Intangibles and Caprice Can Confound Market Value

The impact of buyer or seller “caprice” in real estate transactions can confound the appraisal process in interesting ways. The presence of additional “intangibles” that are distinguished from realty or personal property, furnishings, fixtures or equipment can add another layer of confusion as to what is really being traded in the market and the value of the components. Is it “investment value” or “market value”. USPAP requires an appraiser to estimate and allocate total value to any components and recognize unusual buyer and seller motivations. This is far easier said than done and has been a contentious topic in the appraisal community.

First, consider a few important and relevant definitions from the Appraisal Institute’s Dictionary of Real Estate Appraisal. The definition of “market value” comes in several forms, but can be generically summarized as the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyers and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Alternatively, “investment value” to a particular buyer or seller is based on the investor’s specific requirements that comprise criteria not necessarily typical of the market. “Intangibles” are non-physical assets of a wide variety including franchises, trademarks, securities, goodwill and others. To complicate matters just a little more, terminology related to intangibles and business enterprise value (BEV) varies between The Appraisal Institute, USPAP, IAAO Glossary for Property and Assessment, Journal of Property Tax Management and International Valuation Standards.

Here is where it gets more interesting. The term “caprice” is not found in those alternative definition sources, but is certainly present in the market. Webster's Dictionary defines it as a sudden, impulsive change in the way one thinks or acts; freakish notion; whim; quaint or curious notion. Investor specific criteria or caprice can drive a price for conventional real estate beyond market value. But, with some unique property types, like many Maine coastal islands, the often whimsical, even "eccentric" prices paid are due to caprice in this colorful niche… and they make the market. If a single transaction reflects whimsy, then it would reflect investment value. But, when most of the transactions in a niche reflect some caprice and a lot of subjective judgements, it seems to me that those sales are that market.

In my appraisal review practice, I've sympathized with the challenges facing appraisers searching for arms length, transactions in the oceanfront island market. It requires far more time and research than usual, and the data verification and valuation processes are difficult. Purchase and sale motivations are very varied and usually involve some caprice. Common unit denominators like price per acre, price per waterfront foot, waterfront feet per acre, subdivision potential, number of potential lots, do not create a reliable pattern for estimating island value. These properties are valued "as a whole" with "qualitative" adjustments for features having an impact on island utility, features like distance to a mainland launch lot, existing building improvements, waterfront quality and accessibility, viewshed, any existing conservation easement; and privacy and protection. Appraisers have persuaded me that the intangible motivations in this unique market make sales comparison and adjustments more of an exercise in judgment based on extensive experience.

Some other examples of properties that arouse capricious or intangible motivations are high value properties with architectural significance; unique locations with a "signature" address; family legacy properties encumbered with fractional interests; and residential purchases providing an opportunity to make a “statement”, among others. We humans can be imaginative and impulsive, and “one person’s goose is another’s swan”.

The Appraisal Institute offers a fairly new course on the valuation and allocation of the components of a “going concern” or “total enterprise”. But, the semantic disagreements and ambiguities continue to confound practitioners. Analytical methods for attempting to quantify them do exist and are evolving. But, with regard to unique or special purpose properties, like islands and the examples above, caprice still abounds, defies widely accepted quantification, but has an undeniable impact on value.

By Randolph Glennon, MAI, AI-GRS, CRE, for the New England Real Estate Journal.

Highest and Best Use In Evolving Neighborhoods

Gratifying results of growing consumer confidence and an improving economy are their powerful impact on the imagination of our confident real estate industry risk takers- the developers. Add tough locations with historical baggage and questionable availability of financing, and the momentum of a good idea can be hard to sustain for most. But, the intuitive analytical ability, drive, determination and occasional dose of overconfidence can drive some developers to really spectacular results. The crux of their success is often an ambiguous, but correct, highest and best use conclusion driven by thoughtful examination of a variety of alternative uses of which many have financial feasibility.

