Appraisal Alchemy **Debunked**

Michael V. Sanders, MAI, SRA

Editor's Note:

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The March/April issue contained an article written by Wayne C. Lusvardi entitled The New Appraisal Alchemy, which has sparked quite a debate within the profession. In order to continue to be THE forum for issues of importance to right-of-way professionals, we present the following counter article to Mr. Lusvardi's point. Those interested may also want to read two related Letters to the Editor.

The New Appraisal Alchemy by Wayne C. Lusvardi in the March/April 2000 issue of *Right Of Way* is so filled with misinformation as to be almost ludicrous. The central theme of the article is a rather scathing criticism of recently published and widely accepted work in the area of real estate damages and the appraisal of detrimental conditions.

By way of background, a detrimental condition (DC) might be defined as an event or discovery that has a potential impact on property value. A comprehensive framework for the appraisal of detrimental conditions can be found in *Real Estate Damages - An Analysis of Detrimental Conditions*, published by the Appraisal Institute in 1999.[1] Basic components to a discussion of detrimental conditions include the DC Matrix - a table depicting the stages of a detrimental condition along with potential impacts on value,[2] the DC Model - a time/value graph showing potential impacts on value over time as the result of a detrimental condition,[3] and the Bell Chart - classifying detrimental conditions into ten broad categories with potentially similar value patterns.[4] Mr. Lusvardi's implied definition of the DC Model is broader, generally encompassing the entire analytical approach to detrimental conditions in the *Real Estate Damages* textbook.

Mr. Lusvardi improperly suggests that the term "detrimental condition" applies only to externalities, which are discussed in some detail. In reality, detrimental conditions have a much broader application, including both internal and external influences on value. Lusvardi believes that externalities must be legally internalized before a real estate appraiser can consider them, suggesting that a scenic view, absent an easement to preserve such view, should be disregarded, even though the market might place great value on such view amenity. Mr. Lusvardi goes so far as to indicate that environmental externalities such as pollution or scenic views do not have a market value because they are "public goods held in common ownership," whose effects are "unpriced and uncompensated by markets."

Externalities can and do impact property value, as appraisers have always recognized. To suggest otherwise is absurd. It is certainly true that externalities are

abundant, and often have both positive and negative impacts on value. A new shopping center is an example of an externality that might be beneficial to the community as a whole, while generating potential negative impacts on adjoining owners.

Consideration of these negative impacts does not mean that appraisers are turning net benefits into detriments (or gold into lead, to use Lusvardi's alchemical analogy). Nor is it disputed that the value impact of an externality can change over time. But this does not preclude the appraiser from examining the impact on value at a particular point in time (date of value). If Mr. Lusvardi is critical of tort and environmental law allowing property owners to sue for potential damage caused by "every conceivable type of externality," maybe his criticism should appropriately be directed towards the legal system.

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Mr. Lusvardi is critical of the emphasis on perception in the appraisal of detrimental conditions, apparently not understanding that perception has a major influence on property value.

An important California case, *Reed v. King*,[5] related to disclosure of a decade-old multiple murder in a single-family dwelling and its associated impact on the value of the property - is solely an issue of perception. Perceptions, in fact, are largely responsible for locational desirability, and are easily measured in the market, not "subjective, speculative and thus unprovable." The appraiser's job, of course, is to objectively report the value impact of these market perceptions - good, bad or indifferent - rather than valuing "moral hazards" for the benefit of the client, as Lusvardi implies. Such an approach is advocacy, pure and simple.

The "time/value model" (DC Model) which depicts value changes over time is not original to the structured analysis of detrimental conditions, as correctly pointed out by Mr. Lusvardi, who indicates that the model was not developed by economists or appraisers, but popularized by two geographers in 1994. In all fairness, it should be noted that a variation of this conceptual model was published in an article by Bill Mundy in *The Appraisal Journal* in 1992.[6] The DC Model is intended to be conceptual, and does not presume that value drops because of cost to repair a detrimental condition, only illustrating how value *may* change over time during the lifecycle of the detrimental condition as a result of issues during the assessment, repair and ongoing stages of the DC lifecycle. Value changes attributed to the detrimental condition, if any, may not even have a cost of repair component (e.g., crime scene stigma). Mr. Lusvardi offers the following criticisms of the DC (time/value) Model:

• ***Value differences due to location are damages that are legally compensable.*** Nowhere can this be inferred from the DC Model. Whether a variation in price due to locational attributes is "damage" depends on the fact situation. A property located adjacent to an established nuisance may be perceived as less desirable, but this is simply a locational disamenity, not properly considered "damage." However, if such nuisance or hazard is imposed on a property, a negative response by the market may well result in diminished value relative to the before condition. Whether such damage is compensable, of course, is a legal, not an appraisal question.

• ***The time/value model assumes no offsetting factors which may lessen or mitigate a decline in property value.*** Again, this is inconsistent with the DC Model, which should be interpreted as showing the "net" impact of a detrimental condition on property value. Items such as indemnification, insurance, government grants and low-interest loans, and reduced tax assessments can partially or completely offset the negative impact of a detrimental condition.

