ARE VALUE PREMISES DIFFERENT FOR BUSINESS AND REAL ESTATE APPRAISERS

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Real estate and business valuation appraisers may, at times, be applying different definitions and premises of market value. Much of the difference may occur when the real estate appraiser appraises vacant commercial or industrial buildings and tracts with long marketing times. These are generally non-income producing real estate where the return comes from its growth or resale at some point in the future. There may be no difference when applying the definition to investment grade real estate which is generally marketable within a few months to regional or national investors.

Most real estate brokers and appraisers quickly discover that these vacant properties can take years to sell at full market value. The market value definition taking marketing time into consideration has evolved over the past 80 years for the real estate appraiser. This marketing time is expressed as "a reasonable marketing time" in the definition. The real estate appraiser may apply a long marketing time to account for illiquidity, assuming the property will remain on the market until 100% of its value is obtained. It is not uncommon for the real estate appraiser to state a marketing time of five to ten years for a vacant tract or vacant building. Unless the business and real estate appraiser agree on the same marketing time, the real estate appraiser may be thinking in terms of a five year marketing time to realize full value and the business appraiser may be thinking in terms of a few days to one year marketing time. Other factors which make real estate illiquid is the fact that it is an immovable assets and the demand for that property relies on the market forces at its specific location. The Uniform Standards of Professional Practice (USPAP) sets forth guidelines for the real estate appraiser to follow if a shorter than normal marketing time is imputed in developing the value.

It is imperative for both practitioners to understand each other's use of the term "market value" when valuing real estate in a business since a change in marketing time may drastically affect the value of the real estate. The business appraiser may use the Discount for Lack of Marketability (DLOM) to account for illiquidity whereas the real estate appraiser uses an increased marketing time to account for illiquidity. The real estate appraiser can not shorten the marketing time below what is "reasonable" and still call it market value. The USPAP states that a reasonable marketing time must be allowed in order for the value to be called "market value." Therefore, marketing time must be normal or "reasonable" if the term "market value" is to be used. If we were asked to provide a value based on a one year marketing time for an asset in a business that normally took five years to market we could call it a "one year marketing time value" but not market value.

The opposite is generally true for the business appraiser who operates in a market originating from the very liquid public securities market. The business appraiser may state a value based on a short marketing time of one year or less and apply a DLOM for illiquidity. Other definitions more common to both groups include "value in use" and "investment value" where marketing time is not generally considered. Some of the specifics about the use of the term market value is discussed on the following pages.

THE REAL ESTATE APPRAISER'S INTERPRETATION

First, the discussion begins by giving a history of the evolution of market value definitions and implicit assumptions of real estate appraisers over the last eighty years. Since some real estate is an illiquid asset requiring long marketing times, most of these real estate definitions specify a "reasonable marketing time" as one of the implicit assumptions in the market value definition.

Most real estate definitions specify a "reasonable marketing time" as one of the implicit assumptions in the market value definition. The 1964 **APPRAISAL OF REAL ESTATE** restates a real estate market value definition that has survived for nearly 80 years.

"Market value has been defined in various ways in different parts of the country since most definitions have been taken from decisions in eminent domain cases. However, the most widely accepted are:

*(1)...the highest price estimated in terms of money which a property will bring if exposed for sale in the open market allowing a **reasonable time** to find a purchaser who buys with knowledge of all the uses to which it is adapted and for which it is capable of being used.*

(2) Frequently, it is referred to as the price at which a willing seller would sell and a willing buyer would buy, neither being under abnormal pressure.

*(3) It is the price expectable if a **reasonable time** is allowed to find a purchaser and if both seller and prospective buyer are fully informed."*[1]

The first and most prevalent of the foregoing definitions stating the "**highest price** estimated in terms of money" came out of a decision from the Supreme Court of California, known as the Heilbron Case decided in 1918. This early definition stated "reasonable time."

The 1978 edition of **The Appraisal of Real Estate**, 7th edition, cited the same definition but refined the implicit conditions or assumptions, including "reasonable time," described as follows:

*"Certain conditions or assumptions implicit in the market value definitions are noted in the **Real Estate Appraisal Terminology** as follows:*

1.Buyer and seller are typically motivated.

2.Both parties are well informed or well advised, and each acting in what he considers his own best interest.

*3.A **reasonable time** is allowed for exposure in the open market.*

4.Payment is made in cash or its equivalent.

5.Financing, if any, is on terms generally available in the community at the specified date and typical for the property type in its locale.

6.The price represents a normal consideration for the property sold unaffected by special financing amounts and/or terms, services, fees, costs, or credits incurred in the transaction."[2]

Around 1980, the Federal National Mortgage Association (FNMA) and the Federal Financial Institutions adopted the following definition (changing "highest price" to "most reasonable price") and implicit assumptions including "reasonable time."