I spent early years in my real estate career in Boston, acquiring experience with some really exceptional colleagues and mentors. Early on, in the mid 1970's, I thought it would be a great idea to move to Portland, ME, that little jewel on the Maine Coast. I checked it out and quickly felt that its time had not yet come, still a bit stagnant and conservative. Back to Boston I went for more debt and equity finance tutelage. In the early 1980's, I headed up the coast once again and took another look¬¬. Behold, a stunning renaissance of adaptive reuse and restoration in Portland's Old Port Exchange.

What had made the difference? It was all about a small, ardent and mostly local cadre that had the vision, stomach and money to invest, make smart choices and take risks in turning around that small part of Portland on a somewhat sleepy, rundown, industrial waterfront.

So, I did make that move up the coast to Portland and hardly looked back. At the risk of showing too much favoritism for my new home, you should see it now. The highest and best use of the Old Port Exchange was driven by long term belief that feasibility costs and rent for remodeling and major conversions would be far exceeded not just by market rent, but net income and profit as momentum took hold. It started with rehabbing those old industrial buildings on Exchange, Fore and Commercial Streets, at first one by one, and then creating Chandler's Wharf luxury condos next to Dimillo's Floating Restaurant and Marina. It snowballed. The Old Port synergy converted that old enclave of mostly dilapidated industrial buildings on "made land" and wharves into "Ocean Gateway", an impressive evolution of a now nationally recognized waterfront with high end condominiums, rental apartments, hotels, a major cruise terminal and one of the highest densities of good restaurants and entertainment in the Northeast.

Success breeds more success! After a long time coming, the eastern entry into Portland's CBD from I-295 has been blossoming into another impressive, successful neighborhood rising literally in many places out of the ashes and waste disposal of two centuries of maritime, industrial and railway use. The area is now known as Bayside Gateway. Witness several new office towers totaling more than 150,000 SF, big by Maine standards, with major, local credit tenants. The spinoff is the rapidly increasing conversion and adaptation of many former light industrial or manufacturing properties into more intensive commercial and residential use in west and east Bayside, successful models of urban renewal. Simplified, the crux development hurdle is prospective, capitalized net operating income for converted industrial properties near the end of their economic lives that must exceed the cost of conversion, required entrepreneurial reward and the value of time and costs associated with the marketing period.

Several earlier decades of limited action passed while developers wondered about the future promise of that "sleeper" Bayside location astride a railway serving scrapyards and industrial properties. Those industrial uses, over two centuries, created Brownfields that are seeing resolution as obsolete facilities are relocating outside the city to make way for more compatible uses. Any lingering contamination or stigma impacts on financing or insurance costs and marketability after remedies have been completed is increasingly being accommodated by higher return on investment. Standing on many corners along Marginal Way in Bayside, it's hard to believe that much of the land on which many of the attractive new projects have been erected is industrial-related fill of mostly unknown composition and quality. The adjacent Back Cove water body actually used to extend almost half a mile further inward towards the CBD.

As adaptive reuse has taken hold, declining market risk is constraining capitalization rates. Nevertheless, big challenges are careful, up front evaluation of costs to acquire and remodel (or remove) existing improvements and the weighing of supply versus demand for a finished product. What is the profit associated with the different use alternatives? How do their different risk rates, timing and marketing impact value? What does the market really want and is now the right time?

A matrix is helpful for initial comparisons of the value of alternative uses. Some fundamental components are current and prospective market rent, acquisition costs, purchase price, interim use, development period, operating expenses, and an appropriate discount rate to reflect the time required for development or conversion and marketing. In a recent assignment, I evaluated four plausible alternatives for an obsolete property. Each required a "mini" appraisal to compare values and reach a highest and best use conclusion for the subject property. As a frequent Appraisal Reviewer, I always look for support for a credible highest and best use conclusion. It is usually the make or break fulcrum of an appraisal.

By Randolph Glennon, MAI, AI-GRS, CRE, for the New England Real Estate Journal.

