Guide Note 12
Analyzing Market Trends

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Introduction

Since the value of a property is equal to the present value of all of the future benefits it brings to its owner, market value is dependent on the expectations of what will happen in the market in the future. Therefore, a critical step in the development of a market value opinion is analysis of the market trends. The market trends study should include what market participants (buyers, etc.) believe will happen to market conditions in the future as well as current supply and demand, and anticipated changes to supply and demand. The interaction of these factors profoundly impacts the highest and best use, and in turn the market value of a property. Analyzing current and anticipated market conditions is more complicated – and more critical – when a market is rapidly changing, either upward or downward. A “bubble” market might suddenly turn and decline; a “bust” market might suddenly start to improve. To what extent is an appraiser responsible for recognizing changes in market conditions? What steps must an appraiser take to ensure due diligence is done regarding the analysis of market trends?

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Basis for Proper Evaluation

The Uniform Standards of Professional Appraisal Practice (USPAP) include rules that address these questions.

Standards Rule 1-3 states:

> When necessary for credible assignment results in developing a market value opinion, an appraiser must:
>
> (a) identify and analyze the effect on use and value of existing land use regulations, reasonably probable modifications of such land use regulations, **economic supply and demand**, the physical adaptability of the real estate, **and market area trends**; and
>
> Comment: An appraiser must **avoid making an unsupported assumption** or premise about market area trends, effective age, and remaining life.
>
> (b) develop an opinion of the highest and best use of the real estate.
>
> Comment: An appraiser must analyze the relevant legal, physical, and **economic factors** to the extent necessary to support the appraiser's highest and best use conclusion(s)."
>
> (Emphasis added)

USPAP's Scope of Work Rule states that an appraiser must "determine and perform the scope of work necessary to develop credible assignment results." Scope of work includes the type and extent of data researched and the type and extent of analyses applied to arrive at opinions and conclusions. Thus, the extent of the analyses of market conditions and trends is a scope of work issue. Along with other aspects of scope of work, the extent of these analyses must be determined at the outset of each assignment.

Standards Rule 1-6 requires the appraiser to:

> (a) reconcile the quality and quantity of data available and analyzed within the approaches used; and
> (b) reconcile the applicability of the approaches, methods and techniques used to arrive at the value conclusion(s).

Reconciliation is an important step in the valuation process, especially when market conditions are such that good quality, current data is lacking.

Factors That Cause Markets to Change

Real estate markets are characterized by cycles. Real estate cycles typically involve successive periods of expansion, peak levels of activity, contraction, and troughs.

Factors that cause markets to change are distinctly different from symptoms of change. Examples of symptoms of change include changes in vacancy rates (a leading indicator), falling or rising property prices, increases in the frequency of concessions and seller financing, sales prices exceeding listing price, and other conditions symptomatic of larger, more basic problems. Factors that cause markets to change are generally the product of macro-level forces. They influence market psychology and drive behavior in profound, sometimes dramatic ways. Such causative factors can involve a single defining event or a slower moving series of events that are evolutionary in nature and sometimes not readily apparent to real time observers. Whether they consist of a single defining event or series of related events, these causative factors are indicative of shifts in underlying political and social as well as economic conditions.

Factors That Cause Markets to Change (continued)

Factors that cause markets to change may be capital (transactional) based or fundamental (space user) based. Examples of capital based factors that cause markets to change include:

1. Changes in public policy, particularly related to monetary policy and government spending, taxation, interest rates, the availability of financing and capital formation, length and facilitation of the local entitlement process, and employment initiatives.
2. Inflationary/deflationary pressures on the regional, national, and global economies.
3. Overabundance of investment capital resulting in increased competition (often too much money chasing too few deals), overly aggressive investment strategies, progressively lax underwriting standards.

