Guide Note 10

Development of an Opinion of Market Value in the Aftermath of a Disaster

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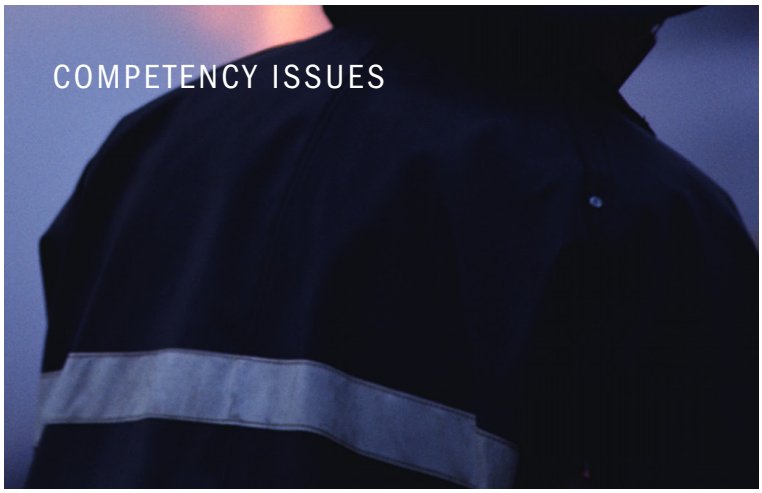

Background/Rationale

In recent years, the United States has experienced terrorist attacks, unusually destructive natural disasters and catastrophic man-made disasters. The aftermath of a disaster poses special challenges in real property valuation. During such periods, real property markets in affected areas often exhibit instability, even chaos. Analyzing market data in such markets can be difficult. Appraisers and clients regularly have sought guidance from the Appraisal Institute on how to handle these situations.

In response, the Appraisal Institute offers Guide Note 10 on "Developing an Opinion of Market Value in the Aftermath of a Disaster" to assist appraisers and clients. The purpose of Guide Notes to the Appraisal Institute's Standards of Professional Appraisal Practice is to provide guidance as to how the requirements of the Standards may apply in specific situations. The Guide Note was adopted by the Appraisal Institute Board of Directors in November 2010.

GUIDE NOTE 10

Developing an Opinion of Market Value in the Aftermath of a Disaster

Natural disasters include hurricanes, floods, tornadoes, earthquakes, tsunamis, fire, severe winter storms, avalanches and mudslides, among others. Disasters can also be caused by human action or error; examples include terrorist attacks, riots, war, panic in the financial markets, industrial accidents, chemical leaks, oil spills, shipping accidents, airline crashes, and structural failures of dams, bridges or buildings. Disasters tend to occur suddenly, taking the public by surprise, even when the location is known to be prone to such an occurrence. Depending on the nature of the disaster, injuries and death may be widespread and destruction of property may occur to varying degrees. Initially the collective reaction to any disaster is shock, then disbelief, mourning and sorrow. Eventually, there is recovery; those affected move on with their lives. Damaged property is repaired and destroyed property is often replaced.

The human tragedy aside, the aftermath of a disaster can be especially problematic in real property valuation assignments.

During that time period, real property markets in affected areas often exhibit instability, even chaos. Analyzing data in such markets presents an array of challenges. *How can an appraiser develop a credible opinion of market value in the aftermath of a disaster?*

Characteristics of "Market Value"

"Market value" is the focus of many appraisal assignments. This Guide Note is intended to address market value assignments only; if the objective of an assignment is not market value, not all of the discussion in this Guide Note will apply.

There are many different definitions of "market value" in use, but all exhibit common characteristics. The entry for "market value" in the Definitions section of the *Uniform Standards of Professional Appraisal Practice (USPAP), 2010 Edition,* addresses these common characteristics:

> **MARKET VALUE:** a type of value, stated as an opinion, that presumes the transfer of a property (i.e., a right of owner ship or a bundle of such rights), as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal.
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> > Comment: Forming an opinion of market value is the purpose of many real property appraisal assignments, particularly when the client's intended use includes more than one intended user. The conditions included in market value definitions establish market perspectives for development of the opinion. These conditions may vary from definition to definition but generally fall into three categories:
> >
> > 1. the relationship, knowledge, and motivation of the parties (i.e., seller and buyer);
> > 2. the terms of sale (e.g., cash, cash equivalent, or other terms); and
> > 3. the conditions of sale (e.g., exposure in a competitive market for a reasonable time prior to sale).

