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Bringing Down the House?

Foreclosure Effects on Market Values

By Charles E. Gilliland

Appraising real estate in difficult markets can be puzzling to the appraisers challenged with interpreting potentially confusing market signals. Recent reversals in residential markets led the Appraisal Foundation to issue a valuation advisory entitled *Residential Appraising in a Declining Market.* This document provides guidance to appraisers as they struggle to make sense of markets buffeted by the downturn in home prices following the Great Recession.

Because specific localized markets may have escaped the downdraft caused by collapsing mortgages, the advisory identifies conditions that characterize a declining market. These include:

- an oversupply of competing properties;
- extended marketing times for active, pending and closed sales;
- prior listings of the subject that reflect list prices notably higher than the current contract, sale price or value;
- prior sales of the subject, comparables or both that reflect higher prices than current prices;
- a decrease in sale prices as a percent of list prices; and
- an increase in REO (properties acquired by lenders through foreclosure) listings in the neighborhood.

The document states that a declining market normally has several of these characteristics.

Identify Client's Intended Use

Describing the state of the market requires analysis of transactions over a period sufficient to reveal trends in prices. Examining historic levels of typical days on the market, median prices, and the relationship between sale price and list price provides evidence of the health of the market. Economic studies and various databases can also provide insights into the direction the market is headed. Analysis of these kinds of information leads an appraiser to conclude that markets are either increasing, stable or declining.

When an appraiser concludes that a property is in a declining market, the assignment entails challenges not encountered in stable or increasing venues. Declining markets likely will have sales of REO, short sales or foreclosure sales. Normal appraisal assignments aiming to estimate market value usually exclude prices for these kinds of transfers because buyers or

sellers were not "typically motivated." Presumably, distressed sellers made concessions that affected the final prices in these transactions, driving them below a reasonable market value. For many appraisal assignments, all of these sales would likely be dismissed by appraisers.

However, when these types of transactions dominate markets in an area, excluding them may leave no market data to analyze. For those situations, an alternate definition of value may better serve a client's needs, especially if they want to know the most likely price the property would fetch under current conditions. The advisory cites disposition value, foreclosure sale, liquidation value and other values in addition to the standard market value as possible objectives of an appraisal. The value definition that most effectively meets a client's intended use of the appraisal should be identified in the report's scope of work and communicated to the client.

For appraisals in a declining market, the determining factor depends on the assumed most likely buyer of the residence. Specifically, buyers tend to be either end users or investors. The former desires to acquire a home to live in; the latter looks for distressed sales, anticipating reselling at a higher price or renting property for income. The advisory stipulates that for sales in the same market, end users tend to pay higher prices, while investors generally pay discounted prices. The gap between the two price levels can be substantial and varies from market to market. An unpublished Center analysis of distressed sales from Multiple Listing Service data confirmed this in Dallas and Austin residential markets.

Describe Market Conditions

The advisory cites three market situations: one dominated by end users, one reflecting a mixture of end users and investors and one in which all sales are consummated with investment buyers. In the first instance, comparable sales selection focuses primarily on differences among properties. In the second case, sales to investors will likely yield lower prices than sales of similar properties sold to end users. For the mixed and investor-dominated market, the selection becomes muddled. Should the appraiser discard investor-related sales in the mixed market or perhaps adjust those sales upward to account for the conditions of the sale?

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Residential appraisal form reports normally do not include a line item for this adjustment, which is frequently encountered in narrative reports. However, the assignment may require an appraiser to make such an adjustment. To help resolve this dilemma, the Appraisal Foundation stipulates that an appraiser should consider " . . . the public perception of the defined term" (market value), "the client's intended use of the appraisal report, and the public policy...." The client should be informed about the condition of the market, but the foundation insists that the comparable sales selection process should abide by the following:

> If an appraiser finds the subject property is located in a market where both non-REO and REO property sales exist and these result in significantly different value opinions, the appraiser should use the comparable sales that represent the actions of buyers most similar to the most probable buyer for the subject. It is also possible for an appraiser to give clients two values, properly defined, in the same report.

