

APPRAISING IN A DECLINING MARKET:

A Practical Guide for the Residential Appraiser

By David Phillips, SRA

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FOREWORD

Declining Markets

What was up is down. There is no surprise to many appraisers (those of a certain maturity) that the market would take a dramatic downturn eventually. Common sense had taken a vacation when it came to both the credit and valuation side of the lending equation. Essentially lenders were making “stated income, stated appraisal” loans.

In recent history some markets saw dramatic increases which nullified the very basic appraisal principal that a property is never worth more than its list price. Beware “the madness of crowds”. It would be simplistic to note that a declining market is the inverse of an appreciating market. The risk on the former can be quite painful and like Tulip Mania, that giant hissing sound from the bursting bubble is being heard around the world.

One of the most disturbing trends is that the new and improved form of “appraiser pressure” is to not check the declining box on the appraisal form. The law of unintended consequences is that the GSEs policy of a 5% haircut in declining markets has indeed created a new class of fraud. Seems like a reasonable policy to me. But like the valuation inflation problems to “make the deal work” we now have compiled a new layer of misrepresentation or incompetence by the appraisal community.

The February 21, 2008 Freddie Mac Bulletin precisely defines a declining market. And of note they are reporting that they expect 205 MSA’s, for the fourth quarter 2007, to be experiencing a decline as compared with 108 MSAs at the end of the third quarter 2007. They anticipate home price depreciation to continue to decline at a rapid rate.

The OFHEO Index, of course, is a macro level index. This does not relieve the responsibility of the appraiser to analyze their property specific micro market. But it sure is a relief valve from lender pressure. There is no doubt that there are stable and increasing submarkets within these SMAs. The onus is upon the appraiser to provide evidence and analysis.

Today’s Freddie Mac Bulletin with a clear a definition of a declining market and with the guidance offered herein we hope to assist appraisers in developing a report that is credible to the lending community.

I have engaged the talents of David Phillips, SRA to write this white paper. As with many skilled appraisers David has too much time on his hands these days and more importantly he, and I, deems this an incredibly important topic. There has been little practical guidance on the “how to” aspects of reporting market conditions. Lenders have been conspicuously absent in the past decade from publishing appraisal policies. Our intent is to offer guidance to both appraisers and to lenders and that this white paper will be a useful resource for best appraisal practices.

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Introduction

Appraising in a market in which values are declining is especially troublesome.

It's problematic not only from the practical aspect of how to spot a trend and report it to the client; but also from the standpoint of the pressures that residential appraisers have from their lending clientele not to report anything that might "kill the deal".

This is an important subject as of this writing. In many parts of the country, single family residential values are in a state of decline with some experts declaring that it may be the first quarter of 2009 before we see any widespread improvement. Several news outlets recently quoted FannieMae's CEO Daniel Mudd as forecasting "a very tough 2008". He also stated that "The correction will begin to turn into recovery in late '09, when we start to see credit clear and liquidity restored." As of the date of publication of this paper, FreddieMac has stated that according to their research "declines in house prices will be more widespread than estimated as recently as the third quarter of 2007." They now are estimating that the number of Metropolitan Statistical Areas (MSA) with declining values will number over 205 instead of the earlier report of 108 MSAs.

We have a good awareness of where the declines have hit the hardest. Where they will hit next is a complex issue and would involve the use of a crystal ball. However, the cause of the decline is clear. Most of the blame can be firmly placed on the so-called *sub-prime crisis* which has had a ripple effect throughout the entire economy.

Declining markets has become the subject *de jour*. Consider the following:

- In September of 2007, FannieMae issued a statement "Valuing Property in Declining Markets" and various Appraisal Management Companies have issued statements as to how to handle the reporting of a declining market.
- The Employee Relocation Council (ERC) has issued a white paper regarding the subject of forecasting in a declining market
- The Appraisal Foundation has made the reporting of declining markets the subject of one of its USPAP Q&A (October, 2007).

The necessity of addressing declining markets has left appraisers more than a little concerned about how to handle the situation. Why? There are several reasons for appraisers' consternation:

- A generation of appraisers have been dealing with rising values. For many, the present situation is the first experience with a declining market.
- Most residential appraisers are not mathematicians, statisticians or economists. Thus, the use of a computer, beyond filling out pre-programmed appraisal software, is a challenge for many residential appraisers. Excel spreadsheets and even elementary analysis software is foreign to many single family residential appraisers.
- There is no one authoritative source for information regarding declining markets. More than this, many of the sources of information regarding this subject use trade jargon ("Wall Street-ese) that is alien to most appraisers.

Because of these problems, the purpose of this guide is to provide practical solutions for the appraiser to use in their everyday practice. Hopefully, you will find in this guide the tools to:

- **Define** a declining market
- **Research the Data** necessary for analysis
- **Interpret the Data** to determine the direction of the market
- **Report the Findings** to the client in a clear, cogent and logical manner

Section 1-What is a Declining Market?

Part 1-What is a Market?