GIS Tools Give Life to Real Estate

We all know that "a picture is worth a thousand words". The same is true of GIS mapping results. So what is it? To paraphrase an Appraisal Institute publication, "geographical information systems enable the user to capture, store, analyze, and visualize real property information data points of interest in a map or geospatial context". The spatial component of data makes it possible for the trained analyst or even casual observer to appreciate important relationships between different types of data that are otherwise less visible in our often mundane appraisal and consulting charts and exhibits. It facilitates analyses of often voluminous data and helps us arrive at conclusions that support better real estate decisions. It can help us work smarter and faster at a more meaningful level. These mapping tools aggregate, illuminate, enhance, emphasize and then convey useful information that most of us humans seem to prefer over words and numbers.

GIS technology emerged in the 1970's. Back in the 1980's, I attended a multi-day, big city GIS course taught by ESRI and was excited about the prospects for more informative and persuasive presentation of appraisal and consulting data and analysis. But, my optimism was somewhat deflated when I noted that little public, geo-coded data was available for analysis and mapping. Assessors and planners were in the vanguard of GIS use, but it took many years for mapping to become commonplace.

Where are we now? The dramatic advances in information and spatial technology currently, for the most part anyway, enhance our work and play. We are overrun by the real or perceived need for immediately available data and information. Technology and commercial mapping software have evolved from our old hard copy road map to dashboard GPS that rivals texting for driver distraction. We have progressed from simple desktop software location and comparable transaction maps to on line Google Earth, Yahoo Maps, Trulia and layered, geographically related data of all types from government entities and many commercial vendors we now take for granted. GIS weaves this all together and integrates the results for interactive use by those with the patience and resources (time and money). GIS is widely used today in many other fields such as government, health, environmental management, demography, and the military.

The results of present day, in depth, real estate related, geocoded data can be displayed geographically in very viewer friendly maps and exhibits. They can be far more content rich and memorable than the often long narratives that characterize our appraisal reports. These days, it is all about identifying and layering “stacks” of raw, geographically related data into information leading to useful conclusions. And, some have moved forward to linking data sets relationally for “IVM” (interactive valuation modelling).

How can real estate professionals now use GIS? For some abbreviated examples, appraisers and assessors can make value decisions using information about comparable property location, size, neighborhood, sale price, access to transportation, demographics, and other economic features. Brokers can visualize geographically suitable properties based on buyer investment criteria, occupancy rates, listings, and time on market. Investors and lenders can evaluate property performance and underwriting effectiveness related to competitive location criteria, positive or adverse neighborhood influences, under or over performing locations, and demographics. Portfolio managers can evaluate diversification risk by property type, occupancy, employment, industry and other geographical impacts. Developers can perform site selection based on mapping of geographical features that are physically, functionally and demographically driven and which illuminate competitive area growth trends and opportunities. Retailers and market researchers can perform trade area analyses by mapping purchasing power to evaluate supply, demand and retail sales per SF.

What does the future hold for GIS users? The pundits believe we will have more geographically related data that is highly integrated into IVMs evolving from current AVMs. Statistical analysis will also be integrated to provide results that drive more reliable interpretations and conclusions. Hopefully, none of this “progress” will remove real time, human judgment from the decision making process. This begs the questions: 1) Are some appraisal niches headed for extinction?, and 2) When? If this sounds remote, we are already hearing about the advent of driverless cars carrying commuters.

Rising standards of practice and fiduciary responsibilities are already requiring more use of GIS and IVMs in some appraisals to support strategic and tactical investment management systems. GIS is still less used by appraisers and many other real estate professionals due to the heavier requirements for hardware and software, data accumulation, geocoding, modelling and integration into reports. But, its use is increasing by some larger appraiser companies, consultants, brokers, assessors, developers, owners, service providers, and portfolio analysts. We are still only operating at a modest level relative to potential uses driven by faster and broader data accumulation, analysis, integration, presentation and “predictive analytics”.

