

DISTRESSED SALES: ANOMALY OR MARKET VALUE?

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The issues arising from the dramatically shifting real estate market are becoming more and more evident as time passes and market data are gathered and analyzed. Issues range from fairness and equity of taxation to the definition of a distressed transaction. One of the most pressing issues is how assessor's offices across the country are treating distressed transactions in their formulation of market value. Should distressed sales be used as a measure of market value? Typically—by both appraisal standards and statutory requirements—the answer is clear: distressed sales are not a true measure of market value. In fact, Idaho Code clearly reflects this ideology in its definition of market value:

the amount of United States dollars or equivalent for which, in all probability, a property would exchange hands between a willing seller, under no compulsion to sell, and an informed, capable buyer, with a reasonable time allowed to consummate the sale, substantiated by a reasonable down or full cash payment. [I.C. § 63-201(14)]

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From this definition it seems clear that a distressed sale should not be used directly in establishing the market value of a property. However, as real estate markets have declined, it has been argued that the market can be so affected by the

presence of distressed sales that real market values may not be that different from distressed sale prices.

Analyzing the Market

Market value in and of itself is a subjective term, and its development requires the consideration of many factors. Regardless of whether a cost-based assessment system or advanced statistical modeling is used, accurate characteristic data are essential to the process of developing market value. Moreover, identification of geo-economic market areas is essential to stratify sales data for analysis and trending—after all, *location is everything*. Adequate sales sampling and normality of the sample are also factors that ad valorem appraisers must consider to ensure accurate trending is applied to a given market area. Development of market value is generally problematic for appraisers for several reasons: a lack of market activity, prevalence of distressed sales, or sales disclosure rules that inhibit sales sampling.

As a result of this market environment, assessor's offices are continually faced with the question of whether or not they can, or should, use distressed sales in determining market value for tax purposes. Not surprisingly, opinions on this matter vary widely, and a great deal of debate surrounds the amount or proportion of distressed transactions necessary to *become the market*. Clearly, there is no exact answer to this question, and the determination of true market value may be more convoluted than appraisal standards or statutory requirements dictate.

Understanding Effects of Distressed Sales

Therefore, rather than trying to resolve the issue of how many distressed sales are needed or what proportion is necessary for them to become market value, this article presents an illustration of their effects on a market area. I use as an example a market area that has experienced, and continues to experience, an ever-increasing population of distressed transactions. Throughout this example, *arm's-length* transactions are those

that meet the previously defined conditions of market value, and *distressed sales* are those transactions that do not.

In the subject market there were 1,004 total sales over an 18-month period, representing a sample size of approximately 14 percent of the total number of improved properties in this area. Of the total of 1,004 sold properties, 129 were distressed and the other 875 were arm's-length transactions. While these numbers alone are a telling indication of the presence of a distressed market, it is not until these sales are arrayed and analyzed that the actual effects of distressed transactions on a market area are seen.

Figure 1 shows distressed transactions as a percentage of total sales, clearly demonstrating the ever-increasing trend of distressed sales within this market. In fact, more than 36 percent of all transactions in this market area were, by definition, distressed in the first quarter of 2009.

Depending on the proportion and distribution of distressed sales, there could be far-ranging impacts on the greater real estate market, including a general deterioration of real estate values across a much broader area.

The effects of this increasing population of distressed transactions are shown in figure 2, where median sale prices for arm's-length and distressed transactions are arrayed and compared by quarter. Analysis of the trend lines clearly shows the market effect of distressed sales. In fact, based on this graphic, it could easily be argued that distressed sales are a reflection of, or are very close to,

