IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TENNESSEE

In re CROSSCREEK APARTMENTS, LTD., Debtor.	No. 96-20170 Chapter 11

M E M O R A N D U M

APPEARANCES:

FRED M. LEONARD, ESQ.
Post Office Box 213
Bristol, Tennessee 37621-0213
Attorney for Crosscreek Apartments, Ltd.

PATRICIA C. FOSTER, ESQ.
First Tennessee Plaza, Suite 1010
Knoxville, Tennessee 37929
Attorney for U.S. Trustee

THOMAS E. CABANISS, ESQ.
PATRICK L. HAYDEN, ESQ.
MCGUIRE, WOODS, BATTLE & BOOTHE, L.L.P.
9000 World Trade Center
Norfolk, Virginia 23510
Attorneys for Walter F. Trent and Lynwood G. Willis

RANDAL S. MASHBURN, ESQ.
BAKER, DONALDSON, BEARMAN & CALDWELL, P.C.
511 Union Street, Suite 1700
Nashville, Tennessee 37919
Attorneys for Condor One, Inc.

MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY JUDGE

This single asset chapter 11 case came before the court for hearing on December 20, 1996, for a determination of the adequacy of the competing disclosure statements filed December 6, 1996, by Condor One, Inc. ("Condor"), a secured creditor, and Walter F. Trent and Lynwood G. Willis, general partners of the debtor (collectively the "Partners"). Condor and the Partners have raised numerous objections[1] to the other's disclosure statement, both contending that the disclosure statements do not contain adequate information within the meaning of 11 U.S.C. § 1125[2] and therefore should not be approved. The principal dispute between the parties, however, is the valuation of the apartment complex owned by the debtor, known as Crosscreek Apartments, in which Condor asserts a first lien as security for

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[1]The U.S. Trustee has also filed objections to both disclosure statements although the attorney for the U.S. Trustee announced at the beginning of the hearing that these objections had been resolved and would be withdrawn.

[2]Under § 1125(b) of the Code, "[a]n acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information." The term "adequate information" is defined in § 1125(a)(1) as "information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor?s books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan ...."

its claim against the debtor. In their joint pretrial statement, the parties requested that the court initially resolve the issue of valuation since this issue impacts on numerous plan considerations, such as the 11 U.S.C. § 1111(b) election, the treatment of claims, and the requirements for a "cramdown" under 11 U.S.C. § 1129(b). Accordingly, the sole issue before the court at this time, and the only issue on which the parties presented evidence at the December 20 hearing, is a determination of the value of the Crosscreek Apartments complex.[3] This is a core proceeding. *See* 28 U.S.C. § 157(b)(2)(L).

I.

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[3]Fed. R. Bankr. P. 3012 provides that the court "may determine the value of a claim secured by a lien on property in which the estate has an interest on motion of any party in interest and after a hearing ...." Although the parties have not referenced Rule 3012 in their joint request for a determination of valuation, the court is in effect holding a valuation hearing as part of the hearing on the adequacy of the disclosure statements. One court has observed that the legislative history to 11 U.S.C. § 1125 indicates that one of the purposes of a disclosure statement hearing is to permit a valuation in cases where only a valuation will provide adequate information. *See In re Reilly*, 71 B.R. 132, 134 (Bankr. D. Mont. 1987)(citing H.R. REP. NO. 95-595, pt. 227 (1977)). That court further noted that a "commentator has written that a full going-concern valuation may well be necessary, and therefore heard, at the time of the hearing on the adequacy of the disclosure statement where the plan itself will make that valuation necessary for confirmation, such as in a cram-down case under Section 1129(b)." *Id.* (citing Trost, *Business Reorganizations Under Chapter 11 of the New Bankruptcy Code*, 34 BUSINESS LAWYER 1309 (April 1979)).

The debtor is a Tennessee limited partnership formed for the purpose of owning, constructing and operating Crosscreek Apartments, a 280-unit apartment complex built in 1985 and located on 25.83 acres of land in Kingsport, Tennessee. Condor asserts a first deed of trust on the complex which lien originated with First American National Bank of Knoxville, Tennessee, and was subsequently assigned to the Department of Housing and Urban Development (HUD) who sold and assigned its interest to Condor in 1995.

This chapter ll case was initiated by the filing of voluntary petition for relief by the debtor on February 1, 1996. Since the filing, the debtor has continued operating the apartment complex as a debtor in possession under 11 U.S.C. §§ 1107(a) and 1108. No trustee or committee of unsecured creditors has been appointed.

