Revisiting Market Value and Market Rent

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Abstract

It is hard to imagine more fundamental terminology in appraisal than *market value* and *market rent*. After all, usually these identify the question being answered in an appraisal, and if the question is wrong the answer cannot be right. Over the years, these two terms have been written about, modified, and debated. Still, even with a definition revision as recently as 2020, the two terms remain ambiguous and potentially confusing. The ramifications are serious. Appraisers supposedly providing opinions about the same thing end up answering different questions. The reader, client, and public in general are left confused. Public trust is diminished. This article addresses the remaining ambiguity in the terms, as currently defined, and offers suggested revisions that should clear up the confusion.

Introduction

Let's be clear: definitions matter. Without clear and concise definitions, the meaning of any word can be misunderstood.

Professionals sometimes use basic industry terms without giving enough thought to their underlying meanings. Professionals sometimes, through no fault of their own, appear to be inconsistent because of definitions that are unclear or poorly crafted. The ongoing controversy over the rights to be appraised is an excellent example of the type of problems imprecise definitions can create.[1] The equally fundamental terms *market value* and its companion, *market rent*, have a similar definitional problem. Both terms involve value opinions, and assignments for both are appraisals.[2] But many fail to fully grasp how these two terms reflect hypothetical transactions that involve activity prior to and as of the effective date of value—not after the effective date of value. In other words, an opinion of market value and market rent both answer questions of "what would have" rather than "what should." Unfortunately, the conventional definitions of both terms create a gray area, which can lead to confusion.

This article considers the definitions of both *market value* and *market rent* and addresses aspects in each that are ambiguous and inconsistent. The purpose of the discussion is to clarify these concepts so they can be uniformly applied. In addition, the article will consider the options that market value and market rent provide to the appraiser. Finally, new, clearer definitions of each will be offered.

Background of Current Definitions

Market Value

In 1971, William Kinnard penned the following definition of *market value*:

> Market Value can be regarded as the price a willing buyer would pay, and a willing seller would accept, with each acting rationally on the basis of available market information, under no undue pressure or constraint, with no fraud or collusion present. It represents Value in Exchange for interests in real estate.[3]

1. See for example David C. Lennhoff and Richard L. Parli, "Through the Looking-Glass: Debunking the 'Dark Store' Idiom," *The Appraisal Journal* (Summer 2019): 180–190.
2. See Appraisal Standards Board, Advisory Opinion 21 in *USPAP Advisory Opinions* (Washington, DC: The Appraisal Foundation, 2020), Line 201, which notes that an estimate of market rent is an appraisal.
3. William N. Kinnard Jr., *Income Property Valuation* (Lexington, MA: Heath Lexington Books, 1971), 12.

This definition covers all the necessary bases while allowing flexibility as to what is being valued—the interests in real estate. It is simple, unambiguous, and allows for adaptation to different circumstances. In contrast, the nearly contemporaneous sixth edition of *The Appraisal of Real Estate* (1973) did not offer a formal definition but presented three ambiguous alternatives.[4]

It was not until the 1975 publication of *Real Estate Appraisal Terminology* that a formal definition of *market value* was presented.[5] That definition has been carried forward, virtually untouched, as the current definition in *The Dictionary of Real Estate Appraisal*, sixth edition.[6] Although there are many current definitions of *market value*, most are quite similar. According to *The Dictionary of Real Estate Appraisal*, sixth edition,

> The most widely accepted components of market value are incorporated in the following definition: The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.[7]

Through time, this definition of *market value* has been modified—shortened in body but elongated through explanatory conditions. One notable alternative definition was introduced in the 1984 edition of *Real Estate Appraisal Terminology*:

> The most probable price which a property will bring in a competitive and open market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and assuming the price is not affected by undue duress. Implicit in this definition is the consummation of a sale as of a specified date and 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 each acting in what he or she considers to be his or her interest;
> 3. a reasonable time is allowed for exposure on 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.[8]

This definition was formalized with the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).[9] While there are alternative definitions that are applicable to different situations,[10] the discussion here will focus only on the one that incorporates "the most widely accepted components of market value."