The Appraisal Institute's *The Dictionary of Real Estate Appraisal, 5th Edition*, includes the following in its entry for "market value":

> The most widely accepted components of market value are incorporated in the following definition:
>
> The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.

The *Dictionary* goes on to cite the definition of "market value" used by agencies that regulate federally insured financial institutions in the United States:

> The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:
> - Buyer and seller are typically motivated;
> - Both parties are well informed or well advised, and acting in what they consider their best interests;
> - A reasonable time is allowed for exposure in the open market;
> - Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
> - The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.
>
> (12 C.F.R. Part 34.42(g); 55 Federal Register 34696, August 24, 1990, as amended at 57 Federal Register 12202, April 9, 1992; 59 Federal Register 29499, June 7, 1994)

The International Valuation Standards Committee defines "market value" as follows:

> The estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.
> *(International Valuation Standards, Eighth edition 2007, 27.)*

It is important to observe that the following elements are common to each of the foregoing definitions:

- Market value results when the parties are typically motivated, are generally well informed, and are acting in their best interest;
- Market value results when the property is exposed on the market for a reasonable length of time;
- Payment is in cash or its equivalent.

An appraiser must be especially mindful of these characteristics of *market value* when appraising in a chaotic or unstable market. Quite often, in the aftermath of a disaster, these characteristics are absent from the transactions that occur – if any occur at all. For example, buyers and sellers might choose to act before they have full information. Because of the disaster, they might be extraordinarily motivated to buy or to sell. Exposure times for properties on the market might become extended, or might suddenly become contracted. Sometimes, market activity will virtually cease altogether in the aftermath of a disaster; open escrows fall out; prospective sellers cancel plans to sell; and prospective buyers cancel plans to buy. The lack of data only further exacerbates the challenge for the appraiser.

Applicability of Basic Valuation Principles

Any appraisal problem must be approached using recognized appraisal methodology and in light of basic valuation principles, regardless of whether market conditions are at their most chaotic. Applying established approaches to solving valuation problems will help to simplify even the most complex assignments. Valuation in the aftermath of a disaster requires special attention to the fundamental appraisal principles of supply and demand, anticipation, change, substitution, contribution, externalities, and balance.

SUPPLY AND DEMAND

In economic theory, the principle that states that the price of a commodity, good, or service varies directly, but not necessarily proportionately, with demand, and inversely, but not necessarily proportionately, with supply. In a real estate appraisal context, the principle of supply and demand states that the price of real property varies directly, but not necessarily proportionately, with demand and inversely, but not necessarily proportionately, with supply.

ANTICIPATION

The perception that value is created by the expectation of benefits to be derived in the future.

CHANGE

The result of the cause and effect relationship among the forces that influence real property value.

BALANCE

The principle that real property value is created and sustained when contrasting, opposing, or interacting elements are in a state of equilibrium.

SUBSTITUTION

The appraisal principle that states that when several similar or commensurate commodities, goods, or services are available, the one with the lowest price will attract the greatest demand and widest distribution. This is the primary principle upon which the cost and sales comparison approaches are based.

CONTRIBUTION

The concept that the value of a particular component is measured in terms of its contribution to the value of the whole property, or as the amount that its absence would detract from the value of the whole.

EXTERNALITIES

The principle that economies outside a property have a positive effect on its value while diseconomies outside a property have a negative effect upon its value.