Examples of fundamental (space user) based factors that cause markets to change include:

1. Changes in migration patterns and population shifts which cause overcapacity in some areas and undersupply in others.
2. Economic shock caused by events such as 9/11, the Lehman bankruptcy, the dot.com bust of the early 2000s, the Arab oil embargo of the 1970s, and periodic spikes in the price of oil, all of which caused wide-scale disruption in property markets affecting everything from corporate strategy, personal live/work decisions, and increased cost of property operation to demand for hotel rooms and second homes.
3. Aging population with its increased demand for retirement communities, congregate care facilities and smaller housing size.
4. Changes in technology such as green buildings, cloud computing, and internet shopping, which affect employment patterns, new industry formations, and new property types (e.g., server farms, disaster recovery facilities.)
5. Natural disasters and industrial accidents, which are usually local or regional in nature.
6. Changes in affluence and income distribution that influence affordability and consumer and discretionary spending habits.
7. Overbuilding and increases in competitive supply.

Market Analysis

Market analys is is defined as “a process for examining the demand for and supply of a property type and the geographic market area for that property type.”

While appraisers generally analyze historic data (e.g. comparable sales) in the valuation process, it is important to recognize that the value of a property is dependent on the future benefits that a property will bring to its owner. Future benefits include the rights to use, occupy, and enjoy the property as well as the right to receive income it may produce. Market values are therefore forward-looking. Data used in the valuation process must be adjusted for market conditions as necessary so the market value conclusion reflects this forward-looking stance as of the date of value. Market analysis provides the framework for making determinations about market conditions adjustments.

Market analysis is a critical step in the appraisal process. Adequate market analysis must be completed before highest and best use analysis, and the determination of highest and best use is critical to an appraisal assignment when market value is the objective.

Market analysis provides the data input to identify the highest and best use of a property in terms of (1) property use (2) market support (economic demand) and timing (absorption rates), and (3) market participants (probable users and buyers.)[2]

[1]Appraisal Institute, The Dictionary of Real Estate Appraisal, 5th ed. (Chicago: Appraisal Institute, 2010).

[2]Stephen F. Fanning, Market Analysis for Real Estate: Concepts and Applications in Valuation and Highest and Best Use. (Chicago: Appraisal Institute, 2005.), p. 5

Market Analysis (continued)

Most market analyses can be completed using a six-step process:

1. Define the product (property productivity analysis): Identify physical, legal and location attributes that shape productive capabilities and potential uses.
2. Market delineation: Identify the market for the use.
3. Demand analysis: Identify characteristics of the most probable user. Analyze demand drivers such as population, income, employment.
4. Supply analysis: Survey and forecast competition. Analyze existing supply, new inventory coming on line in the near future, and proposed construction.
5. Analysis of the Interaction between supply and demand: Determine if marginal demand exists, predict when market will move out of equilibrium.
6. Forecast subject capture: Analyze market penetration.

A seventh step, perform financial feasibility analysis of alternative uses and threshold testing, can be added for proposed properties.

The manner and degree to which these steps are carried out within an appraisal assignment are scope of work issues. The scope of work for an assignment must be appropriate given the intended use. It is the appraiser's responsibility to determine the scope of work for the assignment. The scope of work must meet or exceed what the appraiser's peers' actions would be in the same or a similar assignment, and with the expectations of parties who are regularly intended users for similar assignments.

The appraiser must decline or withdraw from an assignment if the client will not allow the appraiser's scope of work to be adequate for the assignment. The level of market analysis performed must be appropriate for the assignment and not limited solely because the client wishes to reduce the appraisal cost.

The level of analysis can range from simple to highly sophisticated. On a simple level, demand may be inferred from current market conditions, or rates of change used to develop projections. On the more sophisticated level, an in-depth analysis of forecast (fundamental) demand is performed.

Fundamental market analysis may be useful and necessary when analyzing or performing an appraisal of a property for new construction, or when appraising property in a volatile or rapidly changing market. In terms of real estate products, whether it be apartments, industrial, retail or office properties, fundamental market analysis answers the questions of "when and how much."

Competent appraisers continuously interact with buyers, sellers and agents of transaction activity. Ideally, appraisers have frequent and sustained interaction with buyers or lessees in particular. Such interaction allows appraisers to ascertain, analyze, and understand the motivations of market participants. Appraisers must be familiar with the local market dynamics and be able to perform trend analysis and/or fundamental market analysis to the degree necessary for the specific assignment.

