NEW PERCEPTIONS OF VALUE

by Lloyd D. Hanford, Jr., C.R.E.

Real estate appraising is under fire. Critics charge that many appraisals are worthless in today's chaotic market. Property owners are challenging valuations, and buyers and sellers are often ignoring them. And although appraisers say they are trying to adapt to the new era, there is reason for skepticism.[1]

Is this skepticism well-founded? To the degree that appraisers under current market conditions still follow the time-honored approaches to value and methodology for analyzing value, there is reason for wide public skepticism.

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Policy Change Impacts On Market

Prior to October 6, 1979 the majority of residential and investment real estate transactions was predicated on a structure involving debt and equity. Typical transactions included conventional debt in a ratio of 75 percent or more of property value, with a 25 percent or less cash equity contribution. The conventional real estate finance market was relatively orderly with a relatively stable supply of lendable funds at affordable interest rates. In an unprecedented midnight session on October 6, 1979 the Federal Reserve Board raised the discount rate, signaling the beginning of a new, tough monetary policy. Money became extremely tight. By April 1980 the prime interest rate had risen to 20 percent. The cost of real estate financing escalated to a range of 17.5 percent to 18 percent on apartment properties and 14 percent to 15.5 percent on commercial properties with little or no availability of funds. Prime dropped significantly between April and July 1980, hitting a low of 10.75 percent before beginning its upward spike. From August 1980 through January 1981 prime rapidly climbed to an unprecedented high of 21 percent before beginning a descent. During this time funds available for real estate financing were in extremely short supply.

The election and inauguration of President Reagan may be promising but have not altered the capital markets. The stock market, a bellwether of anticipation, has been erratic at best, indicating a substantial uncertainty concerning the immediate future of the economy. Assuming that the president's promise to fight inflation is successful, it could be years rather than months before the measures taken have a stabilizing effect on the economy.

Perceptions of real estate value, long predicated on the availability of real estate financing, have been altered and will remain altered for the foreseeable future. It is indicated that a policy of tight money will

continue. Even if the demand for loans reduces significantly, with a concomitant drop in interest rates to reflect a lessened demand, it would not be reasonable to anticipate a resurgence of a healthy real estate finance picture. If interest rates drop significantly, the backlog of corporate financing coupled with the regular refinancing of government obligations will quickly erode the supply, sending interest rates back up. The backlog of corporate and governmental demand for money should leave very little available for the real estate sector.

Implications For Real Estate

Since October 1979 major changes have occurred in the structure of real estate finance. While the supply of lendable funds may increase, many of these changes should become permanent fixtures in the market. It is obvious that long-term lenders will no longer provide money at interest rates below the rate of inflation, so that appraisers will have to monitor changes in inflationary trends and money supply figures carefully for a prediction of movement in interest rates on real estate loans. The era of the long-term, fixed-rate real estate loan is over. New loans will either be short-term loans, variable rate loans or short-term roll-over loans with renegotiated interest rates.

In the residential field, shared appreciation mortgages (SAMs) may become a frequent device. Major lenders have shifted from the ownership of a debt instrument to the ownership of an equity position, emphasizing participating mortgages, mortgages convertible into an equity position and/or joint ventures.

Changes in the structure of financing have completely altered the concepts of leveraging. The ability to achieve the benefits of a highly leveraged transaction was nearly unique to real estate. At this point in time it is impossible to quantify the value weight given by purchasers to the benefits of leveraging, but it is clear that these benefits have been changed substantially and that the valuator of real estate, to be contemporary, must consider these changes.

Sales transactions negotiated prior to October 6, 1979 occurred under totally different economic conditions than those existing today. Therefore, those transactions are probably of no material significance in arriving at a current market value estimate. Although not provable, it is probable that a majority of transactions closing between October 1979 and April 1980 was negotiated either prior to October 6, 1979 or was negotiated on the presumption that the existent chaos in the money markets was a short-term phenomenon. Probably these transactions do not shed any light on the current market. Belief that the present status of the money market is a temporary or short-term phenomenon has a greater probability of being in error than of being correct.