As of the debtor’s bankruptcy filing, Condor was owed approximately $10,800,000.00 by the debtor. Condor asserts, and so provides in its disclosure statement, that the apartment complex, which consists of the real property and its improvements, has a value of between 8.86 million and 9.5 million dollars. This valuation is based upon an appraisal of the property performed on July 12, 1996, on behalf of Condor by David W. Harris, MAI, a certified real estate appraiser, which

concluded the value of the apartment complex was $9,500,000.00, and the appraisal of Michael E. Green, MAI, CCIM, a certified real estate appraiser retained by the debtor with court approval, which determined that the apartment complex had a value of $8,860,000.00 as of June 26, 1996. On the other side, the Partners claim that the apartment complex's value is $7,600,000.00 based upon an appraisal prepared on their behalf by Richard E. Wallace, MAI, SRA, as of August 30, 1996.[4] All three appraisers testified at the December 20 hearing and their written appraisal reports were introduced into evidence along with the debtor's 1995 financial statements and November 1996 monthly operating report. In conducting their appraisals, the experts had access to the debtor's 1993-1995 financial statements and those for the first six months of 1996. Walter F. Trent, the managing general partner of the debtor, also

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[4]It is not surprising that Condor is seeking a high valuation and the Partners a lower one at this stage of the reorganization. Under the Bankruptcy Code, a high valuation of collateral at the time of confirmation of a plan (i) increases the amount of deferred payments required to cramdown a secured creditor's claim; (ii) may assure the creditor's entitlement to the full amount of interest which has accrued on the debt postpetition; and (iii) may also assure that the creditor's claim for fees and expenses is also secured. *See* 11 U.S.C. § 506(b). Conversely, a debtor (or as in this case the general partners of the debtor) will seek at confirmation a low valuation to reduce its burden under the plan and provide a greater opportunity for cramdown. *See* Richard A. Gitlin & H. Talmage Day, Jr., *Valuation Considerations in the Single Asset Chapter 11*, 310 PLI/REAL 481, 536 (May 1, 1988).

testified briefly at the hearing.

All three experts testified as to the “market value” of the apartments, which they all defined as “the 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 effected by undue stimulus.” Similarly, all three appraisers used the same three recognized approaches to valuation: cost, market or direct sales comparison, and income. An explanation of each is succinctly set forth on page 33 of Mr. Wallace’s report, which as paraphrased provides:

> In the cost approach, the indication of value is derived by estimating the value of the land based on sales of similar land, and adding to this value the replacement costs of improvement less depreciation.
>
> The market or direct sales comparison approach develops a value estimate by comparing the subject property with properties that are similar in nature which have recently sold or which are listed for sale in the open market under competitive conditions.
>
> In the income approach, the value of the property is indicated by the capitalization of an anticipated net rental income stream over a specified period of time. Four steps are required: (1) Gross Income is estimated; (2) Expenses are deducted to estimate net income; (3) A capitalization rate is selected; and (4) The net income estimate is capitalized into an indication of value by multiplying the net income by the selected capitalization rate.

II.

Michael E. Green testified that he is an MAI appraiser, which means that he is a member of the Appraisal Institute, that he is a CCIM, which stands for certified commercial investment member, and that he is a realtor and member of the Johnson City Board of Realtors. He further stated that he is a certified general appraiser in Tennessee, Virginia, and North Carolina and holds broker's licenses in Tennessee and North Carolina. With respect to his educational background and work experience, Mr. Green testified that he holds a bachelor of business administration degree with a finance major from the University of Iowa, that he worked for a MAI in Asheville, North Carolina for three and one-half years and an MAI in Auburn, Alabama for about three and one-half years, and that four years ago, he started his own firm in Johnson City, Tennessee. Eighty to ninety percent of Mr. Green's work is commercial in nature (he typically performs fifty commercial appraisals per year), and he has appraised approximately forty apartment complexes within the past three years.

Mr. Green testified that generally speaking, the apartment market in the Tri-Cities area has fairly low vacancy rates at this time — vacancies have been stable, rents are generally increasing modestly, and although each market has its own

individual nuances, it is a pretty stable, strong market. He stated that over the last three years, the apartment complex market has gotten stronger in general, values are trending upward, and cap rates are trending downward, making a positive impact on value. Mr. Green opined that regionally, the market is stronger than in the early 1990's because financing is more readily available and there is less instability. Mr. Green testified that he visited the Crosscreek Apartments complex twice in conducting his appraisal. He inspected the exterior of all buildings, looked at a representative sampling of the interior units, and examined the audited financial statements of the complex for the past three years, along with six months' income and expenses for the current year. He also personally visited all comparable properties utilized in his appraisal. Mr. Green noted that Crosscreek Apartments complex's tax appraised value is $8,348,000.00 and that in his experience, county appraisals are typically low. From his examination of the tax records, he did not find any evidence that the debtor is seeking to lower the complex's appraised value.

Mr. Green stated that the Crosscreek Apartments complex was one of the nicest in the Tri-Cities area and that if the market were divided into thirds, it would fall in the lower portion of the top third in terms of quality. From what he could

determine, the property had been very well maintained and he did not detect any significant deferred maintenance problems.

Mr. Green briefly discussed his execution of the three methods of valuation. The first step in the cost approach is to determine the value of the 25.83 acres of land on which the apartments are situated. Mr. Green testified that he believed that he had found relatively good recent land sales to compare to the subject property although more would have been desirable. Even though there had not been many multiple-family housing sales in Kingsport within the past few years, Mr. Green stated that he was able to utilize sales that were most similar in terms of highest and best use, staying within the Kingsport city limits to do so. To determine the cost of the improvements new, Mr. Green used cost data provided by the Marshall Valuation Service, a national cost service indexed to the Kingsport market, corroborating those costs with ongoing discussions with local builders and developers and arriving at a cost of $38.12 per square foot. He then depreciated the improvements separately by breaking them down into long and short-lived items, recognizing that some items wear out more quickly than others. He noted that the impact of a higher age would indicate higher depreciation and thus a lower present value. The actual age of the apartments is eleven years and Mr. Green used an

effective age of eleven years. In his opinion, a higher effective age would not be appropriate given the property's high level of maintenance and its excellent condition. He testified that he could understand using an effective age slightly lower than the subject's actual age, but did not do so because some of the components were starting to show some age. Mr. Green concluded that under the cost approach the complex had a value of $9,310,000.00.

