nerej

Liquidation versus market value when appraising

July 07, 2010 - Appraisal & Consulting

You have been asked to appraise a property and the scope of the assignment includes an estimate of liquidation value. Now what?

The most striking differences between the market value and liquidation value concepts lie in their treatment of exposure time and seller motivation. Contained within the definition of market value within the Appraisal Institute's Dictionary of Real Estate is that "buyer and seller are typically motivated" and "reasonable time is allowed for exposure to the open market." However, the definition of liquidation value presumes "consummation of a sale...within a severely limited future marketing period specified by the client," and whereas "the buyer is typically motivated" and "acting in what he or she considers his or her best interest...the seller is under extreme compulsion to sell." Clearly, the intent of the concepts contained within liquidation value is that seller must sell, and do it quickly!

How are these concepts converted into a value conclusion? Ideally, through an analysis of transactional data that were consummated under conditions consistent with the definition. Unfortunately, one feature of depressed markets is that fewer sales occur and sales of comparable properties that conveyed under circumstances consistent with the definition of liquidation value (there are nine criteria) are rare.

Foreclosure auctions (absolute-no reserve auctions) are very effective at conveying title from an unwilling seller to a buyer. Unlike the early 1990s when the FDIC and RTC forced lenders to dispose of non-performing real estate assets, "extend and pretend" has allowed owners to retain investment property longer in this cycle. This has resulted in far fewer opportunities to acquire or analyze sales property data at repriced/liquidation value levels.

Another technique can be through an analysis of surrogate data; sales that may be dissimilar in use or type, but having similar marketability and having sold under conditions consistent with liquidation value. Once again, the real issue is finding data of any kind where the seller must sell immediately.

In the final analysis, absent useful sales data, the appraiser can survey the most active brokers for this property type in its geographic market area for insight into the subject's marketability and using that information estimate the subject's liquidation value by a hypothetical analysis. While brokers may offer opinion as to the overall discount, the key data gleaned in such an exercise is insight into the property's marketability since this information allows the appraiser to create a hypothetically distressed scenario under which such a transaction would occur. This would involve applying discounts to market-oriented sale data (i.e., sales that meet the definition of market value).

Using the example of a property having an estimated two-year exposure period, if the owner must sell in 60 days there is insufficient time for a brokerage firm to perform typical marketing. A combination of direct marketing efforts (phone calls, emails, etc.) and some prominent advertisements are the extent of what reasonably could be accomplished in a dramatically shortened marketing time. Any interest will likely be from users or from short-term owners that would operate the property on an interim basis, until the asset could be "repositioned". In both instances a discount would result from a shortened due diligence period. There would be insufficient time to perform reasonable due diligence. As a result, properties that have characteristics that present a question regarding a physical condition or the level and durability of the income stream are penalized as buyers typically assume the downside and bid accordingly.

Beginning with a market value estimate and making explicit adjustment for the physical and income uncertainties, then considering a yield rate based upon minimal risk, loaded to reflect the above discounts, the market value estimate can be discounted for the term of the normal exposure period to result in a present value akin to a liquidation value estimate.

William LaChance, MAI, SRA, is the 2010 president of the Mass. chapter of the Appraisal Institute and partner at Petersen/LaChance Realty Advisors, Danvers, Mass.