Figure 1. Distressed transactions as percentage of total sales

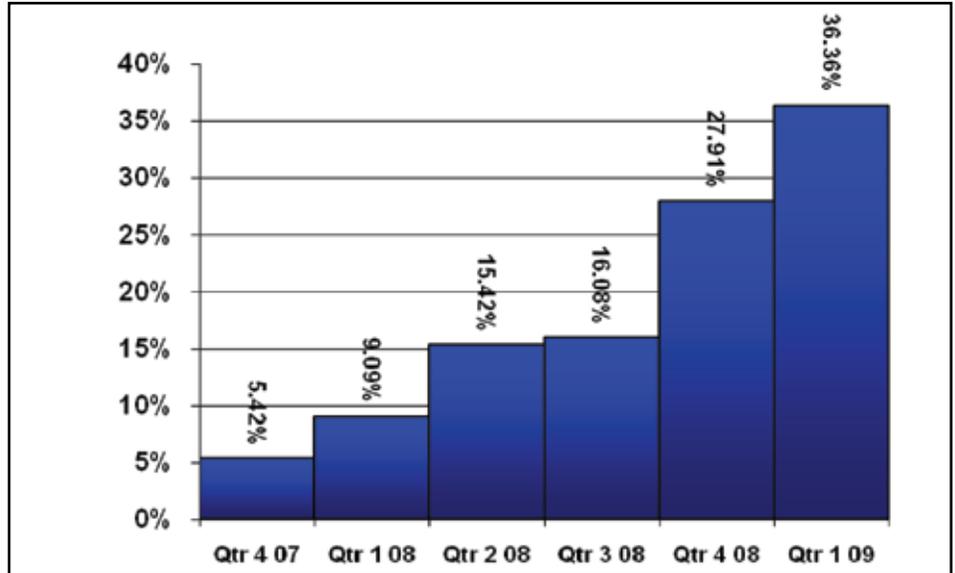
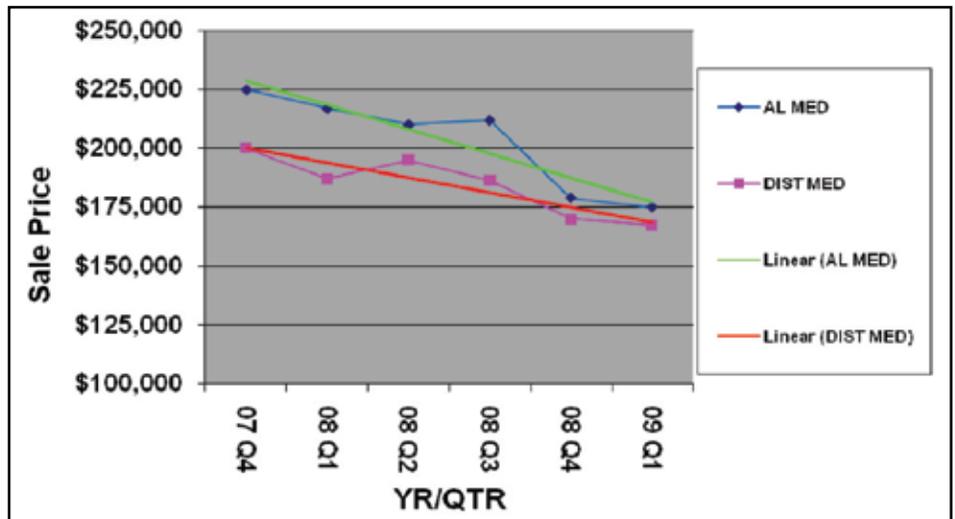


Figure 2. Median sale price analysis: Comparison of distressed and arm's-length transactions



current market value, at least in this market area.

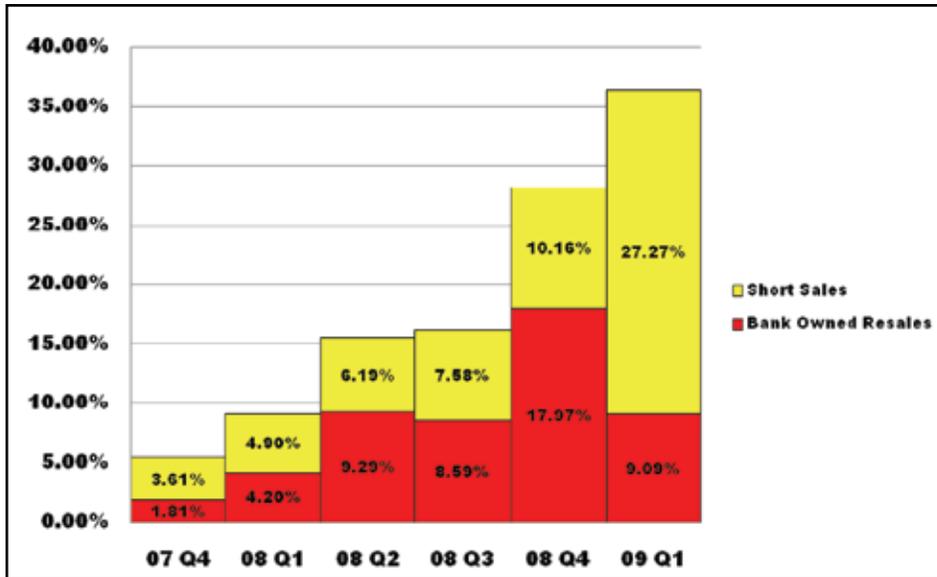
This analysis begs the question, If this market is distressed, what are the effects on the overall market area, the jurisdiction, or the greater geo-economic area? Second, what is the driving force behind these distressed sales, and is there a way to explain the broad disparity among distressed sales? Answering these questions requires more in-depth analysis, on both the micro- and macro-market levels. Depending on the proportion and distribution of distressed sales, there could be far-ranging impacts on the greater real estate market, including a general deterioration of real estate values across

a much broader area. This effect can be tested by analyzing all market areas and measuring the frequency of distressed sales by geo-economic area. Moreover, stratification of distressed sales by type, while comparing sale price or ratio trends of each across sample populations, can shed light on the driving forces of distress in a market.

