Appraising in a Changing Market: The Multi-Tiered Market Data Approach

by Steven R. Smith, MREA, MAI, SRA, 9/21/06

As this article is being penned, we are well into a market cycle that went from boom to bust in the last year. Real estate editors were using terms like "Soft Landing" at the beginning of the year, and have now gone to using words like "Real Estate Recessions" and "Bust".

While this article is written to help deal with the current declining market, the very same principles apply in a booming market. The techniques work on residential, commercial/industrial and land.

What follows comes from things learned first by me during the great recession of 1980-85 in the Southern California markets. For the old time appraisers this will seem like revisiting the past, for younger ones, it may be the best thing since sliced bread, so to speak. We have used these steps in our office for 20+ years and they work. Try employing them in your local markets and see if they work for you too.

If in fact we are headed into a 10-year down market cycle, embracing and employing good appraisal procedures may be the appraisers best defense against suits for professional negligence, or even fraud.

Often, as markets cool and sales start slowing down, the lack of current closed sales sends appraisers off extending an ever increasing radius looking for comparables. In anticipation of the problems that might be encountered by the field appraiser if the current real estate market cycle continues to cool, rates continue to rise and sales volumes decline, while listings increase; a **Multi-Tiered Market Data** analysis may help make more local data available for use as a comparable. It is founded on the concepts in *The Appraisal of Real Estate* that have been in place since the Market Approach was introduced in the 1950s, as a check against the cost approach.

Market Data is defined as "*a sale, listing or offer to purchase, that if properly adjusted, provides a meaningful indicator of value*"[1]. When you think about it, even in the worst

[1] The Appraisal of Real Estate

markets, there is lots of market Data. Whether it is listings, offers to purchase, or, in extreme cases, expired listings, it might not just be closed sales. Certainly at the residential level, finding three closed sales in the last six months, within a mile radius, is the goal of many loan production reports. It keeps the callbacks from coming and makes the reviewers and underwriters happy. But, does it violate the “Location, Location, Location” rule?

Neighborhoods are rarely a radius of a mile except in large Specific Plan areas, often their boundaries are jagged or gerrymandered. Sometimes their boundaries are invisible, more political or social than physical. Sometimes there are physical boundaries within the radius that separate neighborhoods. Sometimes, a neighborhood is made up of one project, development or building. Thus, appraisers who use market data from outside the subject neighborhood by going to a better area or project for data, have to make sure they understand the magnitude of the location adjustment.

The Value of Location

The last thing you want to do is violate the Location Rule. It is often zoning, schools district, country club or project boundaries that make the important Locational factor, not necessarily distance. Locational variances could be a physical or political barrier. It could be school district, city limits, or other invisible lines.

In fact, the Employee Relocation Council forms their appraisers to consider the school district. Where is the local elementary school and does it have a list, or is it closed? For example, in Barstow, Calif., there are some schools that are being used a storage facilities due to what had been a stagnant local economy and growth rate. While other desert cities are bursting at the seams with waiting lists.

> Over half of all buyers buy the Location first, and then the property. For example, sales managers of the in-house sales office at country clubs state that their buyers first buy the Club, and may take one to two years to find their property. The socialization factor in the country club is such that only sales from inside the same club are going to make sense to a buyer interested in that particular club. A home in one might be worth a million more than an identical home in another that is adjacent. Knowing the rankings and locational differences is important. All too often subjects in an inferior country club are being compared with sales from superior ones with no Location adjustment. On the other end of the value range,

when a subject is not located in a country club, choosing comparables from inside one also violates the Location rule, unless you make the necessary adjustment, which can be up to -35%.

In a related instance, in South Central Los Angeles five appraisers were indicted when it was determined that their subjects were in Watts, and none of their comparables were even in the same City. The subject and all the sales were all illegal flips.