A large number of sales transactions occurring since October 1979, particularly in the residential field, have been structured on seller-carried debt either in the form of a first loan, a second loan or wraparound financing. This seller-carried debt frequently has been at an interest rate lower than the prevailing market rate. If appraisers rely on seller-carried financing in processing comparable value, then it is mandatory that they qualify their value conclusions as being based on the assumption that the seller would carry notes equivalent to those in the sales sample. On the other hand, if appraisers report value in terms of cash or cash equivalent, then in processing comparable sales they must apply the market discount rate to any seller-carried financing to report a cash equivalent value for the property being appraised. The latter approach is probably the most consistent under accepted value definitions, since those definitions refer to price in terms of "money" and not in terms of "paper."

Weakness In Residential Market

Much past real estate activity was induced by the belief that real estate is the best inflation hedge. The speculative market of homes and condominiums is evidence of that belief. To measure any hedge, the analyst must be aware that the costs to carry a property in excess of income tend to modify or nullify the hedge. Adjustable interest rates leave questions as to the long-term and real hedge benefits. Evidence based on stock market behavior is emerging that investors may be adjusting their anticipations of future inflation rates. If these anticipations are adjusted downward, it is possible that historic growth patterns in real estate will be modified, inducing less aggressive buying patterns. Today's appraiser should be current on the degree to which fear of inflation — or the reduction of those fears — might impact the marketability and price of property.

The current residential market with high interest rates and equity requirements is one in which a majority of potential purchasers cannot qualify even if loans were available. Under these conditions and consistent with past performance, anticipations of value increases may not be realistic. Under these conditions and despite supply shortages, the number of listings available for purchase on a national basis probably exceeds the number of qualified purchasers ready, willing and able to purchase. A proliferation of "For Sale" signs and the durations of sign postings are signals of this possibility. Advertisements indicating "price reduced" or "owner will carry financing" are additional evidence of a relatively weak market. Probate offerings on an all cash basis and with no bidders are frequently occurring. Motivated sellers or those having to sell are faced with the prospect of a lower price on a cash basis, or if contract price is important they are faced with participating in the financing at a submarket rate of interest. Appraising the current market value of residential property without considering these phenomena is not prudent.

Two-Tiered Investment Market

The investment real estate market is exhibiting changing patterns. Yield expectancies appear to be increasing from 1979 levels, although the number of transactions is insufficient to make this conclusive. The investment property market appears to be dividing into two distinct tiers. The first tier represents property that is of pension fund, institutional, offshore, or large investor quality with concentration on prime-located, major projects like office buildings, shopping centers and general purpose industrials with a cash investment upward of $2,000,000. Purchasers do not appear to be affected by the lack of available conventional financing, and demand appears to be strong despite unsettlement in the money markets. Pension fund, institutional and some offshore investors are cash purchasers and operate without financing. Large investors and developers have the ability to finance through equity participations or joint venture arrangements.

A subcategory of the first tier consists of those properties with existing assumable long-term debt at low interest rates. Demand for this type of property remains high, with some premium for below market rate debt if the debt ratio is high enough.

The second tier of the market is comprised of those properties not of pension fund, institutional, offshore or large investor size or quality, but includes secondarily-located properties and properties of comparatively small size. Properties in this tier are not financed readily. Purchasers tend to be dependent on financing as a basis for acquisition. The second tier apartment properties are probably more adversely affected than other commercial properties. The short supply of new housing and lack of affordability have placed severe pressure on existing rental housing, also in short supply. The result has been the threat or enactment of rent control and/or condominium conversion restrictions. This, in turn, has chased potential lenders out of this market, even when funds are available, and has induced buyer concerns which adversely impact marketability. In general, properties in this second tier appear substantially less marketable than in 1979, with a consequent downward pressure on cash price or the equivalent prospect of seller-carried debt.

While there may be numerous exceptions to these observations, today's appraiser should give detailed consideration to the type of market that may exist for the property under appraisal and the probable transaction structure that may result from an offering.

Need For New Rate Determination

Capitalization rates from previous market transactions, even though negotiated since October 1979, are probably inconclusive and misleading for two reasons:

- Too few "comparable" transactions exist to permit development of a statistically accurate model;
- Money and real estate markets are changing too rapidly to allow any dependence on past transactions.

With high interest rates, variable rate mortgages, short-term loans, renegotiable rates and the lack of available funds, it is no longer practical to develop a capitalization rate using a debt constant-equity dividend, weighted band of investment method.[2] Even if financing were available, the weighted debt constant component would force the capitalization rate to unrealistic heights.[3] For example, a 15 percent interest rate on a 30-year loan would produce a constant of 15.173 percent. A 75 percent debt ratio (.75 x .15173) would force a capitalization rate of 11.38 percent, which is higher than current overall rates. The same problems impact the development of a capitalization rate based on the Ellwood Tables.