With respect to the market or sales comparison approach, Mr. Green testified that it was extremely important to use as recent sales as possible in this changing environment and that there was no compelling reason in this case to use any sales over two to three years old because there had been recent sales that would give good indications of value. Mr. Green stated that for his comparables, he chose sales chiefly from the Tri-Cities area, adjusting the properties for their net operating income per unit as compared to the subject's net operating income per unit, noting that this one adjustment inherently accounts for differences in condition, age, construction quality, amenities and location. Based on these adjusted sales of comparable properties, he concluded that the value of the complex under the sales comparison approach was 8.8 million dollars.

To apply the income approach to value, Mr. Green compared

the subject complex's rental structure with others in the area to determine whether the rentals received by Crosscreek Apartments approximated the current market rate. Concluding that the complex's rates were very close to market, he used the market rates to determine potential gross rental income, deducting from this amount free employee units and an 8% vacancy and collection loss. He then added miscellaneous income to arrive at effective gross income and subtracted from this amount his estimate of stabilized operating expenses, with the difference constituting net operating income (NOI) which under his calculations was $885,754.00. This NOI figure was divided by a 10% capitalization rate to determine present value. Mr. Green noted that his NOI conclusion was less than the debtor's actual net operating income for 1995 ($913,941.00), but explained that his estimate was a "snapshot" of a typical year, his best estimate of what the NOI would average over ten to twelve years which is the typical holding period for an investor. He testified that he arrived at the 10% cap rate by using five various methods, the best three of which supported a cap rate between 9.6 and 10.15%. Mr. Green noted that the cap rates had been trending downward over the last two or three years, and that, in fact, one of the comparables he utilized to determine a cap rate had been resold for a cap rate of about

9½%. He saw no justification for using a cap rate greater than 10.1% and observed that changes in the cap rate produced a sizable effect on value such that a one-half percentage point change would produce a one-half million dollar difference in value.

Mr. Green then reconciled the three approaches to value, rating the income approach as the most reliable indicator because it most directly reflected a property's income-generating abilities, the principal criteria utilized by investors when they purchase investment property. He testified that the cost approach was the least reliable indicator given the subject's age. Using the sales comparison approach to corroborate the value obtained under the income approach, Mr. Green concluded that Crosscreek Apartments complex had a market value of 8.86 million dollars.

Mr. Green indicated that his initial report placed the value at 9.14 million dollars, but that after a telephone conference call with Fred Leonard, counsel for the debtor, Walter Trent, the managing general partner of the debtor, and others, he increased rental reserves for the apartments from $150.00 to $250.00 per unit per year thus producing his present estimate of 8.86 million. He testified that he believed that this adjustment was appropriate and his estimate accurate, although

he noted that appraisal is an art not a science.

On cross examination, Mr. Green admitted that in computing the value under the sales comparison approach, it was necessary for him to utilize the NOI he determined under the income approach and that therefore it was not surprising that the results under the two approaches were pretty much the same. He also agreed that the effective gross income amount he estimated under the income approach was more than the property's actual effective gross income for the past three years ($200,000.00 more than 1994, $50,000.00 higher than 1993) and greater than the first six months of 1996 annualized. He admitted that the miscellaneous income figure he estimated ($69,274.00) was higher than any received by the complex except for the first six months of 1996 annualized ($72,723.00), but noted that his amount was only slightly higher than 1995's miscellaneous income ($68,179.00) and that his estimate represented 4% of potential gross income, the same as in 1995. Mr. Green observed that there was an upward trend in this percentage—miscellaneous income was 2.6% in 1994 and 1.4% in 1993. He testified that the miscellaneous income figure consisted of income derived from laundry and vending, forfeited tenant deposits, and furniture rental from the corporate units. He further testified that his estimate of operating expenses was 46.3% of effective gross

income, including replacement reserves of 4.2%, and that the actual expenses for the property was 46% in 1993, 43.7% in 1994 and 44% in 1995, although these figures included no replacement reserve. Mr. Green stated that he did not use the discounted cash flow method to estimate value under the income approach because this method is appropriate for property with either changing income or changing expenses unlike the subject property which is operating at a stabilized status. He agreed that Eastman Chemical Company dominated Kingsport's labor force but saw no justification for using a slightly higher cap rate to account for this fact because the comparables he used to determine the cap rate were from Johnson City primarily and if Eastman has problems, the entire region, rather than Kingsport alone, will be affected. Finally, Mr. Green was questioned on cross examination regarding his opinion in general of the work of the other experts testifying in this case. Reluctantly, he stated that he did not have an high opinion of Mr. Harris' work, but opined that Richard Wallace does a good job.

On redirect, Mr. Green compared the subject property's net rental income amount and miscellaneous income for the first eleven months of 1996 annualized ($1,662,463.000 and $83,296.00 respectively) to his estimates of effective gross income and miscellaneous income ($1,650,422.00 and $69,274.00), noting that

the annualized figures are higher than his estimates and therefore strongly supportive of his amounts.