Before any analysis of a market begins, a definition of terms would be in order. Although this subject matter is covered in basic appraisal classes, a general refresher is in order.

The word “market” has many different meanings depending on the context in which it is used. You will find many definitions of the word in any standard dictionary. For instance, Random House Unabridged Dictionary, 2006, has 19 different definitions of “market.” But, since we are limiting our subject matter to a specific type of market, the definition of a *real estate market* is the most appropriate.

The Dictionary of Real Estate Appraisal, Fourth Edition, published by the Appraisal Institute defines a “real estate market” as: *“The interaction of individuals who exchange real property rights for other assets, such as money.”*

In this definition, the keyword is “interaction”. What a buyer is willing to pay and what a seller is willing to accept is what makes a market (assuming no artificial barriers to their ability to act).

The foregoing definition is stated in general terms and has greater meaning to economists and others who study Macro-markets than it does to the “boots-on-the-ground” single family residential appraiser. When economists talk about a “market”, they are referring to possibly tens of thousands of properties. When the single family appraiser talks about a “market”, he or she is referring to a single property.

So, what components comprise a market for a single family property? Is it comprised of just the subject neighborhood? Or, is there more to it than just its location?

Not only can these questions be difficult to answer at times, but it is clear that most residential appraisers wrongly define the “market” for any particular property as the subject’s “neighborhood”. It is clear that making a property’s “market” synonymous with its “neighborhood” is wholly simplistic and could be considered misleading in an appraisal of a single family residential property.

Throw in the fact that each market for a particular property may have a “submarket” or multiple “submarkets” depending on the conformity of properties in the area, and you go from what you considered a very standard assignment to what can now be considered a very complex issue.

The Buyer Profile

Real estate appraisal experts seem to agree that there is one over-riding “rule of thumb” when it comes to what defines a market for a particular property. This rule of thumb can be summarized as the following:

A market for any single family property is defined by what, in the buyer’s mind, would be all the properties that would be considered reasonable alternatives to purchase when compared to the subject (assuming no special circumstances or delays in acquisition).

If multiple appraisers were given the assignment of describing the “market” for a particular property; with each appraiser theoretically having the same level of experience and knowledge of the area; it is doubtful that any of the descriptions of the subject’s “market” would match. Why is this? Because each appraiser makes the determination of what constitutes a “market” based on their own definition of what a buyer would consider as a reasonable alternative to the subject property. As one chief appraiser of a major bank put it, “*a property’s market is indicated by typical buyer profiles*”.

The consideration of buyer profiles is part and parcel of what is commonly known as the *Principle of Substitution*. This principle is the basis for both the **Sales Comparison Approach** and **Cost Approach** to value.

The Principle of Substitution is defined in The Dictionary of Real Estate Appraisal, fourth edition as:

The appraisal principle that states 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.

So, what are the factors in a buyer’s mind when choosing between alternative properties?

The factors that comprise a commensurate or similar property hinges on the profile of the *most probable buyer* for any particular property. Factors in determining the “market” for each particular property being appraised can be broken down into four distinct but interconnected categories.

- **Type of Ownership** - Although condominiums, coops, and fee simple detached houses may serve the same function (habitation for a single family), they are not generally considered commensurate. Each of these types of properties have a separate and defined “bundle of rights” and are generally not considered interchangeable when considering the “market” for a particular property.
- **Buyer Motivations** - Is the Buyer an Investor or Owner-Occupant? Investors have a different set of priorities when considering the purchase of a property than does a buyer who intends to occupy the property. The investor’s motivation is the present and/or future net income of the property or its value upon reversion. Period. The individual characteristics of the property are important only as to how much or little they contribute to this income or future value.

On the other hand, the principal motivations for the owner-occupant are the more esoteric and subjective considerations of; safety, security, proximity to essential services/amenities, quality of school district, etc.

- **Physical Characteristics** - When purchasing properties for either owner-occupancy or

as an income producing property, there are certain factors that buyers consider as *priorities*. It is the analysis and comparison of these factors that help define the property's "market".

For example, if a subject property has four bedrooms, three baths, a large backyard, and a large recreation area in the basement, it is more likely to appeal to a family rather than a single person or a couple without children. Thus, the "market" for the subject would consist primarily of properties that would accommodate a medium to large-sized family. Conversely, a one bedroom cottage in an urban area with no playgrounds or schools nearby is likely not to appeal to a large family. In that case, the market would likely be limited to properties that would appeal to single people or couples.

The same criteria can also apply to other physical attributes (e.g., gross living area, age, size of site, etc.). It is here where the experience, knowledge and analytical skills of the appraiser are used to determine which priorities are the most important.

- **Location** – Most real estate experts and practitioners agree that the single biggest determinant of a property's value is its location. Thus, by necessity, the location of the subject in comparison to competing properties becomes an integral part of the definition of the subject's market.

As was stated before, a property's "market" is not synonymous with its "neighborhood". No matter how tempting it might be, a consideration of a property's "market" should consist of much more than just lines drawn on a map.