IVMs are data intensive. Public and for sale databases are now somewhat widespread. But, lack of high quality reliability can still mean some “garbage in, garbage out” regardless of model sophistication and skill of the user. The real estate market is showing increases in the size and capitalization of property owners and managers; their use of securitization; multi- property portfolios; the speed with which decisions must be made; and the amount of information and analyses needed to support decisions. As the experts have noted, these trends all favor use of GIS because of its inherent resource intensiveness. It has some simple, but more complex applications and is probably most suited to larger appraisal firms with the resources and support to use it economically.

GIS education is available from various sources. One of the foremost is ESRI, which conducts courses nationwide in use of GIS application. Appraisal Institute and collaborator texts also provide excellent overviews into the tools and applications. In this improving economic environment with more appraisals, stricter quality control, but flexible Scope of Work requirements, the best education and competent peer review are mandatory. The Appraisal Institute's mission is to provide premier real estate education, publications, peer review, maintenance of exceptional standards and ethics, and advocacy for the profession.

By Randolph Glennon, MAI, AI-GRS, CRE, for the New England Real Estate Journal.

What Type of Value Do You Think You Need?

The type of value that forms an appraisal objective can be vague and ambiguous to many clients and appraisers. For example, an appraiser's eager, fictitious client says he has a “simple” appraisal request involving a restaurant he wants to add to his existing hotel on unused land where contamination has been successfully mitigated. He already “knows” what the hotel is worth and is “comfortable” with his estimated remediated land value. He would just like to know the “value of the restaurant on completion” so he can move forward with the equity syndication of the “completed business”.

Just another simple appraisal? Not really, and where do we start? First, a probing conversation with the client is needed to determine the intended uses and users of the appraisal; the type and description of all of the assets; and the property rights involved. This is part of the USPAP required Scope of Work and leads to the type of value(s) needed. Many clients know they have a problem and are challenged identifying and articulating exactly what it is they need. As an appraisal reviewer and real estate advisor, I’ve learned that this is an area where we can be of great assistance. If highest and best use analysis is commonly accepted as the fulcrum of an appraisal, then that fulcrum in turn rests on the definition of value and the discussion that precedes it. Once this foundation is laid, the appraisal problem and type of value(s) the client really needs should emerge.

There are dozens of values that can be appropriate appraisal objectives, and often more than one at a time. I refer you to several sources that cite and define them, sometimes with conflicting or ambiguous semantics. You can visit the Uniform Standards of Professional Appraisal Practice (“USPAP”) where a brief Definitions section is presented with several of the more prominent ones, including “Market Value” and “Value”. There, value is expressed as an “opinion… of a monetary concept” that “presumes the transfer of a property, 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”. This general definition is only an intended, bare framework within which a specific type of defined value is selected. Note that a Broker Price Opinion (BPO) or a Competitive Market Analysis (CMA) are relevant to list price and not by themselves appraisals of value, the latter of which require compliance with USPAP.

Some other primary sources include the Appraisal Institute's Dictionary of Real Estate Appraisal, FIRREA, the Uniform Appraisal Standards For Federal Land Acquisitions, Interagency Appraisal and Evaluation Guidelines (for OCC, FDIC, Federal Reserve and OTS government-related entities), IVSC and the American Society of Appraisers. By the way, for anyone who has the time and enjoys gymnastic sparring and speculating over value definition semantics and intentions, excellent choices are the lively and often endless discussions about them in appraisal courses or on line blogs.

As for our restaurant developer introduced above, he of course needs several different types of value involving more than one economic unit. The values sought could require several possibilities including current market value; value in use; prospective, hypothetical values on completion and stabilization; business enterprise value allocated to realty, tangible and intangible assets; investment value; and land value as impacted by potential stigma, among others.

In conclusion, the results of an appraisal or counseling session are moot and misleading without an understanding and agreement about the type of value sought. The reader is encouraged to refer to the Appraisal Institute, Appraisal Foundation, and other credible sources for clarification. And, obtaining assistance from appraisers and advisors who have the appropriate professional training, skills and experience is highly recommended.