The investment property appraiser faces a dilemma. Years of refining the art have led toward increased market substantiation for capitalization rates employed. Yet the traditional methods of substantiation and documentation do not exist in a practical sense. Today's appraiser must rely more heavily on judgmental factors without the comfort of reliable, current guidelines for substantiation and a statistically reliable, comparable sales sample. However, judgment need not be exercised in a vacuum for it is still possible and practical to determine yield rates sought by the first tier investors by contacting pension and institutional fund managers. If these rates represent the yields in prime transactions, they tend to establish a floor against which the appraiser can adjust for relative risk in the property under appraisement. Further, offers become a key source of rate information, except in condemnation cases where offers are generally inadmissible evidence. By contacting brokers to determine the basis of current offers, the appraiser can establish a pattern of current buyer behavior. In the last analysis, an appraisal is a judgment and its quality cannot be compromised by reliance on traditional methodology that may be irrelevant.

In the past, lenders used debt coverage ratios in tandem with a capitalization rate derived from a debt constant-equity dividend band of investment. Where financing is available today, the coverage ratio is the key to the amount of financing that a property can command. Lenders will generally seek a coverage ratio minimum of 1.2 to 1 which means that net income before debt service must be 1.2 times debt service. If net income is $100,000, the maximum available for debt service is $83,333. If the available loan is 15 percent at 30 years and the constant is 15.173 percent, then the maximum debt is $550,000 (rounded) or $83,333 divided by .151173. The debt ratio will be 55 percent if the property is selling for $1,000,000. Appraisers should remain current on lender coverage ratios in order to evaluate the marketability

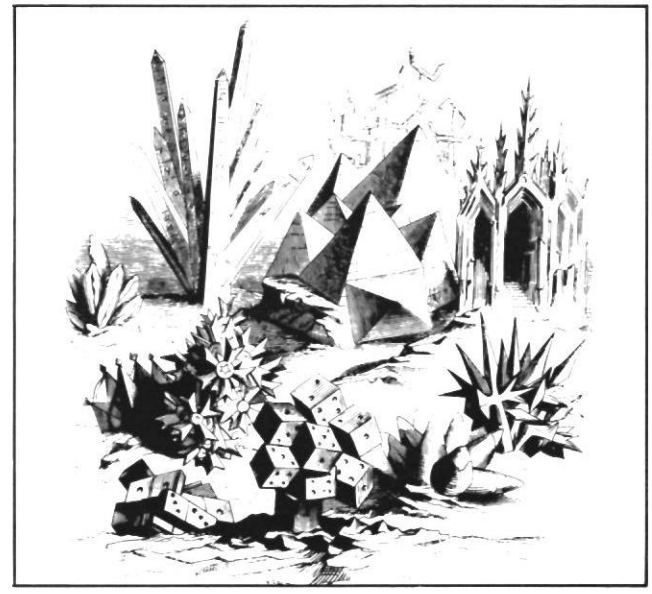
of a property, the cash equity requirements and the ability of the typical purchaser to meet the equity requirement.

Many analysts are proponents of internal rate of return (IRR) or financial management rate of return (FMRR) studies as indicators of investment value. These tools if used are not guides to market value but are subjective analyses based on a series of assumptions as to the future as well as to reinvestment. Predictions as to future income streams are highly uncertain and speculative under current economic conditions. Because of the cloud of uncertainty, these predictions have a greater probability of being in error than of being correct. Studies predicated on any assumption that cash outflows are reinvested are suspect because the typical property owner rarely reinvests all of the outflows. The reinvestment assumption is usually very artificial and causes study results to be equally artificial. Investors effectively can use IRR or FMRR as a basis for qualifying potential investments. For example, investors may determine a need for a 15 percent IRR to make a potential investment worthwhile. The investors can make projections based on a set of assumptions that they are comfortable with, and determine whether or not the desired rate will be produced. An investor can also use IRR studies in projecting the optimum holding period for a property. But appraisers should not construe these analytical tools as market value determinants.