However, appraisers are not expected to be prognosticators. Unforeseen events can completely eradicate conclusions that have been based in trend analysis or fundamental market analysis. A market value opinion is as of a particular date, and it is an attempt to reflect the anticipations of market participants as well as market fundamental trends and analysis. Events subsequent to the date of value that were not anticipated by market participants can cause values to change – in some cases, significantly.

Signs of a Changing Market

Signs of a changing market are symptoms, as opposed to causes. An appraiser observes the symptoms, but must understand the underlying cause or causes in order to properly analyze market trends.

For appraisers and market participants, a “bust” market is usually relatively obvious. However, it can be difficult to spot a “bubble” market when in the midst of one. Further, it can be difficult to tell when a bust market has started to turn and improve, or when a bubble market has begun to decline.

A bubble may be evidenced by:

1. Rate of return associated with a property type, economic characteristics of tenants or users are not typical and tend to be very low. For example, capitalization rates may be very low and or indicate negative leverage, which is often a sign of speculation.
2. Buyers become emotionally involved and act irrationally, contrary to the market value definition.
3. Prices increase at a faster rate than rents.
4. Rates of return decrease below long-range trends.
5. Prices rise while rents and net incomes remain stable or are declining.
6. Traditional buyers are replaced by new ones. “Everyone” starts to invest in real estate.
7. The number of transactions increases.
8. Shorter marketing times.
9. Average days-on-market decreases.
10. Very few expired listings.
11. An increase in the number of properties remaining vacant after purchase.
12. Condominium conversions become more common.
13. The number of persons employed in the real estate sector (real estate sales, mortgage lending) significantly increases.
14. Rents increasing faster than the ability of tenants to pay.
15. Sales prices above affordability of users.

A bust market may be evidenced by:

1. Sellers are reluctant to sell and realize losses; therefore, there are few sales, at least initially.
2. An increase in the rate of foreclosures, to the point where foreclosures become the predominant sales.
3. An increase in seller concessions, both in terms of frequency and magnitude.
4. A tightening of credit markets. Traditional financing becomes more difficult to obtain.
5. An increase in the use of “creative” financing, generally involving seller financing. These arrangements serve to keep nominal prices from falling, at least in the initial stages of a bust.
6. Longer marketing times.
7. Average days-on-market increases.
8. The number of expired listings increases.
9. The number of persons employed in the real estate sector declines.
10. Job growth declining.
11. Rents not rising at the rate of the last few years.
12. Vacancy increasing.

Reconciliation

There are two risks inherently associated with any appraisal that are of particular concern to the intended user. The first is the risk that the reliability of the value conclusion may be adversely impacted by a lack of quality data. The second is the risk that the value might not be sustainable over time. A well thought-out and clearly presented reconciliation process can assist the intended user with these risks.

In the reconciliation process, the appraiser must consider the quality as well as the quantity of data, and how those factors might have impacted the quality of the value opinion. In a slower market with fewer transactions, there are fewer sales available for analysis in the sales comparison approach. Also, when there are fewer transactions, there is less market evidence available for selection of capitalization and discount rates.

The reconciliation process may indicate that more research is needed or that new analyses must be performed. It may reveal conflicts or unresolved questions that need to be answered.

When necessary, the appraisal report should include a discussion of evidence that the value conclusion may not be sustainable into the foreseeable future. This is potentially a controversial and challenging conversation to have with one's client, but it may be a critical issue to highlight.

Summary of Standard Practices

1. Make the appropriate scope of work determination for the assignment given the intended use.
2. Apply market analysis at the level appropriate for the assignment and consistent with the scope of work determination.
3. Understand the causes of a changing market
4. Recognize the signs of a changing market.
5. Communicate the market analysis clearly in the appraisal report.
6. Clearly present the reconciliation process in the appraisal report and discuss as appropriate the likelihood that the value might not be sustainable into the foreseeable future.

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members, Candidates, Practicing Affiliates and Affiliates with guidance as to how the requirements of the Standards may apply in specific situations.)