

Guide Note 11

Comparable Selection in a Declining Market



Introduction

A declining market is generally characterized by few transactions and falling values. Declining markets present valuation challenges because there are fewer transactions available to analyze as comparables (“comps”) in the sales comparison approach or to support an estimate of external obsolescence in the cost approach. In a declining market, transactions

used in an appraisal assignment require adjustments for changes in market conditions, but such adjustments are difficult to support without current transactions. Also, transactions that do occur often do so under conditions that do not align with the conditions of the value definition applicable to the assignment.

GUIDE NOTE 11

Basis for Proper Evaluation

Standards Rule 1-4 states, “In developing a real property appraisal, an appraiser must collect, verify, and analyze all information necessary for credible assignment results.”

Standards Rule 1-4 (a) goes on to state: “When a sales comparison approach is necessary for credible assignment results, an appraiser must analyze such comparable sales data as are available to indicate a value conclusion.”

Characteristics of “Market Value”

“Market value” is the focus of many appraisal assignments. There are many different definitions of “market value” in use, but all exhibit common characteristics. The entry for “market value” in the Definitions section of the Uniform Standards of Professional Appraisal Practice (USPAP), 2010 - 2011 Edition, addresses these common characteristics:

MARKET VALUE: 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 of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal.

Comment: Forming an opinion of market value is the purpose of many real property appraisal assignments, particularly when the client’s intended use includes more than one intended user. The conditions included in market value definitions establish market perspectives for development of the opinion. These conditions may vary from definition to definition but generally fall into three categories:

1. the relationship, knowledge, and motivation of the parties (i.e., seller and buyer);
2. the terms of sale (e.g., cash, cash equivalent, or other terms); and
3. the conditions of sale (e.g., exposure in a competitive market for a reasonable time prior to sale).

The Appraisal Institute’s *The Dictionary of Real Estate Appraisal*, 5th Edition, includes the following in its entry for “market value”:

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

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

The *Dictionary* goes on to cite the definition of “market value” used by agencies that regulate federally insured financial institutions in the United States:

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 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:

- Buyer and seller are typically motivated;
- Both parties are well informed or well advised, and acting in what they consider their best interests;
- A reasonable time is allowed for exposure in the open market;
- Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
- The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

(12 C.F.R. Part 34.42(g); 55 Federal Register 34696, August 24, 1990, as amended at 57 Federal Register 12202, April 9, 1992; 59 Federal Register 29499, June 7, 1994)

The International Valuation Standards include the following definition of “market value”:

The estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.

(International Valuation Standards, Eighth Edition.)

It is important to observe that the following elements are common to each of the foregoing definitions:

- Market value results when the parties are typically motivated, are generally well informed, and are acting in their best interest;
- Market value results when the property is exposed on the market for a reasonable length of time;
- Payment is in cash or its equivalent.

Comparable Selection

Appraisers must consider all relevant transactions that have occurred in the market area and then determine which of those transactions should be used in the sales comparison analysis to arrive at a credible value opinion for the subject property. The best comps are those that are most similar to the subject property in terms of location, size, condition and other features that buyers and sellers believe make a difference to price. After selecting the best comps, the appraiser adjusts for material differences between each comp and the subject property. The appraiser must analyze each comp to ascertain what adjustments are needed. Factors that may require adjustment include atypical buyer/seller motivations and sales concessions.

When the objective of the assignment is market value, ideally each comp selected for use in the sales comparison approach should have sold under the conditions specified in the definition of market value being used. For example, the buyer and seller should have been typically motivated. The seller should not have been under any compulsion to sell, nor the buyer under any compulsion to buy. The marketing effort and exposure time on the market should have been typical for that property type in that market. Payment should have been in cash or terms equivalent to cash; i.e., the seller should not have granted cash or non-cash concessions to bring a sale at the stated price.

When the conditions of the sale do not reflect the conditions outlined in the market value definition, either (1) the appraiser must consider making adjustments for such differences if it is to be used as a comp, or (2) the sale must not be used as a comp.

