The Art of Appraising in a Recession

By Brad Carter, MAI; Sandra McAlister Winter, MAI; and Carolyn Chen Sawyer, MBA

Five leading appraisers share insights for tackling today's market challenges

Many veteran appraisers contend that appraising has never been more difficult. With sales volume approaching non-existent and financing often unattainable, appraisers face an unprecedented task in attempting to value real property in a market that barely functions. *The Art of Appraising in a Ression*, a recent Appraisal Institute Atlanta Area Chapter symposium, brought together five appraisal industry leaders to explore the hurdles confronting appraisers in their day-to-day practices—and to offer solutions.

What follows is a representative sampling of the questions posed and the responses offered during the April 2 symposium.

Lack of Comps

The panel was consistent that a shortage of data requires becoming more flexible; even researchers with the highest standards must sometimes re-evaluate the distinction between what is preferable and what is acceptable.

Marlon Day, SRA, president of M L Day and Associates, Inc., offered his thoughts on this difficult dilemma as it pertains to residential appraisals: "The first step that I take in solving the problem of limited or lack of availability of comparable sales is to review historical sales data for the particular market. Oftentimes the data will show a wealth of sales activity that may have occurred outside of your typical search parameter of six to 12 months. Analyzing historical sales data and determining a reasonable market


Harris Simpson, MAI
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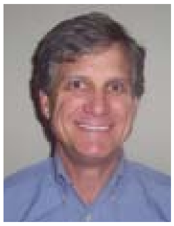
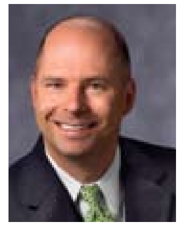

John Cherry, MAI
Managing Director, Butler Burgher Group
Focus: Commercial Properties


Donald Johnson, MAI
Vice President, Wells Fargo Bank
Focus: CMBS Market


Marlon Day, SRA
President, M L Day and Associates, Inc.
Focus: Single-Family


Paul Aase, MAI
Director, Roberts & Associates
Focus: Special Assets

condition adjustment may present itself as a credible option when there are no comparable sales available."

Of course, using more dated transactions heightens the importance of market conditions adjustments and increases the importance of a deep and thorough understanding of market trends and changes. "In conjunction with this method," Day adds, "analysis of current listings and interviews with real estate professionals within the particular market can provide the necessary support for the results of a historical sales data analysis."

John Cherry, MAI, CRE, managing director of Butler Burgher Group, recommends a similar tact for appraising commercial property, and suggests expanding the search of comparable sales to include a longer time frame and a larger geographic area. While making sense of less-than-ideal data can be difficult, market research from interviewing brokers, bankers, sellers, buyers and other appraisers will help determine appropriate market conditions and location adjustments.

"In the case of literally no sales, the appraiser must consider that the subject highest and best use may not be a subdivision," reports Harris "Bo" Simpson, MAI, CRE, in response to a question about the development of a subdivision. He adds that the lack of competitive product in a given market should in itself at least raise the question of feasibility.

However, if a subdivision is believed to be a reasonable form of the highest and best use, and there are no recent lot sales, Simpson recommends that the appraiser extract retail lot prices from nearby home sales (sometimes known as a lot-contribution ratio analysis). "This may require considerable research and judgment. In numerous markets, demand for higher priced homes is declining, and it is often reasonable to conclude that subdivisions once planned for upper price points will eventually be reintroduced at much lower prices. If this is true for the subject property, then a lower retail lot price will also be appropriate, and the projected absorption schedule may be significantly different than for the original product planned. However, the net present value may actually be higher for a more moderately [i.e., lower] priced product."

Market Research

If older sales are to be considered, there are some tools or resources to help measure changes in market conditions to develop and support adjustments. The key to appraising in a recession is "more market research," reminds Cherry. Helpful resources include personal interviews with brokers and other market participants on capitalization and discount rates, as well as trend analysis from investor surveys (such as those published by Korpacz, Realtyrates.com, Cushman & Wakefield, Marcus & Millichap and CBRE), and published economic data (job growth, population growth, etc.). He recommends keeping an updated library of data. The Appraisal Institute's Web site and Lum Library are also excellent resources for such data.