III.

David W. Harris, the appraiser retained by Condor, testified on Condor's behalf. He stated that his office is in Kingsport, Tennessee, that he is an MAI and a non-practicing broker, that he holds a masters degree in economics, and has 31 years of appraisal experience. Mr. Harris noted that 90% of his assignments are of commercial properties, he averages about 100 appraisals a year, and over the last three years, he has appraised 20 or maybe 30 apartment complexes per year. He testified that the apartment complex market in the Tri-Cities area is pretty strong right now, that the market is stable and a bit healthier than the early 1990's, and that there have been increases in rental rates and in values. He noted that Eastman Chemical Company has a very strong impact on the apartment complex market in this area, but saw no adverse effect in the foreseeable future.

With respect to his appraisal of the Crosscreek Apartments complex, Mr. Harris stated that his basic methodology in determining value did not significantly differ from that of Mr. Green or Mr. Wallace. He noted that he had visited the subject

property four to six times, talked with site management, measured the buildings, made interior inspections and reviewed the past three years of financial information and the 1996 monthly operating reports. He opined that the subject property has a value of $9,500,000.00, that it is definitely above average in comparison with other complexes in the Tri-Cities area and has been very well maintained. He detected no significant deferred maintenance problems and stated that he had personally visited all comparables utilized in his valuations.

To determine the value of the subject land under the cost approach, Mr. Harris considered four vacant land sales in the Kingsport area, two of which were fairly recent. Based primarily on the most recent sale of very comparable property (adjacent to a large apartment complex, has been improved for multifamily housing since its sale, and similar topography) which sold at a price of $21,968.00 per acre in March of 1996, he valued the land at $22,000.00 per acre. To ascertain the construction costs of the improvements, Mr. Harris testified that he checked with several different cost sources, primarily local contractors, and arrived at an overall cost of about $50.00 per square foot. He used an effective age of ten years for his depreciation due to the fact that the apartments have been well maintained and stated that he did not see any basis

for using an effective age higher than the actual age.

In his application of the market or sales comparison approach to value, Mr. Harris found only one recent large apartment sale in Kingsport, the sale of the Cabana Apartments in 1996. He supplemented this sale with apartment sales from other areas, primarily Chattanooga and Knoxville, all of which occurred within the last two or three years. He then used three units of comparison: the price per apartment unit, a value indicated by the gross income multiplier, and a value derived by dividing a capitalization rate into net income, reaching an ultimate conclusion under the market approach of 8.4 million dollars.

Under the income approach, Mr. Harris concluded, like Mr. Green, that the rents charged by Crosscreek Apartments complex were about at market value, although rather than the 8% vacancy and collection loss rate used by Mr. Green, Mr. Harris used 10%. He noted that this was somewhat higher than historically but anticipated more competition soon which would increase vacancy rates. Mr. Harris' determination of value under the income approach was based on both the capitalization method and a discounted cash flow analysis, with Mr. Harris' observation that the capitalization method is like a snap-shot in time as of a given date, while the discounted cash flow analysis requires a

forecast of future net income. In the capitalization method, Mr. Harris used two means to determine the appropriate cap rate. The first was an extraction of market sales which indicated a cap rate of 10% and the second was the application of a mathematical formula which utilized current financial data and produced a range of 9 to 10%. The difference in the two results, explained Mr. Harris, may be due to the fact that the market sales occurred up to a couple of years ago when cap rates were higher while the mathematical formula was based on current information, noting that over the past few years the general trend has been a slight decreasing of cap rates, resulting in a higher indication of value. Applying a 10% cap rate, Mr. Harris concluded that under the capitalization approach, Crosscreek Apartments complex has a value of $9,035,000.00.

The discounted cash flow analysis required Mr. Harris to estimate the anticipated rent for the next five years factored by an appropriate growth rate. Using a growth rate of 1% a year which he believed was a reasonable estimate of growth, Mr. Harris calculated a value of $9,580,000.00. To reconcile the two methods, he gave more weight to the discounted cash flow analysis which he stated was the best indicator of value, thus arriving at his final conclusion under the income approach of 9.5 million dollars. Thereupon, he reconciled the values

obtained under all three of the basic approaches, concluding based primarily on the income approach that Crosscreek Apartments complex has a value of 9.5 million dollars.

On cross examination, Mr. Harris admitted that within the past year or two, a couple of complaints had been filed against him with the Tennessee Appraisal Board although no disciplinary action had ever been taken, and that there was a complaint approximately twenty years ago. He agreed that his conclusion of $30,000.00 per apartment unit under the market approach was greater than any of his comparables, explaining that Crosscreek Apartments complex is in a better condition than any of the properties sold. In response to questioning from counsel for the Partners, Mr. Harris testified that he used the complex's current rental rate to compute gross potential income without regard to whether the complex was actually receiving these rates, information which he did not know. He admitted that this information would be relevant if there was a substantial difference in the two amounts and if the complex had any long-term leases, but believed that the complex had no rental contracts that exceeded one year. With respect to his estimation of effective gross income, Mr. Harris conceded that his amount was greater than the complex's actual effective gross income over the last three years, but noted that his estimate

was .6% under what the complex would probably receive in 1996 based on the numbers for the year thus far. Mr. Harris noted that his original estimate of miscellaneous income was $133,000.00, but that he had reduced the figure to $60,000.00 after concluding from talking with on-site management that he had improperly included certain items in this category which did not belong. Despite this reduction, Mr. Harris stated that he was still not satisfied with his estimate of miscellaneous income because he was not completely clear as to what types of income this estimate was designed to include or how Crosscreek Apartments had historically treated this category. Mr. Harris explained that his operating expenses estimate, 45.32% of effective gross income, was based on the complex's audited financial statements and data from other typical properties, and included reserves of $178.00 per unit.