Future Income Projections

Many investment decisions may have been reached based on capitalization of future anticipated revenues versus current market revenues. In 1979 shopping centers were a highly-favored investment due to the belief that inflation would induce increased gross sales and higher percentage rents. In 1980 retail sales growth did not keep pace with inflation and percentage rent anticipations did not universally materialize. Further, tight money coupled with sluggish retail sales adversely impacted retail profitability with local, under-capitalized tenants hit hardest. Vacancy or impending retail vacancy because of business failure or lack of profitability is a reality, with demand for secondary or satellite store space reduced because locals are unable to finance new locations. The high cost of construction coupled with a short supply of space often has induced retail rents to rise beyond a justified point based on realistic volume expectations. If there is a further reduction of consumer spending as a result of anti-inflationary pressures, the viability of predictions of future rents becomes more suspect.

Many future income projections are based on historic increases in rentals. If the economy is brought into greater balance, the historic rates will be irrelevant. If the economy is not brought into greater balance, the historic rates will be irrelevant for sure. Projections based on historic or presumed inflation



rates are capable of measuring only the quantity of dollars. To the extent that future income projections are purely inflation-based, studies of investment value based on those predictions tend to be misleading and unnecessary. If one believes that income will only grow at a rate equivalent with inflation rates, then it would seem far more accurate to base value decisions on current dollars rather than the present worth of future dollars and make the assumption that value and/or income will change over time and according to the rate of inflation. If the analyst believes that income will increase faster than the rate of inflation, then the difference between inflation-induced change and forecast rent becomes the "real increase," and can be translated into present worth without distorting the results. Conversely, if the analyst believes that income will not keep pace with inflation, as in rent-controlled apartments, then the shortfall can be translated into a negative worth.

Conclusion

Chaotic conditions in the capital markets have disrupted traditional concepts of measuring real estate value. Attempts to explain the changes with new, complicated mathematical formulas are noble but artificial for two key reasons:

- Investors or sellers do not employ these formulas in arriving at buy-sell decisions;
- The market is changing more rapidly than new formulas can be constructed and printed.

Therefore, the assumptions underlying the new approach are susceptible to change.

It is probably safe to predict that change will continue at an accelerated rate over the foreseeable future. To meet the challenge of change, real estate appraisers should modernize their reports to be sure they answer the value questions meaningfully. Following are some suggestions toward that goal:

- Include a detailed section on the financing market. Relate its status to the probabilities of financing the project or the lack of ability to finance. Conclude with an opinion as to whether or not the financing market will assist or retard marketability and/or value.
- Develop a detailed analysis of any existing assumable debt or locked-in debt, with an analysis of debt impact on marketability or value.
- Make an in-depth analysis of the typical purchaser market for the property under appraisal. Identify the typical purchaser and the typical purchaser's buying patterns. The potential purchasers are the market for the property. Therefore, the appraisal must somehow relate value to the typical purchaser patterns.
- Add a supplementary section detailing impressions and citing reasons for probable future market changes and their potential impact on marketability, value or price. Include advice on marketing strategy and asking price where appropriate. This added section makes the appraisal report not only a value report but also a consultation report to help the recipient in making decisions.
- Above all, qualify all assumptions and do not be afraid to make appropriate reference to the rapidly changing market and the uncertainty that rapid change brings to any value prediction. There is no rule that says appraisers must be able to develop an unqualified, absolutely correct answer. Accountants and attorneys qualify their opinions whenever qualification is called for, and appraisers should do the same.

Appraisals will be worthless in a chaotic market unless appraisers adapt their analytical approaches and rationale to the market as it is today, not as it was yesterday. While comfortable guidelines and past data have been erased from the board, appraisals are not dead but much alive and improving. To improve the quality of their judgments, though, appraisers will have to remain current on factors that influence the market such as economic theory, economic policy, monetary policy and politics. They will have to reorient their reports to explain the existing market for the particular property being appraised. Finally, appraisers will need to go beyond rendering a dollar value opinion, and render advice on marketing, price, terms, and strategy, or at least render advice on how to use the specific appraisal as a decision-making tool considering the purposes for which the value study was performed.

NOTES

1. Lawrence Rout, "Critics Contend Chaotic Economy Makes Most Appraisals Worthless," *Wall Street Journal* (December 24, 1980), 9.
2. Lloyd D. Hanford, Jr., "The Capitalization Process Revisited," *The Appraisal Journal* (July 1976).
3. Robert A. Steele, "DCR/Re Capitalization Rate Tables for Today's Financing," *The Appraisal Journal* (January 1981).