Valuation Considerations

Forces that influence real property values include social trends, economic circumstances, governmental controls and regulations and environmental conditions. Any or all of these might be impacted by a disaster. Factors that create value include utility, scarcity, desire and effective purchasing power. Again, any or all of these might become issues in the aftermath of a disaster. Property utility might be impacted by damage or destruction; properties might be more scarce because damaged or destroyed properties are removed from the overall supply; desire for property might increase because displaced homes and businesses need replacement space; and effective purchasing power might be impacted by changes in lending policies and practices in the area in response to the disaster.

A disaster might have a drastic impact on both supply and demand, causing them to suddenly be out of balance. There may be a dramatic drop in supply due to destruction and damage. At the same time, there may be a spike in demand because those who suffered loss or damage to owned or leased real estate will need to find replacement space. Many will not have the luxury of time in doing so. This is especially true with regard to residential real estate; people need to find alternative shelter immediately. As a result, sharp increases in asking and selling prices might be observed. This raises several questions from an appraisal viewpoint: Do such higher prices represent “market value”? Are the parties to the transactions “typically motivated” and acting in their best interest or is their behavior irrational? Are the properties being exposed on the market for a “reasonable” length of time prior to sale?

The principles of substitution, contribution and externalities help provide the answers to these questions. As in any assignment, identification of the subject’s market area is critical. Generally, all properties in the subject’s *market* area are similarly impacted by the disaster. “Typical” motivations and “reasonable” exposure times are therefore measured by what is observed in that market area during the same time period. In other words, “normal” is redefined – at least for the time being.

The principles of anticipation and change are especially relevant to valuation assignments in the aftermath of a disaster. There is generally a great deal of *uncertainty* in the market during this time period. Is the disaster likely to be repeated in the near future? Will further damage and destruction result? What is the extent of the damage? To what degree can structures be replaced? Are there environmental concerns, and if so, to what extent? And how long will it take before things return to “normal”? The impact of such uncertainty may be readily perceived but difficult to measure. Uncertainty in real estate markets means increased risk to property owners and investors. Such increased *risk* might be reflected in higher capitalization and discount rates. It might also be manifested in “discounted” prices – which to some degree might offset upward pressure on prices resulting from increased demand and decreased supply.

The appraiser must be especially mindful of issues relating to the date of value. Ideally, comparable data must be selected from the same market area and must be subject to the same market conditions. Transactions that occurred prior to the disaster will not reflect the same market conditions as those occurring after.

Following a catastrophic event, there may be few if any truly comparable sales from which to support a value opinion as of current date. Additional data may need to be taken into consideration such as experience from other disaster-affected areas or anecdotal information obtained from interviews with market participants, for example. It is important that appraisers continue to apply and rely upon the same methods and techniques as in other assignments, remembering the analysis necessary to determine comparability of data.

Some appraisal assignments require the *date* of value to be prior to the disaster. Such retrospective valuations include those provided to assist insurers and insureds in establishing loss amounts for insurance purposes. In these cases, the appraiser must rely on data that occurred prior to that retrospective value date. Such transactions occurring in that time period would not have been impacted by the disaster. The difficulty in these retrospective valuations is that the appraiser cannot obtain firsthand information about the characteristics of the property that are relevant to the assignment as of the date of value; i.e., one cannot go back in time to visually inspect the property. The appraiser must therefore rely on the best available information about the nature of the subject property as of the date of value.

Such an appraisal would be based on one or more *extraordinary* assumptions about the property condition and other characteristics that are as presumed to be true in the appraisal assignment.

The more problematic appraisal assignments are those for which the *date of value* occurs in the aftermath of the disaster. If no data is available on transactions that occurred in the aftermath of the disaster, data on transactions that occurred prior will require adjustment for market conditions. Such adjustments may be difficult to substantiate. An appraiser must be extremely careful in the use of such data and the estimation of any such market conditions adjustment. In time, more transactions will occur and more data will become available for analysis. Until then, the appraiser must work with what is available. The terms and conditions of any sales that do occur must be analyzed more closely; buyer and seller motivations must be investigated more thoroughly, and the nature of the property's exposure on the market must be examined.