Distressed Sales as Comparables

Distressed sales such as foreclosure sales and short sales are common in a declining market. Depending on the severity of the local market downturn, some, many, or even all sales that occur do so under distressed conditions.

Appraisers cannot categorically discount foreclosures and short sales as potential comps in the sales comparison approach. However, due to differences between their conditions of sale and the conditions outlined in the market value definition they might not be usable as comps. Foreclosures and short sales usually do not meet the conditions outlined in the definition of market value. A short sale or a sale of a property that occurred prior to a foreclosure might have involved atypical seller motivations (e.g., a highly motivated seller.) A sale of a bank-owned property might have involved typical motivations, so the fact that it was a foreclosed property would not render it ineligible as a comp. However, if the foreclosed property was sold without a typical marketing program, or if it had become stigmatized as a foreclosure, it might need to be adjusted if used as a comp. Further, some foreclosed properties are in inferior condition, so adjustments for physical condition may be needed.



As is always the case in selecting sales to use as comparables, appraisers must investigate the circumstances of each transaction, including whether atypical motivations were involved, sales concessions were involved, the property was exposed on the market for a typical amount of time, the marketing program was typical, or the property condition was compromised. Adjustments might need to be made for these circumstances. When it is necessary to use a distressed sale as a comp, the appraiser must carefully analyze the current local market to determine if an adjustment for conditions of sale is needed. If no adjustment is warranted, the lack of adjustment should be explained.

Physical condition and conditions of sale are two distinctly different factors that must be considered separately. They may be related to some degree in a distressed market, but not necessarily. An appraiser must not assume, for example, that a property was in inferior condition simply because it was a foreclosure.

The level of investigation needed to meet the requirement for sufficient diligence is generally more than is needed in non-distressed market situations. Further, supporting such adjustments can be particularly challenging when there are few current transactions to analyze. Competency in performing such investigation and analysis are required.

Disposition Value and Liquidation Value

The objective of an appraisal assignment might be disposition value or liquidation value rather than market value:

- Market value addresses the question, What would the property likely sell for on the date of value after a typical exposure period on the open market?
- Disposition value answers the question, What will the property likely sell for after a limited exposure on the market given the seller is compelled to sell?
- Liquidation value answers the question, What will the property likely sell for after a severely limited exposure on the market given the seller is extremely compelled to sell?

In the case of both disposition value and liquidation value, the limited or severely limited exposure time on the market is specified by the client.

Disposition value is defined in the Appraisal Institute's The Dictionary of Real Estate Appraisal, 5th Edition as:

The most probable price that a specified interest in real property should bring under the following conditions:

1. Consummation of a sale within a future exposure time specified by the client.
2. The property is subjected to market conditions prevailing as of the date of valuation.
3. Both the buyer and seller are acting prudently and knowledgeably.
4. The seller is under compulsion to sell.
5. The buyer is typically motivated.
6. Both parties are acting in what they consider to be their best interests.
7. An adequate marketing effort will be made during the exposure time specified by the client.
8. Payment will be made in cash in U.S. dollars or in terms of financial arrangements comparable thereto.
9. The price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

This definition can also be modified to provide for valuation with specified financing terms.

Liquidation value is defined in the Appraisal Institute's The Dictionary of Real Estate Appraisal, 5th Edition as:

The most probable price that a specified interest in real property should bring under the following conditions:

1. Consummation of a sale within a short time period.
2. The property is subjected to market conditions prevailing as of the date of valuation.
3. Both the buyer and seller are acting prudently and knowledgeably.
4. The seller is under extreme compulsion to sell.
5. The buyer is typically motivated.
6. Both parties are acting in what they consider to be their best interests.
7. A normal marketing effort is not possible due to the brief exposure time.
8. Payment will be made in cash in U.S. dollars or in terms of financial arrangements comparable thereto.
9. The price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

This definition can also be modified to provide for valuation with specified financing terms.