Cherry says that first-hand market research also is needed to answer questions like, "What is the absorption period in normal times? How long will it take to recover and return to 'normal times'? What is the competition, both existing and under construction?" His advice came in response to how to appraise a mostly unoccupied property when there is no leasing activity and therefore no absorption rates at competitive properties to analyze.

He also points out that a large supply of product could result in a longer holding period before a normalized rate of absorption can resume. Another important aspect is the "willingness of management to meet the market," including the willingness to reduce rent and offer more concessions. If management is prepared to be influenced by market forces and compete aggressively, this could mean an increase in the absorption rate.

Residential Impacting Commercial

There is unquestionably a link between the health of the housing market and demand for supporting commercial development, but it is not always easy to measure. According to Simpson, "For years the Appraisal Institute has encouraged appraisers to incorporate fundamental supply and demand analysis into their work. This involves taking demographic growth projections and deriving conclusions for the demand for real estate products. I think the appraiser today needs to be a student of economics if he/she is going to be able to understand and navigate financial markets, human behavior, market trends and ascertain the impact on real estate."

Impact of Foreclosures

If it's a market where the only sales are from banks to investors, do those sales reflect "market value"? Market value is the most probable sales price a particular property can achieve in an open market between willing parties. "Therefore, if foreclosures represent the only (or majority of) transactions within a particular market, it would be reasonable to consider the transactions to be reflective of market activity as of a specific date," Day explains.

Foreclosures bring downward pressure on both home and lot prices, Simpson says. "As long as foreclosures continue, buyer expectations will be influenced," he reasons. He cautions that appraisers must exercise judgment in determining whether bank sales rise to the level of defining the market, but suggests that even those that don't could still be of interest. "Even a transaction that does not meet all the criteria of 'market value definition' could still contribute significantly toward defining the market for an asset," Simpson says.

Day expressed similar sentiments on the impact distressed sellers have on all market participants: "There is generally a lack of willingness to pay more for a particular property when there is a comparable/viable alternative offered for less."

Historically, it would be proper to consider the possibility of a stigma when appraising a property that has been advertised for foreclosure, as evidenced by the fact that brokers were not quick to publicize that a property listed for sale was in the hands of a lender. Today, however, some association to a foreclosure is not a stigma. In fact, brokers use "bank-owned" as a selling point.

According to Paul Aase, MAI, CCIM, who focuses on special assets as director at Roberts & Associates, properties in many markets must have something identifying them as distressed assets just to draw attention from potential buyers. Given the wealth of properties available, and the dearth of buyers willing and able to execute a transaction, purchasers do not need to spend time with any seller they do not perceive to be extremely motivated. This trend has become so prevalent that traditional sellers have been forced to represent themselves as being at a disadvantage. As evidence, Aase cites the numerous examples of properties being marketed as "pre-foreclosure" deals as sellers try to convey that they are motivated enough to warrant a buyer's attention—even if they are not a bank.

Another important point to consider is exposure period. If a property is exposed to the market for an extended period, can the value exceed the highest offer? And does it really matter what line of business the seller is in (such as banking), or how they acquired the property (such as through foreclosure)?

Citing the principal of substitution, Simpson adds that in many over-supplied areas lender-owned properties are actually defining the market, as all other sellers must be price-competitive to attract the limited buyers shopping the numerous alternatives. "Again," Simpson advises, "the appraiser needs to use some judgment in this area."

Conclusion

The solutions the panel presented based on their day-to-day practices not only offer guidance on solving challenging appraisal problems, they focus on what banks and review appraisers look for in times of recession. Users of appraisal services want to see that whatever limited data is available has been properly analyzed, and that the appraiser has educated themselves sufficiently through firsthand market research such as personal interviews with brokers, buyers and sellers. In a market that barely functions, appraisers must be more flexible, perform more market research and of course, exercise careful judgment.

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