If a property is highly typical for its area (i.e., properties in the area are of the same relative age, quality, size, condition, etc.), then a more constricted or smaller market boundary might be considered reasonable. For properties that are highly similar in their physical characteristics, the market might be no larger than a city block; or in the case of a condominium project, no larger than the building in which the subject is located.

But, as the subject property becomes less and less typical when compared to the other properties in the area, the geographic boundaries of the subject's market may grow wider. Much like the concentric circles created by a stone thrown into water; if the first ring doesn't include sufficient properties to define the subject's market, then consideration of the next ring might be necessary, and so on and so on. For highly unique properties, the outer ring could be as large as the entire country.

Lending institutions as well regulatory bodies like HUD recognize that there are no arbitrary geographic boundaries to a market. In their Mortgage Letter 2007-11, dated 09/05/2007 and addressed to FHA lenders and appraisers, HUD states that "location" does not entirely describe a market for a particular property. The letter in part states, "*A declining market could be as small as a neighborhood or as large as an entire state...*"

Summary

The definition of a market is difficult to reduce to a checklist. Dictionary definitions are inadequate to describe the market for any specific single family residential property, and defining your market simply as an arbitrary geographic area with no other defining thought processes would be insufficient as well.

Thus, residential real estate appraisers are left with the task of defining the market for each property based on a set of accepted standards; but with each standard having enough flexibility to be changed and molded to accommodate a different set of circumstances with each appraisal. Who said appraising was easy?

Depending on the degree of homogeneity of the subject property, it may be necessary to not only define the subject's market, but also its submarket. For instance, the overall *market* for a condominium property may include only condominiums; but its *submarket* might include only units with the same number of bedrooms and baths as the subject.

The appraiser must first make the determination of what can be considered as similar to the subject property in **type** of ownership. The market for one type of ownership (e.g., fee simple detached dwelling) generally does not include dwellings of a different type of ownership (e.g., condominium, coop, etc.).

A market is also defined according to **buyer motivations**. Investors who purchase rental properties have a totally different set of priorities than buyers who are looking to occupy the property they're buying. Not only do buyer motivations play an integral part in the definition of a *market*; but the **physical characteristics** such as size, age, quality, etc., should also be included.

Lastly, a market for any particular subject property is defined by its **location**. The best alternative or commensurate properties when compared to the subject will have the same or similar locational qualities.

How to prioritize the characteristics of comparison and define what is commensurate from one property to another is where an appraiser's knowledge of their market is essential.

Part 2 – What Constitutes A “Declining” Market?

The words “increasing”, “stable”, and “declining” are familiar to any single family residential appraiser who has completed a Uniform Residential Appraisal Report (URAR). These are objective observations that the appraiser makes for each appraisal and should be supported in the report by observable and verifiable data. These words really need no definition. But it is necessary to discuss the timing of any changes in a market (increasing or declining).

How long does a market need to be showing a decrease in values before it can be earmarked as “declining”?

There seems to be two schools of thought regarding this subject. One opinion is that a market should be earmarked as “declining” as soon as the essential indicators suggest a downturn. Others believe that there should be at least one, and probably two consecutive quarterly

declines before a market can be labeled as having a downward trend.

There are certainly advantages and disadvantages to each approach.

- **Immediate Reporting** - The obvious advantage to immediately designating a market as declining is that the appraiser is not caught playing “catch-up” with the economy. Being pro-active in forecasting trends in their market is sometimes what separates a good appraiser from simply an adequate appraiser. The obvious disadvantage to immediately reporting a downturn is that there may be insufficient data on which to base an opinion, or seasonal differences may cause a “blip” in the stats. Going out on a limb in forecasting value trends has the inherent risk that the data being supplied could simply be market aberrations.
- **Quarterly Reporting** – Waiting to call a market declining for at least two calendar quarters has definite advantages. There is a greater likelihood that the data being mined is sufficient to spot a valid trend. Waiting to report a trend for two consecutive quarters offers a greater measure of validation.

Although there may be a difference of opinion on this subject, most experts can generally agree that one calendar quarter of decline should get an appraiser’s attention; but, two calendar quarters is definitely a trend. As one chief appraiser of a national lender put it, *“I believe a single quarterly decline warrants some level of concern, at least the need to do a deeper dive in that market to understand its fundamentals better. Certainly consecutive quarterly declines elevate such concerns.”*

Another question when considering when to label a market as declining is: how much of a decline is actually a decline? Is .5% decline over two calendar quarters sufficient evidence of a decline? Or is such a small decrease simply the market trying to seek equilibrium? Again, there is not a pat answer to such questions. There is much at stake when an appraiser is deciding whether to call a market as being in decline. Not the least of which is the appraiser’s reputation. The author submits that in order for the “declining” box to be checked, there has to be clear evidence of a decline that the user of the appraisal would deem reasonable and justifiable.