Multi-Tiered Market Data Approach

In order to satisfy lenders in any price range, appraisers can use a multiple-tiers approach that encompasses all of the following:

1. Closed sales, less than six-months old.
2. Pending sales that competed under current market conditions. These should be highly similar, few adjustments, model matches if possible.
3. Current competitive listings (highly similar) discounted by a market derived list/sale ratio, or interviews with listing agent (E.g., Have you had any offers? Where do you think it will sell?) and adjusted normally.
4. Historic sales, older than six months. Some times the best comparisons are not necessarily recent. This is often true at the upper levels of custom homes.
5. Offers to purchase from a ready, willing and able buyer. Sometimes the listings have received valid offers that were rejected, or countered but not accepted. Verify the highest offer and its terms. What if you had a perfect comparable with an offer last month, would that be an indicator of value?
6. Expired listings, double discounted and adjusted normally. When markets die, often the expired listing is the largest volume of market data available. The absence of sales does not mean an absence of market data.

Bear in mind, that while you must always include three comparables, sometimes you are adjusting six, nine, even 12 comparables, if not more in order to provide a credible result. Three unverified sales in a declining market will lead to inaccurate valuations.

Sometimes, especially with high-end homes, the most similar sales occur infrequently. For example, a recent assignment involved a 9,800-square-foot home in the Big Horn Country Club, in Palm Desert. There had been one sale of similar size and quality within the last year and there was one pending and one listing. We interviewed the sales office and went over the housing stock that had been built since the project inception and found that there were an additional 21 that were in the same size/quality range, if not bigger and better; that had never sold. This shows supportable demand and was written into the valuation analysis. The agent with the pending sale that I verified, told me she had more buyers for 10,000-square-foot homes in the project than 4,000- to 5,000-square-foot ones but that there was no inventory available for sale.

Now as the market turns we need to consider negative time adjustments in many markets. In addition, defaults rise as markets decline; in turn, lawsuits against appraisers increase as defaults increase. Notices of default have increased more than 50 percent over a year ago, which means we will likely see a spike in professional liability suits against appraisers within the next year. It is in this type of market cycle that the appraisers really need to b aware of and correctly employ good valuation procedures. Taking the time to verify the transactional aspect of a sale, will help with an understanding of the market conditions. In some local markets, essentially every sale has concessions. Most new home tracts are offering cash-back to buyers, cars, pool/spa packages; all of which need to be verified and adjusted for.

So, the answer is that in a declining market there are always lots of comparables, it's just a matter of how we use them, put them together, verify, analyze and document them. The writing of the appraisal analysis that includes the scope of research and verifications performed will carry weight, add credibility and allow readers to understand the logic and reasoning used. Omit the logic and reasoning and you could get a rejection.

Tips for a compelling report

Once you have compiled the multitude of comparables, the presentation of them is paramount. How they are presented should reflect the context in which they are being included: as a direct comparison used as a primary comparable or to show variance for Location, Time, Lot Size, Improvement Size, etc..

For example, appraisers can create a table of sales as an exhibit in your forms program to show the breadth of the market. You can do it in Excel, calculate the mean and standard deviation, demonstrate the most probable range, and set up the client to understand your selection criteria used for your primary comparables. We usually include a minimum of 25 comps, sometimes more, depending on the depth of date in the given market.

Graphing what the market is doing is also a powerful tool. Appraisers can put graphs of their data-set into the exhibit pages. Showing the trend line on a graph helps back up the Time adjustment, even if you have published data on your zip code or parings. The visual presentation is powerful. For example, I turned in a report to the Dean at St. Thomas University for a class project. It was an appraisal with a feasibility study in a remote desert city. The front cover had a graph, as did the back. Inside there were an additional half dozen graphs and numerous color maps and exhibits. He did not read the report in my presence but thumbed through it and looked up and said “What pretty color!” The visual content aided me in getting an “A” on the report. Additionally, I have testified in court without a report, with just a graph and had judges say that I provided compelling testimony. Try adding a List of Sales, the universe of what exists, and a graph of the data. This can be done by copying and pasting from Excel into an Exhibit page in most forms software packages.