IV.

Richard E. Wallace, a Knoxville real estate appraiser and graduate of East Tennessee State University, testified on behalf of the Partners, noting that he obtained his SIA designation in 1974 and his MIA designation in 1984. Mr. Wallace stated that 75% of his work was in the commercial real estate market and that he performed approximately 100 to 120 appraisals per year.

Observing that counties usually use a cost basis for their appraisals, Mr. Wallace stated that Crosscreek Apartments complex's tax appraised value was $8,474,500.00, with annual taxes of approximately $182,000.00. Like the other two experts, Mr. Wallace used the same three approaches to value, but concluded that Crosscreek Apartments complex has a value of $7,600,000.00, almost two million less than Mr. Harris' valuation and 1.26 million less than Mr. Green's valuation.

To determine the current construction cost of the complex, Mr. Wallace used the Marshall Valuation Service, which he explained was a nationally known cost estimation source, updated quarterly, and well accepted across the country as an authority on commercial building costs. He deducted from this cost 30% for depreciation, which represented an effective age of fifteen years, and added a land value of $515,000.00, concluding that based on the cost approach Crosscreek Apartments complex has a value of $8,485,000.00.

With respect to the market approach, Mr. Wallace testified that he gathered information regarding sales of apartment complexes in the East Tennessee area, and using units of comparison (sales price per unit and per square foot and the gross income method), adjusted by differences in net income per unit, arrived at a value of 7.5 million dollars, concluding that

the apartments have a unit value of $26,800.00 and a square foot value of $30.00. It was noted that the sales utilized by Mr. Wallace in this approach were of properties in Knoxville and Chattanooga rather than Kingsport and Mr. Wallace testified that he did not recall if there were any sales of comparable property in Kingsport. He explained that the comparables used by him were chosen because they had been appraised by his office and thus, he had all the operating data regarding these properties, noting that complete information is necessary for a proper comparison. Mr. Wallace acknowledged that he was familiar with the Cabana Apartments in Kingsport and was aware that they had been sold, but stated that he was not able to verify all the information needed in order to use this sale as one of his market comparables. He observed that the Cabana complex, which had sold at about $15,000.00 per unit, was inferior to the Crosscreek Apartments complex.

The income approach, according to Mr. Wallace, was the most useful in determining the overall value of property because the income that will be produced is what investors are most particularly interested in. The first step in applying this approach is to estimate gross potential income by determining what the apartments should rent for in the open market based on other rentals in the area as well as the subject property.

Because in his estimation there were few true comparables to Crosscreek Apartments in the Tri-Cities area, Mr. Wallace's primary emphasis was the actual income of the complex and its operating history. Like the other two appraisers, Mr. Wallace concluded that the rent presently being collected by Crosscreek Apartments was in line with the market and that management was doing a good job on maintenance and upkeep. Using the rent roll data as of June 26, 1996, which indicated an average rental rate of $455.00 for one bedroom units and $540.00 for two bedroom units, Mr. Wallace projected gross potential income, deducted from this amount an 8% vacancy and credit loss deduction, and added miscellaneous income of 1.5% to arrive at effective gross income, noting that over the last three years, miscellaneous income had ranged from 1.2% to 1.4% of effective gross income. He explained that the miscellaneous income figure on the 1995 income statement included a waived service charge of $84,865.00 which was simply an accounting entry rather than actual cash income and therefore should not be included in a projection of future income. From the effective gross income, Mr. Wallace deduced replacement reserves of $250.00 per unit annually ($70,000.00) and 46% for operating expenses, producing a net operating income of $793,481.00. He noted that it was a common practice in the appraisal of an apartment complex to put in a

reserve for replacement of items such as roofs, appliances, carpeting, *etc.,* although such reserves were not usually included on income statements. Based on the comparable sales utilized by him in the market approach which had capitalization rates ranging from 9.5% to 11.5% with an average of 10.6%, Mr. Wallace used a 10.5% cap rate, observing that a slight increase in cap rate might be appropriate in Kingsport due to the additional risk imposed by the fact that the Kingsport economy is dependent to a great extent on one industry, Eastman Chemical Company.

Mr. Wallace also estimated income utilizing the discounted cash flow analysis, although he noted that he did not place much reliance on this method in arriving at his ultimate determination of value because the discounted cash flow involves a ten-year projection which is more speculative and requires numerous assumptions. Mr. Wallace then reconciled the three approaches to value, giving primary consideration to the income approach and rejecting the cost approach as not particularly relevant in the appraisal of an older apartment complex. He ultimately reached the conclusion that Crosscreek Apartments complex has a value of $7,600,000.00. Like Mr. Green, Mr. Wallace was questioned regarding his opinion in general of the work of the other two experts in the case. Mr. Wallace

responded that he did not hold the work of David Harris in high esteem, but that Michael Green was a “good appraiser, a qualified appraiser.”