In a future article, some other interesting and complex types of value will be explored, like "social or option value" debated with conservation land acquisitions. And, "easement value" regarding intertidal (beaches) and submerged land. The scarce amount of sand and cobble beach produced by more than 3,000 miles of weather beaten Maine coast is in the news again. Upland, private property owners and the recreating public are back in court jousting over historical, habitual rights to beaches for far more than archaic “fishing, fowling and navigating”. A lawyer’s dream come true, this intriguing property rights battle takes us back to the mid 17th century when Maine was still a part of Massachusetts and subject to its laws, language and evolving intent.

By Randolph Glennon, MAI, AI-GRS, CRE, for the New England Real Estate Journal.

Valuation of Assets With Real Estate, FF&E and Business

Just what is the business component of an asset with real estate really worth? Some examples of properties that pose these valuation challenges are lodging facilities; restaurants; shopping malls; fitness clubs or other business enterprises with realty. Real estate appraisal and accounting methods are merging in this specialty that includes assets more complex than intuitively apparent.

Historically, real estate appraisers have often avoided dealing explicitly with the allocation of value into often called realty; furnishings, fixtures and equipment (FF & E); and goodwill. The words “inextricably intertwined” are sometimes used to glibly explain away the need to identify and value the parts comprising the whole. Estimating the value of “goodwill”, “business value”, “going concern value” and other semantically ambiguous and overlapping terms was left to the business appraisers and accountants or simply and implicitly included with the real estate. The result can be overvalued realty that does not reflect the contribution of high risk, tangible FF & E and even higher risk identified or unidentified intangibles that may be present.

Valuation models are evolving with the current Uniform Standards of Professional Appraisal Practice (USPAP), Interagency Guidelines and SBA requirements. They require an appraiser to identify any non-realty items and evaluate their impact on the “Total Assets of the Business”. The explanation and dovetailing of the methods that accounting and appraisal professionals use are convincingly well-presented in a new Appraisal Institute course Separating Real Property, Personal Property and Intangible Business Assets. In my mind, some semantic overlaps and baffling ambiguity still exist with the terminology used by appraisers and accountants. But, the different appraiser and accountant methods for quantification of tangible personal property (FF & E) and intangible personal property (such as trained work force, trade names, non-realty contracts, innovations, and even tenant synergy, amongst others) are persuasive. They offer alternatives between the FASB standards of the accounting profession and the more economic, market based methods of appraisers.

What has historically been called “goodwill” is especially interesting, qualitatively and quantitatively. It has simplistically been a “catch all” for the value premium calculated by any difference between a cost approach threshold value and a higher income or sales comparison approach value. Now, however, we can refer to it as a final, residual, entrepreneurial value left after economic (market) returns to and of the real estate, tangible and any other intangible personal property have been “paid” by the enterprise. Goodwill and other intangibles are typically high risk, have limited life and require much higher discount rates than the real estate. It is easy to see the validity of that premise, but it can be a challenge to identify and evaluate the economic cost or return that those non-realty assets require.

A motivation for this dovetailing of accounting and appraisal valuation methods is the call for “mark to market” values on corporate balance sheets. Financial reporting usually reflects debt interest and amortization, depreciation, and income taxes. The “marking” process for estimating balance sheet values at market value will provide a more real time and real world basis for corporate and lending community decisions and regulations.

Business and real estate valuation is becoming more sophisticated and interesting. USPAP, Interagency Guidelines and SBA appraisal requirements have enlarged the scope of research and analysis required for assets with real estate and business components. Appropriately educated and experienced real estate appraisers have a fine opportunity in this specialty. Working with accountants and experienced appraisers until comfortable and competent is a wise idea.

By Randolph Glennon, MAI, AI-GRS, CRE, for the New England Real Estate Journal.

Reviewing Appraisals–Art and Science

To those occasionally dependent on appraisals, “mystifying” sometimes describes the process. Whether appraisals are the product of tried and true academic methods or some vague art form has long been debated in real estate venues. The simple answer to this cliché is that it is both. The same is true of the appraisal review function, which has grown in importance in this “sea changed” economy. Appraising complex assets with meager transaction data in a persistently challenging real estate market has raised the bar for “appraisers” and “review appraisers” in the provision of reliable valuation services.