The Appraisal Institute seminar *Advanced Sales Comparison and Cost Approach*, created by Nelson Boes, covers trend analysis and graphing the data. For the first report I wrote after taking that class, I put 48 sales on a graph in the highest and best use section of a report, and demonstrated a -2% per-month time adjustment over a 24-month period for lots in Hesperia at that time. The only comment from the reviewer was, "Loved the graph, but why did you put it in portrait style instead of landscape?" The answer was simple, it increased the steepness of the slope and made the point all that more powerful, the market was declining. Graphs can be more persuasive than words.

Now, for later

Appraising in a down market is a learned skill. Most who have been licensed less than 15 years, have not necessarily been through the problems of appraising in a declining market. Residential price trends have been studied by California Polytechnic State University since 1947. In the last four decades, there have been recessions during which prices declined. We are on the cusp of that situation now. While raw statistics published by Dataquick may show no declines in a countywide report, essentially all markets have turned to concessions and gimmicks including cash back to the buyers to help hold up prices. Net of concessions, prices are declining in all but the lowest priced areas.

The big difference now is that the Housing Affordability Index numbers are woefully low compared to last time. In 1990 about 75 percent of Californians could afford the average house. Now the number is under 20 percent. Once hyper-inflated markets stop going up, they will be coming down. The question is the rate and timing of the descent along with the breadth of the valley. It was a long ride to the peak, fueled by abnormally low interest rates and a myriad of some 1,400 loan programs including many with teaser rates. In many markets there was irrational exuberance and behavior

As markets cool down, and turn down, writing with power that includes good primary research and valuation analysis of the market (supply/demand/trends), as well as the data used as primary comparables, goes a long way in separating the professional from the average licensee. As volumes decline, those with the better work product will become the preferred appraiser of the investors.

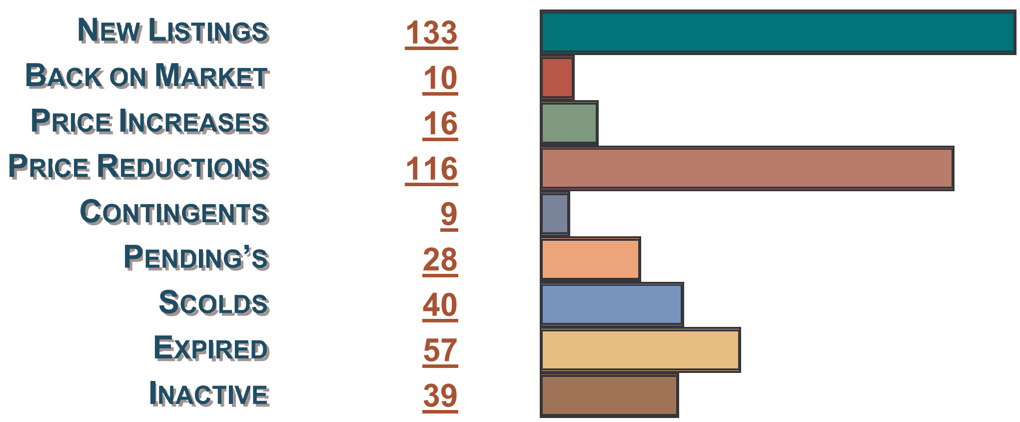
There is a new seminar in the AI about "Communicating with the Client" and an article in the second quarter 2006 issue of *Valuation Insights & Perspectives* titled *Communicating with Clients: What Appraisers Need to Know*. There are several new seminars on statistical applications available through the AI, including one by George Dell, MAI, and SRA on Statistical Applications for Residential Appraisal. . By embracing the concept that our report is a form of written and visual communication and that there are no boundaries on what we can write or how much data we can put into them, we can provide reports that really serve the needs of clients in the dynamics of the current market. Practicing now by writing about what is happening in the market is a good thing, even if prices aren't declining in your area, certainly supply is building up and sales are slowing. Reporting, and graphing the inventory build up and reporting to clients independent of any individual appraisal report, what the market is doing in your area; will make you look like the local expert. Two good examples of this are found in Gary Crabtree, SRA, www.affiliatedappraisers.biz and Beverly Bayers' appraisingmorenovalley.com web pages.