It was brought out on cross examination of Mr. Wallace that his office is in Knoxville, rather than the Tri-Cities, that less than five percent of his business, on a volume basis, involves appraisals of apartment complexes, and that he previously appraised Crosscreek Apartments on behalf of HUD in 1992 at a value of 7.5 million dollars. Mr. Wallace agreed that the subject property is one of the two best apartment complexes in Kingsport, that the property has been extremely well maintained, and that there were no deferred maintenance needs that justified a reduction in value, although the property was getting to the age where replacements will be necessary. He described the current Tri-Cities market which has a 91% occupancy as “pretty good” rather than “strong” and noted that there had been improvement in the market throughout East Tennessee over the last several years. When asked if cap rates were lower than they were in the early 1990’s, Mr. Wallace responded that you would expect them to be somewhat lower since interest rates have softened but that fluctuates.

In response to the observation that the vacant land sales used by Mr. Wallace to determine value under the cost approach

occurred in 1988, 1989, and 1991 rather than more recently, Mr. Wallace explained that he had been unable to find any comparable land sales for the past five years although he acknowledged he did not find the March 1996 land sale adjoining Cabana Apartments used by Mr. Harris. Mr. Wallace admitted that he had used the land sales referenced in his 1992 appraisal of the apartments to determine land value in the current appraisal, dropping the two oldest sales which occurred in 1984.

With regard to his application of the market approach, it was reiterated on the cross examination of Mr. Wallace that none of his comparables were from the Tri-Cities area and none had occurred in 1996, with only one of the six taking place in 1995 and two of the six going back to 1993. Mr. Wallace admitted that one of his listed comparables sold at a rate of $15,000.00 per unit, the same as the sale of Cabana Apartments in Kingsport and that therefore it would have been a similar comparable, but repeated his earlier statement that he had not used the Cabana sale because he did not have all the necessary information. He could not explain, however, why the other two appraisers were able to obtain this information and he could not.

Regarding his utilization of the income approach, Mr. Wallace acknowledged that his projection of effective gross income was less than the complex’s actual income for 1995, even

excluding miscellaneous income which had been artificially high in 1995 due to the $84,000.00 accounting entry, and more than $60,000.00 less than the first eleven months of 1996 annualized. In response to cross examination by Condor's counsel who suggested that Mr. Wallace's projection of income should be increased based on the 1996 income annualized, Mr. Wallace refused to adjust his valuation without specifically evaluating the information contained in the November and year-to-date operating reports and without the entire year's figures, noting that in some businesses there are a lot more expenses at the end of the year although he did not know if this were true of Crosscreek Apartments. He stated, however, that if actual net income for the entire 1996 year was $50,000.00 more than he had projected, the value of the property should be increased in accordance with that amount.

In response to questioning regarding his choice of a 10.5% cap rate, Mr. Wallace acknowledged that his determination of the appropriate capitalization rate was derived from his market comparables which in some cases go back to 1993, but opined that the range of 9.5% to 11.5% from these comparables had been true for the last five years and was true today. Mr. Wallace agreed that his current valuation of 7.6 million dollars is only $50,000.00 greater than the 7.55 million dollars value he

reached in 1992. Mr. Wallace attributed this minimal increase in value, despite an improving economy in the interim and a well maintained property, to the fact that the income of the complex has only increased slightly during this time.

Walter Trent, the general managing partner of the debtor, also testified, noting that the expenses set forth in the 1995 financial statement did not include replacement reserves and that if reserves of $250.00 per unit were added, the net operating income for 1995 would be $801,000.00. He also observed that the escrow for taxes shown in the 1996 monthly operating reports was $20,000.00 less for the year than it should be and that the actual taxes for 1996 would be around $180,000.00. It was his observation that the expenses for 1996 would be greater if the debtor were operating outside of bankruptcy as the debtor was economizing wherever it could, although he admitted that all necessary repairs had been made and that there had been no requests to Condor under the cash collateral agreement for any extraordinary expenditures. Mr. Trent testified that the debtor had not challenged the tax appraisal for the property even though it was believed to be too high because the appraisal was based on replacement cost rather than the income approach and therefore any challenge would be fruitless.

V.

The issue of valuation of Crosscreek Apartments complex presents a battle between experts. The court, having no specialized or superior knowledge as to the proper valuation of the complex, nonetheless must evaluate the experts' determinations of value. All three appraisers in this case are experienced, have similar qualifications and used the same three uniformly recognized approaches to value, while obtaining different results. Accordingly, this court's decision must be based on an determination of whether the appraisers' conclusions are substantiated by the facts and ultimately their credibility.

The court does not find that the appraisal performed by David Harris is the best estimation of the value of the debtor. Although Mr. Harris is unquestionably an experienced appraiser, he at times during his testimony appeared unsure of the factual basis for his conclusions and his written report did not always set forth the data on which he relied for his conclusions. In determining the replacement costs of the improvements, Mr. Harris indicated in his report that he had used his own personal construction experience supplemented by data obtained from other sources such as cost manuals and consultation with "other contractors" to arrive at his estimation of reproduction costs.