The appraiser's analysis must be consistent with the type of value being sought. It is misleading to use sales that occurred under distress conditions, fail to adjust them (when necessary) for the conditions of the market value definition that were not met, and refer to the resulting value as market value. Ideally, when market value is the objective, the comps selected sold under the conditions stated in the market value definition and therefore they do not require adjustment for those conditions. Likewise, when disposition value is the objective, the comps selected sold under the conditions stated in the disposition value definition (including "specified exposure time" and "seller compelled to sell.") The same principle holds true when the objective is liquidation value. However, in a declining market with few transactions, it is generally not realistic to expect that such ideal comps could be found. More likely, comps that sold under different conditions than stated in the value definition must be used and then adjusted as necessary and appropriate.

Appraisers must be careful to identify when sales are occurring at market value, disposition value or liquidation value. Even when the only sales occurring are distressed sales, they do not represent market value if they do not meet the conditions of the definition of market value.

With both liquidation value and disposition value, the time allowed for completion of the sale (exposure time) is not necessarily typical for the market for that property type; rather, it is limited, and it is specified by the client. If that time period is the same as what is typical in the current market, disposition value could be equal to market value.

Market Identification

Market analysis is a critical part of the process of developing a market value, disposition value, or liquidation value opinion. The appraiser must identify the subject's market and understand the supply and demand forces at work in that market. Not all markets move in the same direction at the same rate. For example, volatility may be more prevalent in one location compared to other locations. Generalizations about macro-economic trends in the broader geographic area are not necessarily applicable to a specific market area. Similarly, trends observed for one price range or property type might not be applicable to other price ranges or property types.

In some markets, a "two-market" phenomenon might be observed, whereby there is a measurable difference between properties selling under non-distress conditions and virtually identical properties selling under distressed conditions. This phenomenon may become more prevalent as market conditions begin to improve. In other markets, there may be no measurable difference between properties selling under distressed conditions and those that are not.

Buyer and seller motivations may vary greatly depending on their specific circumstances. Often in a distressed market, buyers expect to find "deals" and will only purchase properties they believe are "undervalued." Seller motivations can vary greatly, too. Sellers with equity may be more willing to sell (even if they have lost equity because of a market decline) than sellers who have very little or no equity. On the other hand, some property owners may willingly dispose of a property – even by defaulting – if they perceive there is little upside potential in the market and their cost to hold the property is burdensome.

Appraisers must remain aware of buyer and seller perceptions about how the market is likely to change in the near future. If market participants anticipate an improvement in the market or a further decline, their actions are likely to reflect that anticipation.



Lack of Available Sales Data

A declining market will likely exhibit very little sales activity. When the sales comparison approach is necessary, but there are virtually no current sales in the market area to analyze as comps, the appraiser must:

1. Expand the geographic area for comp search, then adjust for location as appropriate, and/or
2. Use less recent sales, then adjust for market conditions as appropriate.

When adjustments cannot be quantified using paired sales, other recognized methods of supporting adjustments may be applied, such as surveying market participants, analysis of rent or net income differentials, or cost analysis. Analysis of current listings can help provide an indication of market conditions and trends. The volume of listings, the change over time in volume of listings, and average days on the market should be analyzed to assist in making a determination about changes in market conditions.

Appraisers must be careful not to presume that the cost approach is a superior valuation technique to the sales comparison approach when comparable sales are lacking. Proper application of the cost approach requires the use of cost data that is current as of the date of value, as well as estimation of any external obsolescence that might exist due to market conditions.

Summary of Standard Practices

1. Develop an appraisal of real property in a declining market only after ascertaining adequate knowledge and experience to complete the assignment competently (Competency Rule).
2. Identify the market for the subject property and the economic trends within that market.
3. Understand the type and definition of value applicable to the assignment, and apply valuation methodology that is consistent with that definition.
4. When selecting comparable sales, do not exclude or include any solely because they occurred under distress conditions.
5. In the sales comparison approach, recognize when adjustments need to be made for conditions of sale to comparables that sold under conditions that differ from the conditions set forth in the definition of value applicable to the assignment.
6. When comparable sales data are lacking, expand the geographic area for search and/or use less recent sales, then adjust as appropriate for location or market conditions.

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members with guidance as to how the requirements of the Standards may apply in specific situations.)

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