*"...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:*

(1)Buyer and seller are typically motivated;

(2)Both parties are well informed or well advised, and acting in what they consider their own best interests;

*(3)A **reasonable time** is allowed for exposure in the open market;*

(4)Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and

(5)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."[3]

This same definition is currently given in the **Uniform Standards of Professional Appraisal**

Practice (USPAP) published by the Appraisal Foundation, 1995. The USPAP definition is on page 8 of that publication.

In 1989 many federal financial institutions, including the Resolution Trust Corporation (RTC), which was established under the Financial Institutions Reform, Recover, and Enforcement Act of 1989 (FIRREA), established another definition of value called "fair value." This is not the same fair value used by business appraisers, but is one created by the Office of the Comptroller of the Currency (OCC) as rule 12CFR7.3025. The 1995 USPAP's definition of Fair Value appearing on page 100 is recited as follows:

> *"'Fair value' is the cash price that might reasonably be anticipated in a current sale under all conditions requisite to a fair sale. A fair sale means that buyer and seller are each acting prudently, knowledgeably, and under no necessity to buy or sell-i.e., other than in a forced or liquidation sale. The appraiser should estimate the cash price that might be received upon exposure to the open market for* ***a reasonable time****, considering the property type and local market conditions. When a current sale is unlikely-i.e., when it is* ***unlikely that the sale can be completed within 12 months-the appraiser must discount all cash flows generated by the property to obtain the estimate of fair value****. These cash flows include, but are not limited to, those arising from ownership, development, operation, and sale of the property. The discount applied shall reflect the appraiser's judgment of what a prudent, knowledgeable purchaser under no necessity to buy would be willing to pay to purchase the property in a current sale."*[4]

This definition seems to imply that a current sale is one which can be completed within 12 months. Until the 1994 USPAP recommended stating a particular marketing time for a given market value, real estate appraisers were not widely concerned with the relationship between **market value** and **marketing time**. Standard Rule 1-2(b) comment section states the following: *"When estimating market value, the appraiser should be specific as to the estimate of exposure time linked to the value* *estimate."*[5] USPAP Statement 6 and advisory opinions G-7, G-8, and some clients made this mandatory requiring a real estate appraiser to state the marketing time because the value of various parcels of real property may change drastically with a change in marketing time.

For instance, the market value of one hundred lots in a residential subdivision may be worth $10,000 each if sold individually over a period of five years; however, if we reduce the marketing time to one year, then the value may be $3,000 per lot and we consider all one hundred lots sold to one purchaser with a marketing time of one year. Therefore, the RTC was very much concerned with the one year definition of value that they defined as "fair value" because it was their goal to dispose of many of these properties in a shorter than "a reasonable or normal time." This may be preferable to having one appraiser base his market value on a five year marketing time while another appraiser based market value on a one year marketing time.

Marketing time is very critical in the application of the real estate market value definition. From the early Supreme Court decision in 1918 to the definition in the current USPAP there lies a continuous and strong emphasis about market values tied to a "reasonable marketing time" for illiquid real estate. It is left up to the real estate appraiser to determine what that "reasonable time" is to be. One does not generally think about long marketing time with publicly traded securities but we sometimes think of the discount due to lack of marketability (DLOM) as a reduction in value when we sell stock in a closely held corporation in the same time we would expect to liquidate our interest in a publicly traded company. Therefore, we may say that the DLOM is the counterpart to the marketing time, for should we allow five to ten years to sell stock in a closely held company, we may receive full value without a discount. The real estate appraiser would state full 100 percent value regardless of how long "normal or reasonable" marketing time may be. It would not fit the real estate appraiser's definition of market value if a shorter than "normal" time is assumed. If a client requests a value based on a marketing time of three months for a property which normally required three years to market, it might be called "a 3 months marketing time value" not "market" value.

THE BUSINESS APPRAISER'S INTERPRETATION

The business valuation definition in Section 2 of Revenue Ruling 59-60 states the definition of fair market value as follows:

> *"The amount at which the property will change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."*[6]

The early real estate definition of market value specified a reasonable marketing time to sell real estate; the business valuation definition does not specify any marketing time to sell a business. Practice seems to indicate the same marketing time as that required to sell stock on a public exchange.

The business appraiser may consider a **fixed** marketing time of a few days and then apply a DLOM to account for illiquidity. but the real estate appraiser may apply a **variable** marketing time to account for illiquidity and assumes the property will remain on the market until 100 percent of its value is obtained. Because real estate is the "king" of all illiquid assets, marketing time becomes very important and it becomes imperative for the business appraiser to give the proper instructions to the real estate appraiser so that the proper valuation and DLOM can be applied.