In my career as an appraiser, review appraiser and counselor, several observations come to mind about the contribution of review appraisers. This article summarizes some of the obvious and also less obvious functions and benefits of the process beyond peer review, quality control and regulatory compliance. The reader is directed to an excellent Appraisal Institute publication titled Appraising the Appraisal, by Richard Sorenson, MAI, for a thorough presentation of the technical and practical nature of the review process. Some reader knowledge of the appraisal process is presumed in this article.

The 1980’s recession again revealed inconsistency in the quality and reliability of appraisals. This time it led to the creation of the Uniform Standards of Professional Appraisal Practice (“USPAP”) in 1987; FIRREA in 1989 with Interagency Guidelines; and the formalizing of additional appraisal guidelines by IRS, transportation authorities, the U.S. government for federal land acquisitions, and others. USPAP Standards 1 and 2 relate to appraisals and Standard 3 relates to appraisal reviews, explaining the detailed requirements of each.

How does appraisal review contribute to the real estate investment process and what do reviewers actually do? The extent of an appraisal review can be limited or broad depending on the nature of the assignment and complexity of subject property appraisal issues. There are several terms used to describe the different functions and level of detail available in that process. These terms are not clearly defined or consistently used by appraisers or clients. For example, an abbreviated “desk” or “administrative” review can mean a limited check for compliance with client or USPAP requirements, and does not penetrate far into appraisal “issues”. A “technical” review of an appraisal report, with or without a reviewer field inspection, usually involves a thorough and constructive critique of the appraiser’s description of the subject property, market data selected for analysis, highest and best use analysis, appropriate use of valuation methods, and the value conclusion. A reviewer can also evaluate an oral appraisal report, file memoranda, or portions of an appraisal. Individual or portfolio assets can be reviewed in different geographical locations far from the reviewer’s base.

Since there are so many types and levels of an appraisal review, the review appraiser and client must agree in advance on a USPAP required “Scope of Work”. It discloses the nature, extent, and detail of the review process for the subject appraisal and must lead to a credible reviewer conclusion that is not misleading. An appraisal review can be required as a simple bureaucratic compliance checklist, at one extreme, or as a critical part of a financial transaction, asset management, disposition or litigation, at the other. The technical methods, analytical requirements and judgment required in an appraisal review contribute obvious value to the process by completing due diligence and supporting clients or employers in carrying out their fiduciary responsibilities. To most investors, a competent appraisal is a welcome part of a prudent asset management process. An evaluation of that work product by an appropriately experienced review appraiser mitigates risk, provides effective communication between appraiser, reviewer and client, and adds confidence in the decision making process.

So, a reliable appraisal or appraisal review requires a skillful combination of “science and art”. The “science” part is the gathering of appropriate market information and use of time tested and often complex valuation methods developed by the appraisal industry. The “art” part is the judgment that is required at many steps along the way, from appropriately characterizing a more complex subject property; researching comparable transaction data; selecting and using correct valuation methods in an ambiguous or distressed market; and reconciling often conflicting results and inconsistent market information into a reliable value conclusion. The increasing use of automated valuation models risks marginalizing the important role that judgment plays. The reviewer provides a common sense “safety net” for quality control and support for sound, confident financial decisions.

What are some of the characteristics of the best reviewers, beyond education, experience and competence? In an industry with tight deadlines, a paucity of transaction data and the large amount of detail in the appraisal process, mistakes are inevitable. Perfection is not the goal. A good reviewer does not dally over trivialities or make the mundane momentous, but instead focuses on key issues in an appraisal that lead to either a credible, reasonable conclusion or require a “leap of faith” to a questionable one. A good reviewer communicates effectively and empathetically with the appraiser. He or she recognizes the strong parts of an appraisal and provides constructive criticism where warranted. This is done in a cooperative spirit, when possible, to reach a reasonable, well-supported appraisal conclusion. An experienced, professional reviewer wants to be part of an appraisal problem’s solution.