FreddieMac has published their guidelines relative to what constitutes a declining market. In their published bulletin, February 21, 2008, they regard an area to be in decline if either of the following two market phenomenon are present:

- If the overall decline for the subject’s MSA (per OFHEO) is greater than 1% for the most recent two quarters, or
- If there is an overall decline in the OFHEO MSA statistics year-over-year. The exception to this rule would be if the most recent two quarters have shown an increase.

A discussion of OFHEO and its advantages and disadvantages are in the following section.

Section 2 – Researching The Data

Part 1 - Data Sources

After the “market” for a particular property has been defined and the appraiser is ready to study whether a downturn has taken effect, it becomes incumbent on the appraiser to properly identify the data which is the most useful.

There are similarities between what national lenders, AMCs, and Relocation Companies are looking for when it comes to spotting declining markets. These similarities generally involve accessing national reporting agencies and private research reports.

There are a number of reporting agencies that publish national data that are worth the time to explore. FannieMae, in Announcement 07-22, dated in December of 2007 leaves it up to the individual loan correspondents to determine what indices are best for their market: but does mention three suggested data sources:

National Data Services

1. **National Association of Realtors® <http://www.realtor.org>**

Advantages – The NAR provides a wealth of comprehensive information on their website. Median prices for both detached housing and condominiums are tracked by quarter and for every Metropolitan Statistical Area (MSA). The NAR also has what they call a Housing Affordability Index (HAI). As its name implies, it gauges the affordability of housing based on current available loan terms and the incomes of borrowers. Another handy tool is the Pending Homes Sales Index (PHSI). This is useful for spotting housing trends before the actual sales data is available.

Disadvantages–The disadvantage to this data is that it provides no more specific data than individual MSAs.

2. **Office of Federal Housing Enterprise Oversight (OFHEO) <http://www.ofheo.gov>**

Advantages - Like the NAR site, the OFHEO site is full of useful information about markets in general. Rates of Appreciation are broken down into several different categories (i.e., by state, by MSA, slowest MSA appreciation, etc.) and provides a good historical perspective of where markets have been and where they are going. The year-to-year and quarter-to-quarter comparisons are interesting and informative.

Disadvantages-By its own admission, the data given on the OFHEO website is *broad* in scope. Like the NAR data, it gets no more specific than Metropolitan Statistical Areas for its reporting. Also, since the index is calculated by repeat sales of properties *and* appraisals of past sales, its results have definite limitations. The use of only repeat sales means that new construction is not included. The use of appraisals in this data instead of using hard data exclusively could also lead to misleading results. Dare we forget that appraisals are simply opinions?

3. **Standard and Poor’s S&P/Case Shiller® Home Price Index**

www2.standardandpoors.com/spf/html/products/url_homeprice.htm

Advantages - This index tracks on a monthly basis, which makes trend-spotting easier and more detailed than using quarterly numbers. This index uses the weighted matched-pair system of tracking appreciation and the data is washed in order to eliminate “outliers” in the market. Outliers, which may be caused by market anomalies, may cause the overall numbers to be skewed. Thus, the elimination of the outliers from the data provides a more realistic picture of the trend in an area.

Disadvantages-Statistics are only available for 20 MSAs; and, while the index updates on a monthly basis, they are always at least two months behind in their reporting. Also, this index does not collect data for condominiums or coops. This makes it useful only for single family detached dwellings.

While these studies provide accurate indications of market directions, there is a nagging problem with how beneficial these studies are for the micro-markets in which the average field appraiser practices. For instance, a national index that blends both single family detached dwellings and condominiums into one indicator might show an overall increase in values for a zip code or MSA. What this data won't show is what portion of the market is appreciating in value. Are values increasing for both condominiums and single family detached dwellings? Or could it be that single family detached dwellings are increasing rapidly but condominiums are decreasing in value? If you go just with the national indices, you won't be able to make that determination.

Another overall problem with using indices that report data for large geographic areas is that that most properties have their own market and sub-market deep within a zip code or MSA.

Thus, it is possible that relying on these indices exclusively might lead the field appraiser to an erroneous conclusion regarding the direction of the subject's market. While lenders rely on “macro” indicators, they are increasingly relying on appraisers to offer more analysis of the “micro” markets in which they work.

FreddieMac recognizes the possibility that certain “submarkets” within a MSA may actually be running counter to the overall market. In just published bulletin to their sellers, they state that maximum financing is allowed even in declining MSAs if rigorous analysis points to stable or increasing prices in a smaller geographic area.

Localized Data Services

For the vast majority of appraisers, the local Multiple Listing Service (MLS) remains the principle resource for real estate data in their respective practices. Typically maintained by the local Association of Realtors®, it is the source that most appraisers go to for historic as well as up-to-minute market activity.

The chief advantage that the local MLS has over all other data sources is that it provides the search capabilities for very specific areas and categories of comparison. In areas in which most real estate activity is channeled through brokers affiliated with the Association of Realtors®, most other sources of real estate activity (whether public or private) are used as supplemental or back-up sources.

