is no business value.

1. Recommended Section 232 valuation steps are as follows:

   Step 1: Going Concern market value must be established ***first*** and will require the bulk of the effort for the appraisal.

   a. Going Concern Value should include a market derived management fee if supported in the market place. The Going Concern value is a USPAP compliant, commercial, market value, independent of any special HUD rules.
   b. The management fee for each sale comparable should be itemized in sufficient detail for the reviewer to be able to duplicate the "Cap" rate calculation.

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[1] Note: References to Section 232 refer to both FHA Section 232 and Section 232/223(f) programs

c. Establishing the Going Concern value as the first step serves as the benchmark for the upper limit of value.

Step 2: *After* the Going Concern Value is established, the HUD Adjusted value is estimated. The intent of the HUD Adjusted value is to remove an *estimate* of the business value from the Going Concern. This second step can be accomplished in relatively few pages in the report.

a. It is not the intent to provide detailed calculation instructions for arriving at the HUD Adjusted value. There are calculation suggestions in the MAP Guide as well as an article in the Winter 2005 Appraisal Journal. The calculation procedure is left to the judgment of the appraiser.
b. The final test is that the HUD Adjusted Value should be *acceptably lower than Going Concern value (as described below.)*. It is understood that this may be *construed* as an underwriting policy.
c. Note: it is *not acceptable* to estimate the HUD Adjusted Value first and then increase that amount and label it "Going Concern." This could result in erroneous amounts that are higher then Going Concern.

2. *"Acceptably lower"* Defined

The phrase *"Acceptably lower than Going Concern value* above connotes HUD's expectation that the estimated HUD Adjusted Value and its relationship to the subject's estimated Going Concern value is 1) supported in the market place, 2) adequately analyzed by the appraiser and 3) reasonable.

The MAP Guide (Ch. 7, page 27) suggests Proprietary Earnings percentages between a low of 5% to 10% for Board and Care, up to 15% to 25% for a Nursing Home. **However, it must be emphasized that these are only "general guidelines" and based on the level or levels of care to be provided, market conditions, etc. the actual proprietary earnings may be higher, or lower, than the general guideline range(s).** While HUD offers several potential methods of determining the "Real Estate Only" value (see Chapter 7, Page 22, Section 3., of the MAP Guide) it is the responsibility of the appraiser to determine and use the method that provides the most reliable, best supported value indication.

The difference between the HUD adjusted value and the going concern value will generally bear some relationship to the percentage of net income attributable to proprietary earnings. However, it is possible that other considerations may be at work. For example, it may or may not be appropriate to use the same capitalization rate in each value determination. Therefore, a one-to-one relationship between the proprietary earnings percentage and the ratio of going concern value to HUD Adjusted value should not be assumed. What is important is that the reasoning behind the appraiser's estimates of value be transparent to the MAP underwriter and to the HUD reviewer. Care should be taken to insure that there is no misinterpretation and/or misunderstanding of the Section 232 guidelines that leads to erroneous appraisal conclusions. Additionally, care should be taken to insure that statements like concluded value *"may be higher or lower than market"* are not a part of the appraisal. It is our belief that such statements are inconsistent with the letter /or the intent of the MAP guidelines and HUD regulations. The correct relationship is: Going Concern is market value; HUD Adjusted is *acceptably lower* than market value.

3. HUD Form 92264

a. It is understood that the form 92264 presents some problems with dovetailing the Section 232 appraisal requirements with the various line items.

b. The "Remarks" section of the form 92264 should include the clarifying statements similar to the following:
   i. "Going Concern value (includes market derived management fee) $_____".
   ii. HUD Adjusted value (excludes an estimate of business value) $_____"

4. Basic appraisal requirements
   a. Final Reconciliation of value must be provided with an analysis that incorporates all the data in the report.
   b. The narrative must be internally consistent with and explain the numbers, forms and charts used in the report.
   c. The math must be correct.

Summary

The key to avoiding errors is to first identify the true Going Concern value of the health care facility. This value should include a management fee, as with a standard, commercial appraisal, without regard to special HUD Adjusted rules. Once the appraiser has determined the Going Concern value for the facility, the overall market value for the facility, and then its HUD Adjusted value as noted above, one may juxtaposition the two values to test the reasonableness of the value estimates and conclusions by the market.

We find that Section 232 appraisals that follow these guidelines require less preparation time by the MAP appraiser, to underwrite by FHA lender and to review by HUD. As such, we strongly encourage lenders and appraisers to consider this guidance when completing or underwriting Section 232 appraisals.