Because the USPAP definition of market value includes a stipulation that *"**a reasonable time** is allowed for exposure in the open market,"*[7] a reasonable time to market a vacant commercial tract may be five years but in business valuation, a marketing time of one year or less may be considered. Advisory Opinion G-7 goes on to say that if the marketing time is shortened to less than what is "reasonable or normal," we no longer have conditions that meet the definition of market value, but instead, some other definition of value. It may be referred to as "value based on XX years marketing time." The exposure draft to Advisory Opinion G-7 discussed how the appraiser may want to provide a matrix showing the **price** (not market value) versus the marketing **time** for a particular piece of real estate so that the client can use the information in disposing of the property. There is also additional discussion about excessive marketing time that the real estate appraiser may confuse with "prospective" value or some value in the future. This issue becomes very cloudy, requiring much market data to determine whether an appraiser is stating a market value based on a long marketing time or is stating a prospective value.

EXAMPLE

As an example of the impact of marketing time on value, a recent request from a business appraiser to appraise a movie studio is cited. The property is described below with changed values to protect the confidentiality of the assignment. The studio consisted of ten buildings, containing about three hundred thousand square feet with ceiling heights of up to forty feet in over seventy percent of the space. The business valuation appraiser requested market values under orderly liquidation and forced liquidation because the business was not producing enough income to support a competitive return on the assets. We also suggested that market value under normal marketing time and value in use may be helpful.

The amount of time to liquidate the business was not stated, so a one year marketing time for the orderly liquidation value and a ninety day value for the forced liquidation value was suggested. The one year value would coincide with a one year accounting cycle and would also conform to the definition of fair value as established by the OCC in liquidating the assets of banks and S & L's taken over during the early 1990s. Because the real estate appraisal profession does not have a definition of orderly liquidation and forced liquidation with a specified marketing time, we suggested that the following values may be synonymous with the values requested.

Value in Use:	Determined by reproduction cost new, less physical and functional depreciation. (marketing time not pertinent)
Market Value Under Alternate Use:	Determined based on a normal marketing time of five years.
Orderly Liquidation Value:	Based on a one year marketing time value. (equivalent to real estates fair value definition)
Forced Liquidation Value:	Determined based on a ninety day marketing time.

Based on the rulings of the OCC, FDIC, and RTC's fair value definition, assuming a one year marketing time, these seemed to be equivalent to the orderly liquidation value and we proceeded with the valuation of the property. This property consisted of several buildings that had alternate uses for storage warehouse purposes, competing with other storage warehouses in this market. The marketing time for industrial properties of this type in this particular market area has been about five years based on studies performed by a state agency and by an appraiser's studies of marketing time. There was no evidence in the market to indicate that this five year marketing time for industrial properties encroached on the "prospective value" because the value of many industrial properties had remained flat or declined slightly over the last seven to eight years.

The marketing time for real estate tends to increase as the prospect for immediate cash flow disappears. This may be analogous to a decrease in the DLOM for dividend paying stocks. We know that real estate is a "notoriously illiquid asset" with marketing times ranging from a few days to ten years or more. Marketing times of ninety to one hundred and twenty days for a residence, six to twelve months for an apartment building, and five to ten years for vacant commercial and residential tracts are common.

In the case of the movie studio, a change in highest and best use would occur when we considered market value under alternate uses, orderly liquidation, fair value, or forced liquidation. The value in use was simple to determine since it involved the calculation of the reproduction cost new less depreciation for age, condition, and functional obsolescence to the movie studio business. In determining the market value under alternate uses, one may consider a change in highest and best use from a movie studio to that of a storage warehouse. This involves gathering storage warehouse comparables to develop a strong market approach. In a cost approach for the alternate use value, one may use replacement cost new for a similar warehouse rather than reproduction cost new for a movie studio, which may be about twice the warehouse replacement cost. The income approach for the alternate use value involved determining comparative rental rates, expenses, absorption and a DCF analysis. From a study of exposure times of properties of this size, in this particular market, it was determined that it would take five years to market and that to reduce the marketing time to one year would require a considerable discount. The discount was based on sales of other similar warehouse and industrial buildings that sold in this market with a short marketing time where the sellers were not willing to wait a normal amount of time to market their properties. The discount was determined to be about fifty percent by reducing the marketing time from five years to one year. The ninety day forced liquidation value required an additional discount based on studies of distressed sales conducted by lenders, auctioneers, and officials of the courts. We furnished the following values to the business appraiser:

Value In Use:	$12,000,000
Market Value for Alternate Use:	$ 6,000,000
Value W/One Yr Marketing Time:	$ 3,000,000
Value W/Ninety Day Marketing Time or Forced Liquidation Value:	$ 2,100,000

In valuing closely held businesses, the business appraiser may consider a relatively short marketing time similar to that of a security sold on a public exchange and then apply a DLOM to reflect illiquidity, but the real estate appraiser may consider a long marketing time to account for the illiquidity. It is imperative for both practitioners to understand each other's use of the definition of market value when valuing real estate in a business. The real estate appraiser may be able to provide the business valuation appraiser with a real estate value based on a known marketing time allowing the business appraiser to apply a more accurate DLOM.

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