There are several providers of MLS services across the country. Among the larger companies, Rappatoni, Fidelity, and First American seem to dominate.

If you are fortunate enough to be located in a disclosure state (a state in which sale prices are a matter of public record), a good source of local data would be the local government office where these prices are recorded. This could be the County or Township Assessor or possibly the local Recorder. While these offices may be good authoritative sources of sale prices, these offices generally do not have the resources for the appraiser to easily search for comparable sales or compile statistics for a specific area. Generally, mining data from these sources is labor intensive.

There are other private data services available depending on the region in which you practice like RealTrac and MetroScan. However, often these subscription services are cost prohibitive for all but the larger appraisal companies.

Part 2-Utilizing the Data

After the sources of adequate data have been identified, the real fun begins.

Data gathering and interpreting that data into useful statistics can be fun and enlightening if the resources you're using are sufficiently sophisticated.

- **Step One - Identifying Your Market.**

This subject has already been discussed to a certain extent in the foregoing Section. However, this is the initial step to any search. Defining the market for your subject can be very easy if the subject property is a conforming dwelling in a homogeneous area. However, it can be very difficult if your subject is a unique property for its area or is located in a rural or semi-rural area with limited sales.

After identifying the type of ownership, buyer motivations, the physical characteristics of your subject, and analyzing the location of the subject; it is generally best to start your search by limiting your search parameters to categories of comparison that are the most similar to the subject. For instance, if your subject is an owner-occupied one story ranch style dwelling, built 20 years ago in a particular subdivision, then the logical point to start in searching for data in its particular "market" would be the latest data regarding properties with similar characteristics and being in close proximity to the subject.

If, after conducting this initial search, you believe that the properties chosen are not suitable; or if you suspect that a wider search would glean more suitable data, then it may be advisable to widen your parameters to include a wider geographic area. **Or**, if the market indicates that staying within a particular geographic location for your comparable search has over-riding importance in defining the market, then you might want to widen your search parameters to include properties that are in the *same location* as the subject but with *different physical characteristics* when compared to the subject.

An appraiser's familiarity with their particular market is the essential ingredient in determining what search parameter(s) will receive the greatest emphasis in any particular appraisal.

- **Step Two - Discovering Price Trends**

There is no one definitive source or "check-list" for an appraiser to use to define value trends. One positive outgrowth of the discussion regarding declining markets over the past year has been the various and innovative ways that a declining market can be identified. The list is not exhaustive, but here are a few items that are generally regarded by experts as being *identifiers* or possibly *precursors* of a declining market:

1. Listed and Pending Sales

A national Appraisal Management Company (AMC) recently adopted a policy that requires an analysis of pending sales and active listings in each appraisal.

The consideration of all pertinent market data (i.e., closed sales, pending sales, active listings, withdrawn listings, offers to purchase, etc.) has always been required of appraisers; but it takes on particular importance when there is evidence of a market decline.

The discovery of these listings and pending sales are easily documented by doing a simple search of the MLS. However, an analysis of active listings or pending sales is most useful when the properties are highly similar or commensurate to the subject. In markets without an MLS presence, it will probably be necessary to interview market participants to spot a trend.

2. Ratio of Listing Price to Sale Price

Generally speaking, in periods of market balance when supply equals demand and there are no artificial barriers to a free exercise of the market, the asking price of a listed property typically is slightly higher than its subsequent sale price. This is a market phenomenon that is fairly uniform across the country.

In periods when demand for suitable housing outweighs the supply, it is not uncommon for sale prices of properties to be over 100% of their listing prices. In markets such as these, buyers who are desperate to find suitable housing may engage in a bidding war for properties and cause upward pressure on prices.

Conversely, when supply outstrips demand (as is common in areas with high numbers of foreclosures), there commonly is a precipitous drop in the ratio of listing price to sale price.

3. Marketing Times

When supply and demand are in balance, marketing times are relatively stable over any given period of time. But when supply outweighs demand (as in the case of high foreclosure areas), marketing times typically grow longer. This phenomenon has a high correlation to absorption rates (discussed later). These longer marketing times can manifest themselves in both *sold* properties and *listed* properties. Thus, it is important to keep track on the marketing times of both active listings and sold properties. An increase in marketing times can be a *precursor* of declining prices. If your data is good and up-to-date, you could be ahead of your competition in forecasting a decline in prices by watching the trend line of marketing times.

It is important to note that in some markets real estate agents remove listings and re-enter the same property as a fresh new listing with a new lowered price. Appraisers need to be aware that reported marketing times can be manipulated.

4. REO Activity

Experts generally agree that a strong herald of troubled times for any real estate market is an increase in REO activity. REO is an acronym for “**R**eal **E**state **O**wned” and got its name from a line item in lending institutions’ balance sheets. The dampening effect of REOs on a market is caused by these properties being placed on the market by highly motivated lending institutions. These properties will then compete with normal market entries and has the effect of driving prices downward.