What types of clients do review appraisers serve? Given the high percentage of appraisal work that is driven by debt and equity finance, the appraisal review process has a crucial role in evaluating the quality and value of funded assets. Financial institution appraisal review staff are usually appropriately educated, very experienced, salaried professionals with high standards and ethics. They carry out an important function in the selection of fee appraisers and management of the appraisal process with the primary goals of quality control and compliance.

Well-seasoned, independent review appraisers also play an important role serving financial institutions and a wide range of clients like attorneys, municipalities, government agencies, corporations and individuals. Beyond assessing compliance and competence, the review appraiser can provide additional service by discussion with the appraiser; completion of an independent appraisal; focus on contentious appraisal “facts” or use of valuation methods; and many other ad hoc needs.

In a litigation support role, an appraiser can objectively and without bias critique another’s appraisal; complete a new independent appraisal; explain valuation methods, concepts and semantics; assist in the preparation of interrogatories; evaluate depositions; interpret oral testimony; provide additional market research and analysis; and testify as an expert witness. A real estate consultant with appraisal review expertise can provide strategic counseling and support for attorneys and influence litigation outcomes.

Appraisal Institute professional designations, MAI for commercial and SRA for residential, signify excellence in appraisal education, experience, and professional conduct. The Appraisal Institute’s mission is to provide premier real estate education, publications, peer review, maintenance of exceptional standards and ethics, and advocacy for the profession. In this challenging and uncertain economic and political environment, performing appraisals and reviews has become more of an “adventure”.

A qualified and experienced review appraiser provides a very useful, timely and cost effective evaluation of the data, methods and conclusions in an appraisal. These professionals also offer additional appraisal consulting or independent counseling services with insightful analyses, creative and practical solutions to real estate problems, and assistance with strategic planning, management and disposition of assets.

By Randolph Glennon, MAI, AI-GRS, CRE, for the New England Real Estate Journal.

Contamination- Valuing Detrimental Conditions

During recent years, the public has become increasingly aware of the extent of detrimental conditions that surround us, particularly contamination. As a result, much has been written about the labyrinthine issues involved in valuing their impact on real estate. For in depth presentations of the theoretical aspects, refer to various excellent articles in the Appraisal Journal by professionals in this field. And, don’t miss other Appraisal Institute publications like Real Estate Damages: An Analysis of Detrimental Conditions; Environmental Site Assessments And Their Impact On Property Value, Real Estate Valuation In Litigation; and Appraising The Tough Ones. Doing research on line at the AI’s LUM Library and on the internet via key words or phrases will yield hits and other links to a growing volume of research data and articles on the subject. Try “brownfields”, “stigma” or “contamination” with a few of your favorite search engines, and see the results.

All types of valuation checklists, techniques and contamination event flow chart timelines have been created to help grasp the relevant issues and measure damages not only “before and after” the detrimental condition event, but also during remediation and after event termination and case closure. In his Appraisal Institute seminar Detrimental Conditions, Randall Bell, MAI, identifies no less than 255 different types of unfortunate conditions, followed by imaginative "Bell Chart" valuation models to grapple with ten different classifications of negative impact.

Is stigma real? At some point, it is highly likely that an appraiser, as planned or otherwise, will confront the need to evaluate the impact of some tangible or intangible detrimental condition. The valuation methodology is becoming more refined thanks to greater recognition of the negative impact of contamination on marketability, utility, financing, insurability, operating costs and liability to the public. We know that the impact on these components can often be measured with market data, paired or repeat sales or through income modeling using DCF analysis or direct capitalization. But, the remaining risk and uncertainty regarding success of the cleanup, possibility of reoccurrence, discovery of additional contamination, or new claims against the property can perpetuate the sometimes persistently lingering cloud of uncertainty over a property that "most" of us recognize as "stigma". A property can often be adequately mitigated and "blessed" with a comfort letter from jurisdictional regulatory agencies, but those experienced in these matters know that the loss in value does not commonly or naively end there.