Distinguishing between Short Sales, REOs, and Arm's-Length Transactions

Figure 3 shows the proportion of distressed sales in this sales population by type: bank-owned resales and short sales. Note the relatively even proportion of short sales in all but one of the six quarters, suggesting that short sales

Figure 3. Type of distressed transactions as percentage of total sales

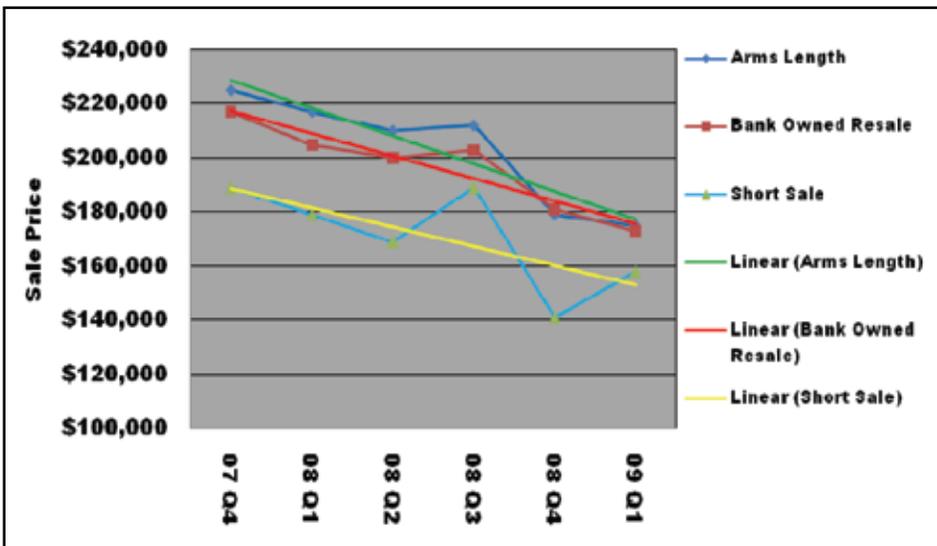


may be only part of the driving force behind sale prices in this market. Typically speaking, there are inherent differences between bank-owned resales and short sales. Short sales are an agreement on the part of the lending institution to accept a portion of what is owed on the property, which may or may not be a fair reflection of market value. However, bank-owned resales, if they are marketed by a realtor, or through a multiple listing service for a time period considered to be an average exposure to the market, will likely be very close to fair market value in this type of market. Given the inherent differences in these transaction types, and the relatively even distribution of

distressed sale types within this sample population, one may expect a difference in sale price level between short sales and bank-owned resales.

Figure 4 shows the median sale price by quarter for arm's-length transactions, short sales, and bank-owned resales. The difference between bank-owned resales and arm's-length transactions is much smaller than that between arm's-length transactions and short sales. However, the key factor in the small difference between arms-length transactions and bank-owned resales is the fact that the average marketing period only deviated by a maximum of nine days between the two populations over the sample quar-

Figure 4. Median sale price analysis: Comparison of distressed transactions stratified by type



ters. Meanwhile, short-sale properties averaged 63 days on the market over the sample time period, a full 37 days less than that of the average arm's-length transaction.

Geospatial Analysis

Another useful tool for analysis involves mapping sales, while geocoding the distressed sales in general or by type, so their occurrence can be arrayed geospatially. Geospatial analysis, if employed with a time metric, can show locational trends of distressed transactions that would not be evident in any other method of analysis. By arraying data geographically, the question of whether distressed markets are localized should be easily answered.

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Summary

Overall, the process of stratifying and analyzing distressed transactions revolves around a diligent program of sales validation. Without sales validation, this type of analysis is much more difficult if not impossible. While this article is not meant to resolve the debate over true market value, it does provide some insight into the effects of distressed sales on typical transactions within a given market area. Moreover, it shows the propensity of sales levels between arm's-length and distressed transactions to be similar in markets with large proportions of distressed sales. Most importantly, it demonstrates the necessity of identifying, stratifying, and analyzing distressed market transactions to determine their effect on the overall market. ■

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