Market Value Relationships

There is nothing intuitive about a property's value.

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Market value is not an inherent condition but evolves from a unique balance of a property's utility and the demand for and supply of competing properties. In short, market value is market dependent. Identifying the correct market is crucial for determining a property's highest and best use and will guarantee the consistency needed to produce credible valuation results.

In certain situations, identifying a market and performing a market analysis can involve invoking some artificial conditions and adjusting for increased risk, measuring the use against other competing uses. In this way, highest and best use and valuation are self-reinforcing. The highest and best use conclusion is based on evidence of market activity, and that market activity is used to value the property.

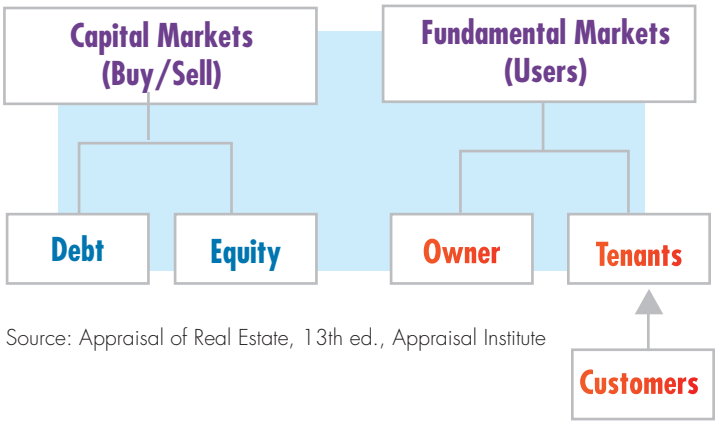
The question is, what is the relationship of markets to a property's highest and best use and to its valuation?

Occupancy Defines the Market

A property's use is manifested by the need and desire for the real estate, which is measured by occupancy. Since occupancy is the actual use of a property type, the empirical evidence of demand can only be determined by studying occupancy of an existing type and class of real estate over time. The initial occupancy when a property type is introduced to the market is critical because it provides the first evidence of market activity and offers proof that a market may exist. A market cannot be said to exist without a history of market activity, and that history begins with the initial occupancy.

In real estate appraisal, the supply of and demand for competing like properties is used to establish the market value. The capital market analysis focuses on the buyer-seller relationship, while a fundamental market is concerned with the actions of owners, tenants and customers, all also acting independently as market participants. The components of these two markets are shown below.

Capital Markets and Fundamental Markets



Source: Appraisal of Real Estate, 13th ed., Appraisal Institute

Although capital market and fundamental market are shown as two distinct considerations, they are very much interrelated. The fundamental market produces the conditions that are transferred in the capital market. The conclusion is unavoidable - the value of real estate is primarily a function of those actions taken by the owners, tenants and customers. These actions, which are all expressed by occupancy, serve as a tangible expression of the needs and desires of users that results in the demand for space, and coupled with the competitive supply, gives the space its value.

Real estate appraisal is the combination of observation and analysis. The observation comes first, because without it, there is nothing to analyze. In market analysis, occupancy is primarily what the appraiser observes, and therefore occupancy is a necessary precursor.

Lacking initial occupancy does not mean that a potential market does not exist. However, until the property type is introduced and initial occupancy takes place, there is no actual proof of value. For example, consider an area that has a variety of rental apartment complexes but no condominiums. A potential market for condominiums may exist if it can be shown that other similar communities have condominiums or if surveys of potential users within the subject community indicate a desire to live in a condominium. If the area has never had the property type and occupancy has not occurred, it is difficult to prove that an actual market exists.

Conducting the Market Analysis

Market analysis studies the performance of a particular property or property type relative to user needs. Studying a fundamental market shows how users and occupancy will affect price behavior, which is needed before a capital market can be accurately measured. Although the market analysis can be done without an appraisal, an appraisal cannot be completed without market analysis. In fact, market analysis is one of the few essential components of every appraisal, as it measures the impact of current/future demand and supply conditions of a particular property type and uses this information to predict the future performance of a specific property. This is important because value incorporates the present worth of future benefits.