Market Rent

The definition of *market rent* has gone through an evolution similar to that of market value. In *The Appraisal of Real Estate*, sixth edition (1973), the concept of "economic rent" is identified and linked to its source ("based upon current rentals being paid for comparable space").[11] *Economic rent* was later distinguished from market rent and defined to mean "the amount of rent necessary to provide an adequate return on development cost."[12]

4. Appraisal Institute, *The Appraisal of Real Estate*, 6th ed. (Chicago: Appraisal Institute, 1973). It notes three alternative "widely accepted" definitions that embody "the subjective premise" of *market value*. (Page 25). In addition, a later reference simply states, "The market value estimate has been defined as an interpretation of the reactions of typical users and investors in the market." (Page 273)
5. Byrl N. Boyce, ed., *Real Estate Appraisal Terminology* (Cambridge, MA: AIREA and SREA, 1975), s.v. "market value."
6. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), s.v. "market value."
7. *Dictionary of Real Estate Appraisal*, 6th ed., s.v. "market value."
8. Byrl N. Boyce, ed., *Real Estate Appraisal Terminology* (Cambridge, MA: Ballinger Publishing for the Society of Real Estate Appraisers 1984), 161. There were six conditions in the 1984 definition, which included a statement that "financing, if any, is on terms generally available in the community at the specified date and typical for the property type in its locale"; this element was subsequently dropped.
9. *Federal Register* 55, no. 163 (August 22, 1990): 34228–34229.
10. See for example, Interagency Land Acquisition Conference, *Uniform Appraisal Standards for Federal Land Acquisitions* (*UASFLA*), 2016 ed. (Washington, DC: US Government Printing Office, 2016), available at http://bit.ly/UASFLA.
11. See for example *The Appraisal of Real Estate*, 6th ed., 315.
12. *Dictionary of Real Estate Appraisal*, 6th ed., s.v. "economic rent."

With the publication of *The Dictionary of Real Estate Appraisal* in 1984, the term changed to "market rent." The method of obtaining market rent was dropped from the definition of *market rent* in the fourth edition (2002) of *The Dictionary of Real Estate Appraisal*, and five "conditions" were added to the definition at that time.[13] That definition has been carried forward into the current *Dictionary of Real Estate Appraisal*, sixth edition (2015), where *market rent* is defined as follows:

> The most probable rent that a property should bring in a competitive and open market reflecting the conditions and restrictions of a specified lease agreement, including the rental adjustment and revaluation, permitted uses, use restrictions, expense obligations, term, concessions, renewal and purchase options, and tenant improvements (TIs).

In February 2020, a revised iteration of the definition of *market rent* was approved by the Appraisal Institute Board of Directors. It reads as follows:

> The most probable rent that a property should bring in a competitive and open market under all the conditions requisite to a fair lease transaction, the lessee and the lessor each acting prudently and knowledgeably, and assuming the rent is not affected by undue stimulus. Implicit in this definition is the execution of a lease as of a specified date under conditions whereby:
>
> - Lessee and lessor are typically motivated;
> - Both parties are well informed or well advised, and acting in what they consider their best interests;
> - Payment is made in terms of cash or in terms of financial arrangements comparable thereto; and
> - The rent reflects specified terms and conditions, such as permitted uses, use restrictions, expense obligations, duration, concessions, rental adjustments and revaluations, renewal and purchase options, and tenant improvements (TIs).

This 2020 definition of *market rent* includes parallels to the definition of *market value*; therefore, it is important to explore concerns with the definition of *market value*.

Market Value Issues

The current definition of *market value* has four major deficiencies; these are related to issues of timing, financing phase, exposure time, and undue duress.

Timing

A careful read of the definition of *market value* leads one to believe that the value being sought could be the amount for which the property *should sell*—that is, during the period immediately following the effective date of appraisal. This conflicts with how an operative part of the definition—a reasonable time for exposure in a competitive market—expects the timing to be interpreted.

Appraisers preparing market value appraisals accept that the history of a subject property hypothetically includes a period of market exposure that immediately precedes the effective date of value.[14] However, an inconsistency exists in that the definition mandates that the determination be what the property *should* sell for while also mandating that the property has been on the market for a reasonable exposure period. And the inconsistency extends to how the definition is applied when appraisers favor the "reasonable exposure time" phrase while ignoring the grammatical discrepancy. However, if the roles were reversed, every market value appraisal would become a *prospective* appraisal, dependent on marketing time, answering a different question entirely: how much should this property sell for if the owner put it on the market on the effective date of appraisal?

There are certainly legitimate reasons for prospective market value appraisals. But according to the definition, even in such cases the value would be double prospective—first for the future effective date and second for the future sale's expected sale date beyond the effective date.[15]

Financing

The availability and price of financing affects the value of real estate on both the macro and

13. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 4th ed. (Chicago: Appraisal Institute, 2002), s.v. "market rent." Interestingly, one of the conditions of *market rent* was "a reasonable time is allowed for exposure in the open market."

14. For the formal definition of *exposure time* see *Dictionary of Real Estate Appraisal*, 6th ed., s.v. "exposure time."