Clearly, similar houses in the same market area could have dissimilar valuations depending on the assumed potential buyer. Because of that possibility, the advisory discusses the following list of values:

- disposition value,
- liquidation value,
- market value and
- other values.

Define Alternative Values

By definition, market value reports the most probable price expected from a sale in a free and open market between informed buyers and sellers, assuming that neither is under duress. Official definitions impose a set of restrictions designed to describe a transaction that approximates an ideal, perfectly competitive market as closely as possible.

Most alternate value definitions represent a departure from this ideal. For example, disposition value subjects the estimate to current market conditions with a seller compelled to sell. A liquidation value envisions a sale within a short period with a seller under extreme pressure to sell. An appraisal reciting an alternative value in addition to market value should contain explicit definitions of each value concept used.

These stipulations acknowledge that price does not necessarily equal value. Sales of apples or oranges occur at prices set by competitive forces in the market place. Most buyers find the offer of these items at a take it or leave it stated price. Shopping among competing sellers normally results in observing similar prices in all markets. Those prices arguably reflect the value of the apples or oranges in the given market. However, a late shopper encountering a seller with a few oranges left and a burning desire to close may be able to strike a bargain by offering to buy the remaining stock at a lower price. Those specific circumstances have caused the agreed-to price to stray from the previously established market value.

In real estate, each transaction occurs after some price negotiation. The classic definition of market value assumes that neither buyer nor seller holds an advantage in those negotiations. The interplay of offer and acceptance occurs in the environment of current market realities with the result reflecting market value for typically motivated buyers and sellers.

Consider Circumstances Carefully

When circumstances in the market environment mutate, the negotiations likely will change to reflect those changes. For example, a noticeable drop in interest rates reduces borrowing costs to buyers. Each one can now offer more for a given

property. That reality traces through the market in general price increases.

Similarly, when sales of foreclosed properties occur in a market, observers might anticipate an overall drop in prices, believing that foreclosed properties sell at a discount from market values. That drop would follow from two circumstances: the seller is motivated to liquidate an unwanted investment, and inventories of foreclosed properties add to the supply of homes on the market. The casual observer would justifiably expect foreclosure sales to drive values lower.

Unlike the markets for apples and oranges, where large volumes are traded each day, real estate markets generate a limited number of transactions requiring careful consideration of the circumstances involved in each individual transaction. Appraisers normally dismiss transactions that do not fit the criteria specified by the appraisal definition of market value from their analyses. Appraisers frequently note sales of foreclosed properties before dismissing those transactions as reliable indicators of market value, citing undue pressures on the seller.

One can assume that sales of foreclosed properties should result in transactions at apparently depressed prices. Possibly because of such perceptions, the Texas Property Tax Code contains the following provision referring to appraisal of homes for property tax purposes:

> § 23.01. Appraisals Generally
>
> (a) Except as otherwise provided by this chapter, all taxable property is appraised at its market value as of January 1.
>
> (b) The market value of property shall be determined by the application of generally accepted appraisal methods and techniques. If the appraisal district determines the appraised value of a property using mass appraisal standards, the mass appraisal standards must comply with the Uniform Standards of Professional Appraisal Practice. The same or similar appraisal methods and techniques shall be used in appraising the same or similar kinds of property. However, each property shall be appraised based upon the individual characteristics that affect the property's market value, and all available evidence that is specific to the value of the property shall be taken into account in determining the property's market value.
>
> (c) Notwithstanding Section 1.04(7)(C), in determining the market value of a residence homestead, the chief appraiser may not exclude from consideration the value of other residential property that is in the same neighborhood as the residence homestead being appraised and would otherwise be considered in appraising the residence homestead because the other residential property:
>
> (1) was sold at a foreclosure sale conducted in any of the three years preceding the tax year in which the residence homestead is being appraised and was comparable at the time of sale based on relevant characteristics with other residence homesteads in the same neighborhood; or
>
> (2) has a market value that has declined because of a declining economy.

Many Texans find that residential tax values have continued to rise even as foreclosure sales have popped up in local markets.