It is possible to online resources to research REOs and foreclosures. National figures are available as detailed as down to zip code levels. However, in a relatively well-defined market with adequate sales information, you may not have to settle for zip code numbers. It is possible to achieve even more specificity (or what is sometimes called granularity) regarding REO and foreclosure activity. In urban areas, REOs are often listed by brokers who deal exclusively in that type of property. In those cases, you will be able to identify REOs by simply looking to see who has the property listed.

The most foolproof way to identify REO properties in your market is by researching the owner’s name in public records. If the owner of a specific sold property or listing is a lending institution or law firm, you will have a good indication that the property is an REO.

5. Average and Median Sale Prices

Possibly the most accurate and easily identifiable factors in documenting a declining market is to calculate average and median sale prices for properties in the subject’s market.

The disadvantage to using this data is that it is re-active instead of pro-active. In other words, by the time you see the shift in average and median prices, it’s already happened and all you can do is react. At least one national lender uses only median sale prices to

the exclusion of average sale prices. The belief is that average sale prices are too sensitive to the possibility of being polluted by outliers (sale prices that are much smaller or larger than the majority of the sales).

With many MLS systems, the median and average sales prices of your market will be calculated automatically. If the system doesn't do the calculations for you, it doesn't take a great deal of time for you to calculate the numbers yourself.

6. Absorption Rates and Inventory

Lenders and Relocation Companies alike depend on absorption rates as a key indicator of market activity.

This indicator is used in forecasting and tells the appraiser the length of time that it will take for the current inventory of listings to sell in a given market; and, when calculated over a period of time, is useful in spotting trends.

Typically, the methodology for calculating this indicator involves dividing the present number of *active listings* in any given market by the rate at which they have historically been selling. While this calculation usually includes just active listings, at least one national relocation company instructs their approved appraisers to also include *contingent* and *pending* sales in the absorption rate calculations.

Another way of spotting a downward trend is by simply counting inventory. A strong indicator of a soft or declining market, at least initially, is the increase in properties being offered for sale in a particular market.

When auto-makers see an increase in inventory, they correctly read this as a sign that demand is waning. As a response, they take measures to regain equilibrium in their market. They achieve this by offering special discounts to buyers *and* either slowing or stopping production for a period of time.

The real estate market reacts much of the same way when there is a glut of properties offered on the market. At the time of the initial shockwave of increased inventory, the market tries to seek equilibrium by lowering of prices. After that, it is not uncommon for the actual number of properties offered for sale to take decrease as sellers become discouraged and take their properties off the market.

Other good evidence of possible trouble in the housing market includes: changes in population, changes in employment, and changes in housing permits. Depending on the area in which you practice, these figures may not be readily available. Or, they may not be available until months after the fact.

After determining what resources will be used for identifying trends in the subject's market, it becomes necessary to define the time frame that the study will encompass. The time frame of the analysis will depend a great deal on the quality and quantity of data. If the data is sparse and relatively stale, it is possible that a quarterly snapshot of the market indicators up to two

years prior to the appraisal is advisable. In cases where the comparable sales are plentiful and recent, quarterly reports of the indicators for three or four consecutive quarters may be sufficient.

Section 3-Interpreting the Data

After the search for the data is completed, the next task facing the residential appraiser is to organize the information in an understandable format. Then the determination of whether the data is sufficient to peg the market as “declining” can be made along with the rate of the decline.

The following illustration is an actual property and the data used in this section is real. This property was chosen because it is believed that the complexity of the analysis is more instructive than it would be if the example property were a simple conforming residential unit.

Case Example:

The subject property is ten years old, has two stories, four bedrooms, two and a half baths, a full basement and is situated on a standard sized lot for the area. Through the appraiser’s familiarity with the area, it is known that there are very few rentals in the area and a search of the MLS has uncovered little in the way of REO competition. However, county records seem to indicate that the subject is newer than the typical residence in the area and there are very few two-story dwellings. Most of the dwellings in the area are one-story ranch style houses.

A drive-through of the area further reveals that while the subject neighborhood is fairly well defined by natural and man-made boundaries, the actual “market” for the subject goes well beyond the “neighborhood”. This is caused by the subject’s relative unique age and style.

Subject Neighborhood

Using data which is readily available from the local MLS, the following information for the subject “neighborhood” can be graphically presented:

Subject Neighborhood Indicators

| | 1stQ/2007 | 2ndQ/2007 | 3rdQ/2007 | 4thQ/2007 | Overall | NetChange/Month |
|-----------------|-----------|-----------|-----------|-----------|---------|-----------------|
| Avg. DOM | 70 | 35 | 72 | 84 | 17% | 1.42% |
| List/Sale % | 97.54 | 97.78 | 97.73 | 97.33 | -.2% | N/A |
| Med Sale Price | \$209,950 | \$194,900 | \$197,000 | \$182,000 | -13% | -1.08% |
| Avg. Sale Price | \$201,804 | \$197,148 | \$204,925 | \$179,718 | -11% | -0.92% |

Your calculations may differ slightly due to rounding.