Market analysis has three critical ingredients: demand, supply and geography. Demand always comes first, as market analysis is ultimately concerned with the needs and desires of the users. But market analysis is also concerned with the property's competition and geography. Therefore, demand must be compared to supply, and the comparison must be restrained by a geographic area, which is where the analyst has the most control. The geographic market area can be described as the area in which alternative or similar properties effectively compete with the subject property in the minds of probable, potential purchasers and users. This determines the natural market area. For example, depending on the competition, the natural market area for a neighborhood retail property typically includes a five-minute travel time. While intervening opportunities can reduce an extended geographic market area, if no competition exists within five minutes, the travel time can be extended. As a result, the extended geographic market area can therefore be seen as an artificial market that exists only due to a lack of competition.

If the analysis is on a natural market area that lacks current supply, as in the case of a proposed property that hopes to represent initial occupancy, the artificial market area would need to include at least one example of the property type. This satisfies not only the supply component of the definition, but also the demand component. Without initial occupancy in the natural market area, there is no measurable demand.

There are two reasons why measureable demand is important. First, without initial occupancy, the analysis becomes a study of a potential market. This kind of analysis has its place, but it would produce speculative results if performed in support of an appraisal. Second, the existence of actual occupancy allows for demand segmentation, which differentiates the most probable users of a property type from the general population. Segmentation for a residential use, such as with condominiums, focuses on the market with the effective buying power to act on the desire. Without solid evidence of demand in the form of occupancy, demand segmentation becomes speculative.

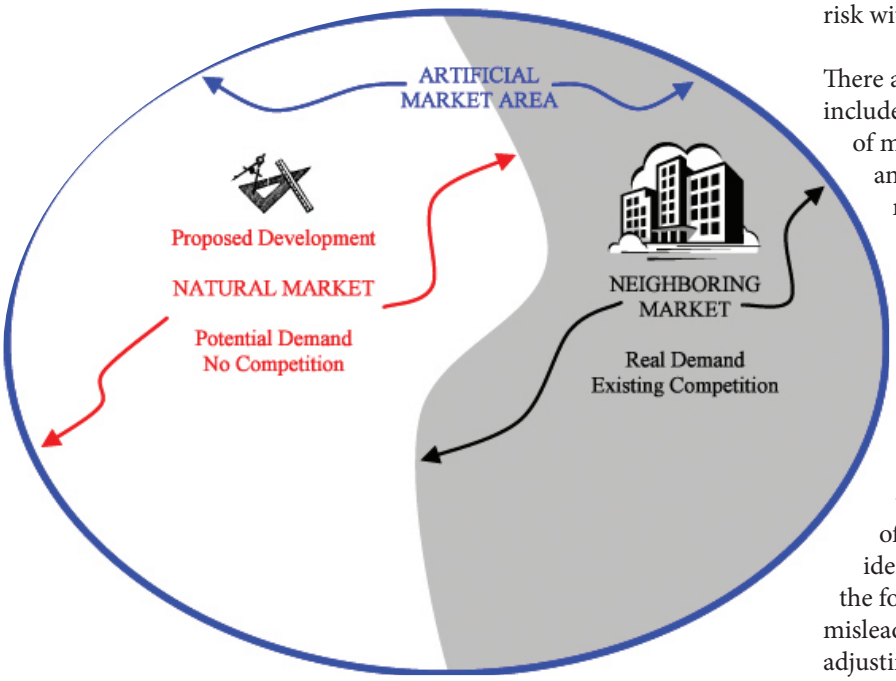
By expanding the market area to include the property type, segmentation becomes possible.

Case Study, Part 1

A vacant parcel of land was proposed for development with a 100-unit residential condominium. The property's characteristics indicated strong potential for multifamily use, but there were no condominiums within the property's natural market area. The appraiser believed that there was potential demand for condominiums in the area, but the analysis could not proceed unless an actual market could be identified. This could be accomplished by expanding the market area as demonstrated below.

Since the occupancy was spread over an area that lacked real demand, using an artificial market area would provide less reliable results than if the property type existed within the natural market. Without condominium occupancy in the natural market area, the demand cannot be proven. As a result, the measurement or forecast of demand is de facto speculative. While extending the market area alleviates this issue, it is not without costs.

Market analysis is only as reliable as the information on which it is based. If decisions are based on an analysis whose geographic area has been artificially manipulated to include a neighboring market, then the results will likely contain a greater degree of uncertainty than if a property type were present in the natural market.



Determining Highest and Best Use

Just as market analysis needs a market to produce supportable results, a highest and best use conclusion requires market analysis to be supportable. A highest and best use analysis requires a comparison of alternative, financially feasible uses. Determining financial feasibility relies on interpreting and analyzing the relevant and credible market evidence in the market area, as well as in the subject property's competitive market. In other words, financial feasibility can only be determined if there has been occupancy of the property type in the market. And since market analysis cannot be performed without proof of occupancy, market analysis serves as a filter for alternative uses in the highest and best use decision.