Include Foreclosure Sales If . . .

The foundation advisory acknowledges that appraisers may include foreclosure sales if state assessment rules require it and still comply with Uniform Standards of Professional Appraisal Practice. The way seems clear for tax appraisals to decline to reflect the sale prices on the foreclosure sales. However, many Texans find that residential tax values have continued to rise even as foreclosure sales have popped up in local markets, leading them to conclude that the appraisal district is disregarding the code. The appraisal district responds that the sales were considered, but they did not impact the estimated market value of the homestead property.

That response reflects the dual nature of price levels in markets populated by foreclosures. The first difficulty arises over the meaning of the instruction to "not exclude from consideration" foreclosure sales. As this discussion makes clear, an appraiser may likely find a two-tiered market where foreclosed homes appear in a neighborhood. Arguably, sales to end users represent the best evidence of market value given the legal definition envisioning arms-length transactions.

Sales to investors probably reflect some level of duress. In fact, appraisers would likely make conditions of sale adjustments before including the sale in an appraisal. Thus appraisal districts can consider foreclosure sales without allowing the depressed price levels to affect their estimates of market values.

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THE TAKEAWAY

Foreclosure sales do not automatically depress values of all houses. Depressed prices of foreclosures may present investment opportunities when those prices return to owner-occupied market values.

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About the Real Estate Center

The Real Estate Center at Texas A&M University is the nation's largest publicly funded organization devoted to real estate research. The Center was created by the Texas Legislature in 1971 to conduct research on real estate topics to meet the needs of the real estate industry, instructors and the public.

Most of the Center's funding comes from real estate license fees paid by more than 135,000 professionals. A nine-member advisory committee appointed by the governor provides research guidance and approves the budget and plan of work.

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DR. LUIS TORRES

Dr. Luis Torres has joined the Center staff as an associate research scientist. Dr. Torres comes to the Center from Banco de Mexico where he was an economist and communications analyst. He is an author, lecturer and researcher who has extensively studied the Mexican regional economy and U.S.- Mexico issues.

Dr. Torres received a master of economics in 2006 and a Ph.D. in economics from the University of Colorado in 2011.

Born in California, he has a master of science degree from the University of Texas at El Paso (2002). He received a bachelor of arts degree in economics from the Instituto Tecnologico de Estudios Superiores in Monterrey, Mexico (1995).

The new Center researcher is fluent in written and spoken English and Spanish.

To read more on Dr. Torres, go to:
http://recenter.tamu.edu/staff/ltorres

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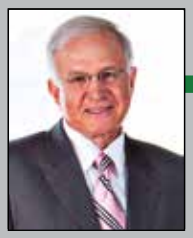

GARY MALER

Gary Maler, Real Estate Center director, is one of nine 2012 Outstanding Alumni for the College of Architecture at Texas A&M University. Maler received a master of architecture degree in 1974. He lifted the Real Estate Center to global prominence after a private-sector career spearheading some of Houston's most notable developments.

"Under his leadership, the Center has become one of the most highly respected and trusted sources of research and information that is heavily relied on by members of the legislature, the governor's office, state agencies and the business community," said Susan Combs, Texas comptroller of public accounts.

More on Maler's award can be found at
http://recenter.tamu.edu/news/pdf/NewsRel27-0812.pdf

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DR. CHARLES GILLILAND

A book by Dr. Charles Gilliland — *Buying Rural Land in Texas* — will be released by the Texas A&M University Press this month. In it, Dr. Gilliland demonstrates that buyers can and should arm themselves with knowledge of the land-buying process, potential problems and available resources.

Dr. Gilliland has been with the Center since 1977. He is a clinical professor of finance, research economist and the Helen and O.N. Mitchell Fellow for the Mays Business School. He is a recognized authority on property taxation and appraisal, but it is his rural land expertise that he called on to complete his latest major undertaking.

Buying Rural Land in Texas is $25 and is available from the Texas A&M University Press Consortium at http://www.tamupress.com

See more on Dr. Gilliland at
http://recenter.tamu.edu/staff/cgilliland

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