No evidence was presented as to what, if any, construction experience is possessed by Mr. Harris. The court believes that the more appropriate source for cost estimation is the Marshall Valuation Service used by both Mr. Wallace and Mr. Green and noted by both to be a nationally accepted authority for construction costs. Subjective determinations like that of Mr. Harris are always susceptible to criticism and doubt and while it is certainly advisable to verify the data derived from the Marshall Service by the appraiser's own experience and knowledge and consultation with local contractors, these should be supplemental rather than primary sources in the manner utilized in the appraisals of Mr. Wallace and Mr. Green.

In his application of the income approach, Mr. Harris was not aware of the rent actually received by Crosscreek Apartments, only the rental rates currently charged by the complex which did not take into account any long-term leases in place. Also, Mr. Harris was admittedly confused as to the make-up of the miscellaneous income category as referenced in the debtor's financial statements and could not explain the basis for his estimation of $60,000.00. In his final determination of value, Mr. Harris gave primary emphasis to his discounted cash flow analysis as opposed to the capitalization method, while Mr. Wallace gave less weight to the discounted cash flow analysis

finding it to be more speculative and Mr. Green did not use it at all, stating that this type of analysis was more appropriate for properties with changing cash flows unlike the debtor which generally has a stabilized operating status. The court finds Mr. Wallace's and Mr. Green's approach in this regard to be the more logical. Furthermore, the court finds that replacement reserves of $250.00 per unit are more appropriate than the $178.00 amount used by Mr. Harris, due to the fact that some aspects of the apartments, such as heating and air-conditioning, appliances, *etc*., are nearing the end of their useful life.

Finally, the substantial differences between Mr. Harris' estimations of income, expenses and resulting net operating income and the actual income, expenses and NOI of the debtor belie the accuracy of Mr. Harris's conclusions. His estimation of effective gross income is higher than any of the debtor's actual EGI for the years 1993-1995 and his NOI estimate of $903,368.00 (adjusted by his replacement reserves of $50,000.00 since the debtor's actual NOI as shown on its financial statements reflects no reserve) is almost $40,000.00 greater than the highest NOI earned by the debtor in the years 1993 to 1995 and more than $85,000.00 greater the average of debtor's actual NOI for these years ($867,935.00).

From their testimonies at the hearing and their written

appraisal reports, it was evident to the court that both Michael E. Green and Richard E. Wallace are knowledgeable, well-qualified and experienced real estate appraisers. But, as to be expected, each appraisal had its own particular strengths and weaknesses. The written appraisal report of Wallace & Associates was the best in many respects. It was straight-forward, the easiest of all three reports to follow and comprehend and for the most part, provided the bases for the conclusions reached by Mr. Wallace. It did not appear to the court, however, that Mr. Wallace was as thorough in gathering data for his appraisal as he could have been and should have been. In applying the cost method to determine the value of the land on which the complex is situated, Mr. Wallace apparently made no effort to obtain recent comparables, relying instead on the most recent sales listed in his 1992 appraisal of the complex, which by the time of the present appraisal were several years old (one in 1988, one in 1989, and the other in 1991). Even these sales were not particularly comparable to the subject land. Two of the three properties were purchased for a residential subdivision and had values of $10,000.00 per acre with the third selling for $17,614.00 per acre, values substantially lower than Mr. Wallace's conclusion of $20,000.00 per acre for the subject property. No basis for this amount was offered other than the

statement that the appraiser had researched sales of apartment land in other markets and that land suitable for apartment use generally sells at a higher price per acre than the typical residential land. Mr. Wallace did note, to his credit, that sales data to support his valuation was extremely limited. The comparables utilized by Mr. Green and Mr. Harris were better, with Mr. Harris' being the best since he found a sale within six months of his appraisal of property adjoining an apartment complex which sold at $21,968.00 per acre, almost exactly Mr. Harris' estimate of $22,000.00 per acre.

Nor does it appear that Mr. Wallace obtained the best selection of recent sales of similar properties for the market approach to value. Three of the properties were in Knoxville and three were in Chattanooga, more than 200 miles from the subject area. Furthermore, with one exception, all of the sales were more than two years old. Mr. Wallace admitted on cross examination that the sale of the Cabana Apartments in Kingsport in March of 1996 was comparable to one of the properties considered by him, although inferior to Crosscreek Apartments complex, but blamed his failure to include this sale on his inability to obtain the requisite data, even though the other appraisers were able to access this information. It would appear to the court that sale data on an apartment complex in

Kingsport where the subject property is located, occurring within the past six months, would be particularly relevant and worth additional effort to obtain, notwithstanding that other complex's inferior condition. Mr. Wallace's failure to obtain and consider the Cabana Apartments sale casts doubts on the thoroughness of his efforts.

Mr. Green, on the other hand, clearly conducted a thorough appraisal, personally visiting and evaluating all of the comparable properties utilized by him in his evaluation, including those used to estimate land value. His appraisal report properly set forth the foundations for his conclusions although at times his adjustments and calculations were difficult to follow. Both he and Mr. Wallace used the Marshall Valuation Service to determine the replacement cost of the improvements, which from their statements was the appropriate means to determine construction cost, and the court believes that Mr. Green was correct in depreciating the improvements based on their actual and economic life of eleven years, rather than the fifteen years utilized by Mr. Wallace. Both Mr. Green and Mr. Harris saw no reason for using an effective life greater than eleven years and, in light of the consensus of all three appraisers that the complex was in above-average condition and had been very maintained, the court agrees.