This link between the highest and best use and market analysis is absolute. However, if the property type does not exist in the natural market area, the market analysis and relative value of an alternative use will be less reliable. That is, unless the specific use is present in the local market, the relative value of that use has more risk associated with it than a use that exists in the local market. It is only fair to compare the alternative uses if the risk is equalized among all the alternatives. This means that the relative land value analysis that a use produces must recognize that, all else being equal, introducing a new use to a market is more risky than expanding an already present use.

Higher risk requires the expectation of higher rewards. In the multifamily residential case study, condominium use is more risky than rental use simply because it is not represented in the local market. Assuming that land value could be quantified for condominium use, the value must be adjusted to equate the risk with that of land for a rental project.

There are three recognized methods of equalizing risk. They include the qualitative comparison of results, the application of more conservative value estimates to riskier alternatives, and discounting the riskier alternative. Whichever method is chosen, accounting for the differences in risk among alternatives will result in a fair comparison of alternative uses.

Establishing Market Value

Just as market analysis supports highest and best use, highest and best use supports market value. Therefore, if market value is the goal, it is the highest and best use that is valued, since use is the major determinant of value. Consequently, it follows that the purpose of identifying a property's highest and best use is to identify the focus of the valuation. It would be inappropriate and misleading to employ one use to value another without adjusting for the use difference.

In practice, the adjustment for a different use should not be necessary. The reason for this is that any application of the four recognized methods of deriving and supporting adjustments requires that a market exists in both uses under consideration. These methods include data analysis, statistical analysis, cost-related approach and capitalization of income differences. For example, if data analysis is used as in the case of paired sales, there must be sufficient data of both uses in order to extract a reliable difference. This dictates that a pool of transactions must exist from which the difference can be extracted for both the subject use and a different use. The very existence of such a pool, however, negates the need for the adjustment, since the transactions of the subject use could be used to value the subject property.

While this discussion focuses primarily on the sales comparison approach, similar observations are relevant to the income capitalization and cost approaches, since both also extract market evidence from some form of local occupancy.

Case Study, Part 2

An appraiser was asked to value a vacant parcel for residential use potential. After accounting for risk differences, the appraiser concluded that a multifamily rental rather than condominiums was the parcel's highest and best use. The appraiser wanted to value the land through sales comparison, but a market search revealed that land sales that were most recent, most similar in size and most proximate in location were all purchased for hotel development. All multifamily land sales had occurred much earlier, and they were more distant and varied greatly in size.

To use the hotel development land sales would require determining whether the different uses would produce different land values. This would depend on a comparison of market information for hotel and multifamily uses and would be reliant on information derived from multifamily uses. However, such information would be adequate on its own to value the land— if not by sales comparison, then by extraction, allocation or income—thereby negating any need for the hotel land sales.

In this case, the hotel land sales would be of interest to the appraiser in forming an opinion of the property's highest and best use. However, if the land's highest and best use was concluded to be other than hotel development, the hotel land sales should not be considered comparables unless the difference in value due to differences in use could be measured. Without independent support for the adjustment, only the same uses should be mined for valuation data. This requirement cannot be violated, but it can be avoided simply by revising the highest and best use conclusion to match market evidence.

"...highest and best use and valuation are self-reinforcing."

Conclusions

Market activity is the foundation of real estate appraisal. Without market activity, a market does not exist, market analysis is not possible, a highest and best use conclusion cannot be supported and the use cannot be valued.

Empirical evidence is a necessary component of any appraisal. The evidence is first used to support a highest and best use conclusion. This evidence is the actual occupancy, as without occupancy, there is no market. An appraiser may be tempted to conclude a highest and best use based on anecdotal evidence, for this might result in a higher indicated value, but market value must be based on empirical evidence. In order to obtain such evidence, an artificial market area would need to be identified so as to capture demand demonstrated through occupancy.

Similarly, market activity will produce comparables. These comparables need not be the most current available, but only similar in use. In theory, it may be possible to adjust the comparable properties for a different current use or highest and best use. However, in practice this should not be necessary.

In summary, market activity not only supports the highest and best use decision, but also serves as the basis for the value of the use. In this way, highest and best use and valuation are self-reinforcing. The highest and best use conclusion is based on evidence of market activity that is in turn used to value the property.

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