Subject Neighborhood Absorption

| # of | Sales/Mnth | Current Listings | Absorption |
|------|------------|------------------|------------|
|------|------------|------------------|------------|

| | | | | |
|---------------|-------|------|----|-----|
| | Sales | | | |
| 2nd Half/2007 | 37 | 6.17 | 18 | 2.9 |

This neighborhood has the earmarks of slowly declining values. Over a 12 month period, broken down by quarter, it can be seen that

- Overall marketing times are increasing
- The median sale price is declining
- The average sale price is declining

What is interesting to note is that while overall prices are declining when analyzed on an annual basis, this particular neighborhood had a rally in the third quarter with slightly higher prices before resuming its slide in the 4th quarter. This third quarter rally was preceded by substantial drop in marketing times in the 2nd quarter and a slight increase in the list/sale price percentages. This seems to support the contention by many observers that one quarter's drop in average marketing times and an increase in the list to sale price percentage (however slight) can actually *foretell* lower prices in the next quarter.

In the second graph, the absorption rate for the subject neighborhood is illustrated. The absorption rate for the last six months of 2007 was almost three units per month. Translated into terms of a monthly supply, this means that there is roughly a six month supply of housing units currently on the market. In many markets a six month supply of housing units is an indication of a balanced market (i.e., equal number of buyers and sellers).

If the subject property were typical for the neighborhood, this might be the end of the analysis for our subject. However, as was stated, the subject property is not typical for the area. It differs from most properties in the area because of its two-story design and its newer vintage.

Thus, a second tier of analysis is done in order to determine if the "market" for the subject is different from the "neighborhood" statistics. Remember, the "market" for a property is comprised of properties that would be considered alternative or commensurate properties and that a buyer would consider similar to the subject.

Subject Market

Since two-story sales are scarce in the neighborhood, a search of two-story dwellings that were within a one mile radius of the subject, were analyzed. The age of the dwellings was not considered because of the lack of data on which to rely. The radius of the search is wider than the actual defined neighborhood because of the relative uniqueness of the subject. However, even when widening the search, the actual number of sales from which to draw conclusions is very low compared to the wealth of data that was available for the neighborhood as a whole.

The statistics for the subject's "market" (not neighborhood) reveal the following:

Subject Market Indicators

| | 1stQ/2007 | 2ndQ/2007 | 3rdQ/2007 | 4thQ/2007 | Overall | NetChnge/Mnth |
|-----------------|-----------|-----------|-----------|-----------|---------|---------------|
| Avg. DOM | 58 | 54 | 94 | 117 | 50% | 4.17% |
| List/Sale % | 97.8 | 96.88 | 96.98 | 96.69 | -1% | -0.83% |
| Med Sale Price | \$212,450 | \$224,000 | \$238,000 | \$255,000 | 17% | 1.39% |
| Avg. Sale Price | \$203,650 | \$268,670 | \$265,550 | \$290,000 | 30% | 2.50% |

Subject Market Absorption

| | # of Sales | Sales/Month | Current Listings | Current Absorption |
|---------------|------------|-------------|------------------|--------------------|
| 2nd Half/2007 | 15 | 2.50 | 13 | 5.2 |

The first chart shows some interesting details regarding the market's reaction to the two story dwellings. Like the numbers for the neighborhood as a whole, the market for the commensurate properties also had a slight decline of marketing times in the 2nd quarter which was then immediately following by a hefty increase in median sale prices in the 3rd quarter. However, a substantial rise in the marketing time in the third quarter was *not* followed by lower prices in the 4th quarter. In fact, just the opposite was true. Thus, we have conflicting information. Contradictions in data indicators happen more often than not. This is real life.

During the whole year, the listing to sale price percentage remained relatively stable and had only a 1% change during the entire year. Thus, no real trends could be spotted in that indicator. There was also contradictory information given regarding the ability of the marketing times and listing to sale percentage to foretell increases in prices. While the marketing times went down in the 2nd quarter, the listing/sale percentage went down as well (albeit very slightly).

The second chart shows us the absorption rate for the subject "market". All sales of two story dwellings within a one mile radius of the subject for the last six months of 2007 are included in this graph. The absorption rate for the market indicates a strong seller's market (entire inventory selling in less than three months). These numbers strongly support the upward trend of median and average sale prices (as represented in the first graph).

Overall, the information for the subject *market* is contradictory. This could very well be caused by the lack of sufficient numbers of sales with which to spot a trend. When faced with contradictory data such as presented above, the appraiser (after scratching their head and staring at the computer screen with a blank look on their face) has to dig deeper and try other indicators to see if a trend can be spotted.

A search of the market for active listings and pending sales is undertaken to see if it can explain why the data given in the MLS statistics is contradictory. And, in this particular case, the active listings in the area tell the story.