Telling the client and their investors or funding sources, in our reports, about what the market is doing, should not be a problem. Especially once you understand and realize that every regulated lender must analyze each market that they are making loans in and holding loans in, every year. From the top down, everyone in management knows that the markets are doing. Why should appraisers no be on the same page?

If you receive client pressures from telling the truth about your market conditions, after having proved and demonstrated what it is doing, ask to talk to a higher level management person at the client, or ask to talk to the investor. Put together a conference call, and see if they don't already know what is going on.

The more we tell the truth about the market, the more our reputation changes, the more respect we will have. Our client base may change as fewer loan brokers may want to use us, but the investors and mortgage insurers will. There is noting more rewarding than to have loan brokers being told they must use you, because you are the one appraiser the investor trusts.

Market data, yes, we have lots, let's use it to tell the story of the market. Here is what one of my local MLS boards looks like, you interpret it:



Compare the impact that the writing and numbers have compared to the graph of the data has in this chart. The visual impact is great. When Listing to Sales ratios become inverted, with fewer selling each day, and more being listed, the inventory build-up will lead to price declines. This graph is from the Coachella Valley market area that includes the area from Palm Springs to Thermal, CA. For over a year the List/Sale ratio has been inverted. This MLS system uses Rappitoni, which includes a Listing History. Use what is available in your local MLS to demonstrate market condition and provide support for why you don't have 3-closed sales less than six months. We can click on the highlighted Price Reduction number and be taken to all the ones that were reduced today and then look at their histories. We are now seeing multiple price reduction and still a lack of sales volume. The marketing times of the standing inventory is much greater than the closed sales. This market has changed in the last three months. Part of our job is to report market conditions. Knowing what they are is easy in most large markets with an active MLS.

Often we go to the Price Reduction list and look for a model match for your subject. Using a model match that was reduced today, and interviewing the agent about what it will take to sell it in terms of concessions or additional price reductions; is a good way to demonstrate your knowledge of what is happening in the market. It will also add support to your Time adjustments.

Closed sales from 3-months ago may be little more than history. When we interview agents on closed sales, we ask if they could get the same price today. Most often, the answer is no. We are seeing current listings at lower prices than the most recent closed sales in some markets.

Some national franchised offices are now training their agents to take listings 10% below the market value they get by running their CMA's[2]. One of the appraisers in our office had a birthday lunch with several couples over the weekend. Two who had purchased homes in the last year, were going to sell them because the costs were much higher than they expected. Their realtors were telling them to list the homes 10% below the market if they wanted to find a buyer and not just sit on the market. This means that the best piece of market data may well be the one listed today, not the one that closed last month.

There are many people, from investors/speculators to young families that bought too much house, who need to bail out because they costs are eating at them. Anyone who purchased a home in our local markets in the last two years with less than 20% cash down payment is likely upside down. The artificial price increases created by investors and speculators, real estate gamblers, in the last several years, is not supported by fundamentals.

Check in your markets if you had a similar run up in pricing, one that was irrational, and see if there aren't current listings at prices lower than recent closings. In a down market, a discounted listing may be the most relevant piece of market data to demonstrate 1} Market Trend information, 2} Days on Market information, 3} Seller expectations, 4} Concessions, etc.

[2] Competitive Market Analysis: The format agents use in their listing presentations to sellers, three closed sales, three pending, three listings and three expired listings. This is raw data, with no adjustments, from which an opinion of value is reached and reported to the owner.

BIO:

Steven R. Smith, MAI, SRA, runs Smith Realty Advisors in Redlands, Calif. The firm does real estate appraisals and consulting, provides expert testimony, fraud research and analysis, forensic reviews and litigation support.