Deferred marketability. It is when the issue of stigma is raised that the storm clouds often roll in. I say "most" recognize it because during the course of carrying out many appraisals of properties suffering from a detrimental condition, I have been surprised to encounter a few knowledgeable individuals who question the validity of the concept. They seem to believe that a property, once mitigated, has recovered all of its market value, or that because it is difficult to quantify loss with paired sales, then no protracted value loss exists. This, of course, denies what can be a persistent, negative impact on marketability, the key component underlying the very definition of market value. The public perception of future risk after the physical remedy has been completed can thin the market, prolong marketability, and, therefore, diminish market value. A concern in litigation is the varying degree to which utility of the damaged property during and after mitigation can offset part or all of the damages driven by reduced marketability. The critical problem seems to be the challenging estimation of the prospective duration of the stigma.

<u>Alternative Valuation Dates?</u> Estimation of damages is further obscured when a governmental agency with jurisdiction requires a valuation date on the date of the appraiser's inspection, *after* the date of contamination. The degree to which the cause has been identified, the remedy proposed and executed, and use of the property retained during the cure, affects the magnitude of impact on utility and deferred marketability as the property gradually recovers its "bundle of rights" and value. For a really implausible outcome, imagine estimating total damages suffered by the owner if the required valuation date is subsequent to event mitigation and return of the property to full use. It has been requested many times. Where, then, is the compensation for deferred or diminished marketability?

<u>Value In Use Or Market Value?</u> Some may accept the concept of stigma, but deny the negative impact on value if the owner or tenant of the property continues to occupy it during the remedy. This belief seems to confuse "value in use" with "market value", the latter of which is typically the basis for estimation of damages. We know that value in use can easily exceed or be less than market value depending on the owner's particular property requirements. For instance, does the property meet some unique requirements of the owner or tenant, or is it underutilized? This issue is similar to one that often arises in the valuation of vacant special purpose property for assessment purposes. Should its value be penalized as a distressed property or discounted for a longer marketing period, or should it be valued as available for

immediate occupancy?

Where is that elusive market data? Concern about unwanted publicity and its impact on value makes most owners of contaminated properties understandably shy about discussing marketing obstacles or transactions details. And, it almost always makes their lawyers, insurers, lenders and other interested parties downright evasive. Excavation of data from public documents reposing in regulatory agencies can be a long and tedious task. Non-disclosure agreements can silence other sources of data. As a result, discovery of market data to support quantification of that sometimes obscure and intangible stigma is usually a challenging exercise that requires dogged persistence.

Which venue is appropriate for litigation? It is also probably not too surprising how different a client's perspective can be regarding the different components of value diminution and the appropriate venue. The outcomes can be unforeseen. Juries can be emotional, empathetic with the injured party, less enthusiastic about exploring in detail the valuation concepts and their merits which support your conclusion, and …unpredictable. Binding arbitration forecloses appeal options. Mediation can be a less expensive and more efficient process for achieving a more timely result, but usually propels parties towards a compromise which may not be equitable. Case law is inconsistent, particularly with regard to recognition of stigma, and there seem to be a few prevailing judicial attitudes. As summarized in City of Santa Fee V. Komis, one proposes that it is "based on pure speculation by an ignorant public and will never be an element of damages even if it affects the market value of the land". Another holds that "while conjectural damages are non-compensable, if fear is shown to be reasonable, (or at least not wholly unreasonable) and in fact affects market value, the loss is compensable". Another suggests that "impact on market value caused by “fear” may be shown and compensated without proving the reasonableness of that fear”. That is quite a range of interpretation. Some serious strategic planning by your client is in order, given the variety of attitudes and possible outcomes for your appraisal.

What does the future hold? The number of detrimental condition assignments is sure to increase as public awareness grows. Valuation of contamination does not lend itself to automated valuation models or template approaches to appraising that are becoming more commonplace. Credible appraisals and supported recommendations in this specialty require extensive research, technical analysis and judgement based on considerable relevant education and experience. This interesting and challenging field continues to evolve rapidly and favors the professional appraiser.

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