There is presently an active listing just around the corner from the subject. It is a two-story dwelling like the subject, but slightly older and slightly smaller. However, its marketing history is illustrative of the problem facing our subject property. It has already been on the market 145 days (longer than either the “neighborhood” average or the “market” average). It has gone through three price drops and probably is due for another in the near future. Because of this property’s similarities to the subject, and because it can actually be placed on the sales comparison grid, it becomes very useful evidence of a declining market.

So, to summarize our findings in this particular example:

- Statistics for *neighborhood* indicate a softening market with increasingly longer marketing times and lower listing/price percentages. *Quality and quantity of data is good.*
- Statistics for *commensurate properties* when compared to the subject shows generally rising prices but also longer marketing times and stability in the listing/price percentages. Data is contradictory. *Quantity and quality of data is suspect.*
- *Active listing* very similar to the subject in physical characteristics and in proximity has had extended marketing times and has been lowered in price three times since its inception. *The quality and quantity of data is excellent.*

Out of the three sets of indicators, two clearly show that values in the subject area are falling. The only indicator that does not show a falling market is the indicator that has the least amount of data on which to base an opinion. Conclusion: *greatest emphasis is placed on the indicators that that have the greatest degree of validity.* In this case, the indicators with the greatest reliability and validity point to a declining market. Thus, downward market adjustments would be warranted when comparing market sales to the subject property.

Section 4 - Reporting to The Client

The Uniform Standards of Professional Appraisal Practice state that every appraisal must be communicated in a manner so as not to be misleading. It is essential that when reporting findings to the client that it be done in a clear and understandable manner. It's not enough for the appraiser just to have the requisite knowledge; it is imperative that the appraiser communicate their thought processes to the reader in a logical and persuasive manner. It should be the appraiser's goal in each report to lead the reader to the same conclusions as the appraiser. Anything less, and the appraiser has not done their job.

The appraiser should not be an advocate for any particular party or property, but should be an advocate for each appraisal that bears her or his signature.

The reporting of an appraisal is not an easy task even in a stable market. But, when the added complexities of a declining market enter the equation, it becomes essential that the appraiser not be a mere "form-filler". An appraiser needs to be a communicator who can be understood and persuasive in their arguments.

Playwright George Bernard Shaw once said, "*The single biggest problem in communication is the illusion that it has taken place.*" This problem is illustrated in too many appraisals that come across the desks of chief appraisers, reviewers, underwriters, etc. The appraiser has assumed that they have communicated the appraisal, when actually the opposite is true.

Consider the following suggestions:

1. **Be Consistent** - Whatever is put down in words in an appraisal, make sure that it is consistent with what is stated elsewhere in the report. If you describe a declining market in the neighborhood section, then that issue must be addressed throughout the report, and in whichever approach(es) to value is used.
2. **Be Understandable** - Use words and sentences that explain what you are trying to convey. Assume the reader knows nothing about the subject property or the market in which it's located. This will increase the likelihood of effectively communicating the appraisal.
3. **Do Your Homework Before Checking the Box** - National lenders and investors have made one thing clear; if a subject is located in what has been identified as a declining area, and the appraiser hasn't checked the "declining" box (or explained why the box isn't checked), they will send it back.
4. **Keep Digging** - Appraisers are often faced with contradictory information when researching data. If faced with this situation, the best appraisers will keep digging until the preponderance of data points them to an answer. If the median and average prices of the market point to different or contradictory conclusions, check other indices to find a pattern.
5. **Check Your Spelling and Grammar** - If a client has to wade through a report with a number of misspellings and poor grammar, they will not be inclined to cut you any slack. If you can't get the *little* things right, the reader may wonder about the accuracy of the *big* things.
Tell the Truth - If you misrepresent market conditions your entire appraisal report becomes suspect.

As one reviewer recently said when asked about what he was looking for in an appraisal, “*First: We want the truth*”. Reviewers don’t want fluff or unsubstantiated opinions. They want properly analyzed data presented in a manner that can be clearly understood.

One thing is certain; appraisers are under more scrutiny than ever before. In appreciating markets, lenders may have a tendency to give more credence to credit-related issues and less to collateral. In a declining market, collateral comes under greater scrutiny and the quality of the appraisal becomes magnified in importance.

Websites useful for further research and information include:

FannieMae - www.efanniemae.com

FreddieMac - www.freddiemac.com

U.S. Department of Housing and Urban Development – www.hud.gov

Employee Relocation Council - <http://www.erc.org/toolkit/>

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His professional experience includes performing valuation assignments in Missouri, Kansas, Illinois, New Mexico, and Colorado. His experience also includes a period in which he was an appraisal auditor (quality control) for the largest home lender in the country.

Mr. Phillips has appraised a wide variety of property types and was lead appraiser in the appraisal of 300 residential properties in the Village of Valmeyer, Illinois, following the flood of 1993.

Other distinctions include his membership on the St. Louis County Board of Equalization, and his authorship of "Appraising Disasters: When the Levee Breaks" in the January, 2004, issue of *Working RE* magazine and the ebook *Guide to Single Family Residential Inspection*.

Mr. Phillips and his wife have two sons and currently live in suburban St. Louis.