• After stating that the time/value model ignores the impact of market conditions, which may be an independent cause of any decline in property value, Mr. Lusvardi contradicts himself by noting (correctly) that the DC Model offers caveats about distinguishing the effects of detrimental conditions from the background effects of the real estate cycle, as well as other unrelated factors which might impact value.

Analysis of detrimental conditions might utilize one or more of the three traditional approaches to value, with Mr.

Lusvardi offering criticisms of each approach:

• ***Sales Comparison Approach*** - The DC Market Comparison Approach is criticized as being illogical, noting that differences in value are not indicative of damage or diminution. Again, it is certainly true that established externalities (pre-existing conditions) will result in discounts to value that would not appropriately give rise to damage claims. Value diminution is caused by an event that results in a significant perceptual difference between the before and after condition, if in fact the market attributes some value impact to said event. Mr. Lusvardi characterizes this phenomenon as "a wealth distribution program masquerading as damage law."

• ***Cost Approach*** - Mr. Lusvardi notes the DC Model's "over reliance" on the Cost Approach, without any elaboration. The model certainly presents the Cost Approach as a valuation alternative, but makes no comment on its importance relative to other valuation approaches. Mr. Lusvardi further criticizes the DC Cost Approach due to its failure to consider alternate methods to remediate hazardous conditions. It is true that clean-up costs are often imposed by regulatory agencies, but such costs are still market-based, since the market has no choice but to accept environmental laws and regulations, in much the same way the market accepts zoning ordinances, land use restrictions, building codes, etc. This would hardly be characterized as a "political reaction," as stated by Lusvardi. Nor does the analysis of detrimental conditions advocate use of an approach that results in higher damages than another approach, what Mr. Lusvardi characterizes as a violation of the lesser-of-rule.[7]

It is the rigorous application of all applicable approaches to value, in fact, that allows the appraiser to ascertain whether repair or remediation cost does in fact exceed diminution in value. The Cost Approach is nonetheless a useful tool for evaluating damages, particularly to an environmentally-impaired source property with a mandated clean-up program.

• ***Income Approach*** - Mr. Lusvardi believes the Income Approach is inadmissible in most insurance or eminent domain cases, because it is prone to speculation and manipulation, notwithstanding the fact that some property interests cannot be properly valued without the use of the Income Approach. J. D. Eaton notes that "while courts differ greatly in their attitudes toward income capitalization approach evidence,[8] ... testimony pertaining to the income capitalization approach to value will generally be admitted by the courts as long as the property under appraisal is income-producing in nature and market support is presented for the estimates made by the appraiser in applying this approach."[9]

Lusvardi's suggestion that use of the DC Income Approach would "likely impeach any expert valuation witness" is nonsense. It has been my experience that the Cost and Sales Comparison Approaches are equally prone to subjectivity and manipulation - if we are to disregard the Income Approach, as Mr. Lusvardi suggests, perhaps we might also discard the other two valuation approaches as well.

Mr. Lusvardi's misrepresentation of real estate damage analysis is nothing short of incredible. Perhaps even more troublesome, however, is the overall tone of the article. The classification of detrimental conditions (the Bell Chart) was purportedly "invented to serve as a menu for damage lawsuits," with Lusvardi indicating the "DC Model [to be] so inconsistent . . . that one runs the risk of being called unkind for lack of finding anything worthwhile about it." Accepted real estate damage concepts and methodologies are likened to the ancient pseudo-science of alchemy, and characterized as "uninformed," "dangerous" and "an embarrassment to the profession."

Real estate damage analysis, as criticized so derisively by Mr. Lusvardi, has been extensively tested and peer-reviewed, and is widely accepted by the appraisal profession. Lusvardi apparently advocates ignoring market-based perceptions in favor of his own opinions of how he thinks things should be. After wading through Mr. Lusvardi's gross misrepresentations, one is left with no material support for his claims. ■

Michael V. Sanders, MAI, SRA is a partner in the appraisal firm of Bell Anderson & Sanders, specializing in real estate damages and related valuation issues. He received his undergraduate degree in business administration from California State University Fullerton, and is a designated member of the Appraisal Institute. Mr. Sanders is qualified as an expert witness, and has previously published on the topic of real estate damages in The Appraisal Journal, San Francisco Law Review and Orange County Lawyer.

[1] Randall Bell, Real Estate Damages - An Analysis of Detrimental Conditions (Chicago: Appraisal Institute, 1999)
[2] Ibid., p. 9
[3] Ibid., p. 15
[4] Ibid., p. 17
[5] Reed v. King, 145 Cal.App.3d 261, 193 Cal.Rptr. 130 (1983)
[6] Bill Mundy, "The Impact of Hazardous Materials on Property Value," The Appraisal Journal (April 1992), pp. 155-162
[7] See Mozzetti v. City of Brisbane, 67 Cal.App.3d 565, 136 Cal.Rptr. 751 (1977)
[8] J. D. Eaton, Real Estate Valuation in Litigation, second edition (Chicago: Appraisal Institute, 1995), p. 174
[9] Ibid., page 194