Sustainability of value

A client might request an opinion of value, but to many clients the answer to another question may be paramount: *How durable is that value?* Are values in the aftermath of a disaster likely to be sustained over time? If values have risen in the aftermath of the disaster, are they likely to fall again in the near future? If values have fallen, are they likely to rise again? It is important to recognize that these questions are separate from the question of value, and answering them goes beyond the provision of an appraisal.

To some degree, the sustainability of value over time will be reflected in the current market value, because market participants build their expectations into prices; if they believe values will rise in the long run, they might be willing to pay more now. After a disaster there is much more uncertainty, and this tends to cause buyers and sellers to be more cautious. In the aftermath of a disaster there is more than the normal amount of risk in the marketplace. The market may be very fluid. Changes to market conditions may cause changes in market value to occur more rapidly than usual.

It may be helpful to communicate to the client the relative reliability of the value opinion. It is appropriate to point out in the appraisal report that the data upon which the appraisal is based is limited in quantity or quality and that this affects the reliability of the conclusions. If acceptable to the client, expressing the value opinion within a range may be an appropriate way to address this situation.

Competency Issues

The requirements of the Competency Rule in USPAP become greatly enhanced in assignments to develop market value opinions in the aftermath of a disaster. The Competency Rule identifies several types of competency, including competency with regard to (1) a property type (2) a market (3) a geographic area and (4) an analytical method. An appraiser who previously possessed sufficient competency to appraise a given property type in a given area might not have sufficient competency to appraise the same property type in that area in the aftermath of a disaster.

Government agencies and other bodies such as Fannie Mae, Freddie Mac, and the bank regulatory agencies might issue guidance or impose additional requirements on appraisers working in the affected areas after a major disaster. Appraisers must be cognizant of such additional requirements and pay them particular attention, as they may become enforceable requirements for such assignments.

Appraisers should be wary of requests to provide services other than appraisal services for which they lack competency. For example, in the aftermath of a disaster, some clients might request a signed report indicating the condition of a property, noting any damage or destruction. Unless the appraiser possesses the requisite competency to make judgments about these matters, the appraiser must not take on assignments that require competency that is beyond that of a real property appraiser.

Appraisers must avoid making statements of fact about what they *believe* they observed, when such statements are not substantiated by the necessary expertise. For example, an appraiser might observe what he or she thinks is mold in a flood-damaged property; but without definitive input from an expert in mold, making a statement about the presence of mold might be misleading. Instead, the appraiser's statements should be limited to what he or she actually observed. Instead of stating that mold was observed, state that "a black substance was observed on the walls."

Appraisers must not allow their personal involvement in the disaster to affect their objectivity. This can be challenging in the wake of a disaster that has affected one's own family, friends and/or hometown. An appraiser must be prepared to decline any assignment in which he or she cannot maintain impartiality.

Summary of Standard Practices

1. **Developing an opinion of value in the aftermath of a disaster might require competency that surpasses or is different from that required prior to the disaster.**

2. **The characteristics of the applicable definition of *market value* must be carefully examined when appraising in a chaotic or unstable market.**

3. **Valuation in the aftermath of a disaster requires special attention to the fundamental appraisal principles of supply and demand, anticipation, change, substitution, contribution, externalities, and balance.**

4. **Transactions that occurred prior to the disaster will not reflect the same market conditions as those occurring after. Ideally, comparable data must be selected from the same market area and must be subject to the same market conditions as the subject property.**

5. **In appraisal assignments for which the date of value is a retrospective date prior to the disaster, the appraiser must rely on comparable sales that occurred prior to that retrospective value date.**

6. **In appraisal assignments for which the date of value is a retrospective date prior to the disaster, the appraiser must rely on the best available information concerning the nature of the subject property as of the date of value. Such an appraisal would be based on one or more *extraordinary assumptions* about the property condition and other characteristics that are as presumed to be true in the appraisal assignment.**

7. **Unless the appraiser possesses the requisite competency to make judgments about these matters, the appraiser must not take on assignments that require competency that is beyond that of a real property appraiser.**

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members, Candidates, Practicing Affiliates and Affiliates with guidance as to how the requirements of the Standards may apply in specific situations.)