With respect to his application of the sales comparison approach, Mr. Green was diligent in finding apartment sales occurring within the last three years in the Tri-Cities area, unlike the other two appraisers who relied primarily on sales in Knoxville and Chattanooga for their comparables. Furthermore Mr. Green's and Mr. Wallace's adjustments to the comparables based on their net operating income per unit, which they cited as the best indicator of value, makes good sense.

Overall, the work of both was commendable, with the court finding Mr. Green the most thorough of the two, and Mr. Wallace the most experienced, although the court perceived a certain bias in favor of the debtor by Mr. Wallace and an effort by him to estimate a lower, even though defendable, value. The critical difference between the appraisals of Mr. Green and Mr. Wallace were their conclusions derived from the income approach since both placed primary reliance on this approach for their ultimate determinations of value. Consistent with his thoroughness in the other approaches, Mr. Green went to great lengths in his application of the income approach to value to determine whether the Crosscreek Apartments complex's rental income was consistent with the market area. Mr. Green's estimations of income and expenses, however, were not supported by the complex's actual financials—his income figure was too

high and his expenses, excluding replacement reserves, too low. As he admitted on cross examination, Mr. Green's estimation of effective gross income ($1,650,422.00) was higher than any of the years for which financial information was presented (1993-1995), and higher than the first eleven months of 1996 annualized. Because Mr. Green's estimate was meant to represent the current market rates (which all agree is in line with the complex's actual current rentals) less a vacancy rate of 8%, it is unclear how his estimate can be higher than 1996's actual income which has a vacancy of only 7.3%. In light of the complex's lower historical income figures, the court does not find Mr. Green's estimation of effective gross income to be plausible.

Mr. Green's projection of expenses at 46.3% of effective gross income, which includes replacement reserves of 4.2%, is also out of line with the complex's actual expenses for 1993-1995. As Mr. Green testified, Crosscreek Apartments complex's expenses for the years 1993, 1994, and 1995, without any inclusion for replacement reserves, represent 46%, 43.7%, and 44%, respectively, of effective gross income for those years, an average of 44.57%. Yet Mr. Green estimated expenses of only 42.1%, excluding his reserves.

Finally, Mr. Green's bottom line, his net operating income

estimate of $885,754.00, is greater than the complex's actual NOI for any year, once actual NOI for each year is reduced by replacement reserves of $70,000.00 (so that "apples" can be compared with "apples" because no reserves are included in the financial statements). The adjusted NOI for 1993 is $795,137.00, for 1994 it is $754,727.00 and the adjusted NOI for 1995 is $843,941.00, a range of more than $40,000.00 to more than $130,000.00 less than Mr. Green's estimation.

Like that of Mr. Green, Mr. Wallace's projection of income is not supported by either the complex's historical or current actual income. As he acknowledged on cross examination, Mr. Wallace's projection of effective gross income ($1,599,039.00) is substantially less than the complex's reconstructed EGI for 1995 ($1,643,882.00), less than 1993's reconstructed EGI ($1,615,088.00) and less than 1996's income annualized based on the first eleven months of operations. Mr. Wallace's net operating income estimate of $793,481.00 (adjusted to $863,481.00 to add back in the replacement reserves) is less than the net operating income for three out of the four years in question (1993-1996 annualized), with the trend to be of increasing income rather than decreasing. Accordingly, the proper projection of net operating income is apparently somewhere in between that of Mr. Green's and Mr. Wallace's.

With respect to the appropriate capitalization rate, Mr. Green and Mr. Harris testified that 10% was appropriate, while Mr. Wallace selected 10.5%. Mr. Green's analysis of the issue was the most extensive: he used five various methods to make his determination, concluding that based on the best three, a range of 9.6% to 10.15% was indicated. Furthermore, the market extraction method utilized by him, which he indicated was the most reliable method, was based on his market comparables, all of which were in the Tri-Cities area. The appropriateness of Mr. Wallace's choice is called into doubt by the fact that it is based on sales more than two years old and outside the Tri-Cities area, despite his assertion that the range of 9.5% to 11.5% on which he based his conclusion has been true for the past five years and is true today. Both Mr. Green and Mr. Harris indicated that cap rates are trending downward, with Mr. Green noting that one of his sale comparables had resold since the date of his appraisal at a cap rate of 9½%. The court finds that a cap rate of 10% is best supported by the evidence.

In summary, while giving primary weight to the income approaches by Mr. Green and Mr. Wallace, including replacement reserves of $250.00 per unit annually, and a capitalization rate of 10%, the court concludes that Crosscreek Apartments complex has a value of 8.2 million dollars. An order to this effect and

sustaining both objections by Condor and the Partners to each other's disclosure statement based upon lack of adequate information in the valuation of the Crosscreek Apartments complex will be entered contemporaneously with the entry of this memorandum opinion.

ENTER: January 17, 1997

BY THE COURT

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MARCIA PHILLIPS PARSONS
UNITED STATES BANKRUPTCY JUDGE