15. Prospective appraisals for relocation companies are not to be confused with market value appraisals. Relocation companies are seeking an "anticipated sale price," which includes an estimate of marketing time (up to 120 days) as well as the forecasted (future) sale price.

micro levels. The general availability of financing and the loan-to-value ratio can be significant factors that influence property value, and the specific financing terms in a transaction can also affect the price.[16]

However, it is only on the micro level that appraisers address financing directly—and only as it pertains to a comparable, e.g., an adjustment to answer the question, what would the comparable have sold for if it had sold in cash or its equivalent? There is only an indirect requirement to address the general availability and price of financing as they impact the subject property. It is, in essence, contained in the all-inclusive phrase "in cash, or in terms equivalent to cash, or in other precisely revealed terms." Which one is it? They all qualify as candidates for market value. As such, the "cash equivalence" inclusion in the list is redundant.

The definition of *market value* references (in an open-ended manner) the financing of a property, but it seems almost irrelevant to the goal of establishing a uniform basis of value. Why should it matter, as long as the financing is in "precisely revealed terms"? This ambiguity produces a choice: either the definition requires an "all cash" conclusion or it allows for any financing alternative. The point is, the term *market value* should be able to accommodate any of these qualifications.

While the current definition is ambiguous, the body of knowledge clearly favors the "cash" standard for the subject property, and the only consideration for alternative financing is with comparable properties (and their adjustment under the *transactional* category). In fact, *The Appraisal of Real Estate*, fourteenth edition, ignores the possibility that something other than cash can be contemplated by a seller, calling the adjustment "cash equivalency calculations."[17] But can market value be determined for a property whose sale will include non-cash equivalency?

Consider an owner intending to sell a property while holding a mortgage at precisely revealed, but clearly below-market, terms. The owner is interested in the property's value under these circumstances. Market value should be able to accommodate such assumptions, answering the question, what is the market value of such a property under these terms? The impact of the advantageous financing on the property can be calculated just as easily as the effect of the same conditions on a comparable. In short, a simple clarification of what is being valued is all that is necessary.

Exposure Time

Just as financing can influence a property's market value, so can exposure time. The current *market value* definition calls for "reasonable exposure." However, the impact on property value of a variation from reasonable exposure is considered only in terms of a comparable. *The Appraisal of Real Estate*, fourteenth edition, notes that "some arm's-length sales may reflect atypical motivations or sale conditions due to unusual tax considerations, *lack of exposure on the open market*, [emphasis added] or the complexity of eminent domain proceedings." (Page 410)

The presumption is that the subject property is being valued after having been exposed to a competitive market for a reasonable period. But can market value be determined for a property whose exposure period has been different than "reasonable"? In fact, a not-so-rare appraisal assignment of market value can call for a value conclusion assuming a "quick sale" or an "auction sale," in just the same way as an unqualified opinion of value can. The determination of market value for a property under such conditions would involve the same computations, but in reverse, as with a comparable. The standard that the subject market value only applies to a property that has had "reasonable exposure in a competitive market" is unnecessarily restrictive. Again, a simple clarification of what is being valued is all that is needed.

Undue Duress

The current definition of *market value* ends with "assuming that neither [buyer nor seller] is under *undue duress*." [emphasis added] This phrase raises two questions: Is there ever a level of duress that is not "undue"? And, can there ever be any duress that is consistent with the concept of a fair sale?

In a technical sense, the answer to both questions is no. *Duress* is defined by *Merriam-Webster* as "compulsion by threat" and by the *Business*

16. *The Appraisal of Real Estate*, 14th ed., 408.

17. *The Appraisal of Real Estate*, 14th ed., 408.

Dictionary as "coercion to effect an unwilling person's agreement to a transaction."[18] Whether it be compulsion or coercion, the result is absolute. Duress is either present or it is not; and any presence is in complete opposition to the notion of a "fair sale." It cannot be a fair sale if there is duress in either party.

Can duress be accounted for in the same way other factors are under the category of *conditions of sale*? Possibly, but not by measuring directly the impact of duress on the subject property or comparable. The impact would be manifested indirectly in the exposure period. It is nearly axiomatic that a transaction cannot occur under conditions of duress and also have a reasonable exposure time. For example, suppose a seller is under duress and prices the property intentionally low in order to consummate a quick sale. In such a case, the sale price and the marketing period might be outliers.[19] The former would be a reason for the latter. Or, suppose a buyer is under duress (e.g., a 1031 exchange deadline) and offers full price for a property that just came on the market. If most properties of this type sell below listing price, the short exposure period would be an outlier. It is cautioned that there is no substitute for personal confirmation in determining the validity of a conditions of sale adjustment.

Of course, a transaction could involve a distressed seller or a distressed buyer and not violate the "undue duress" standard. In such a case, no conditions of sale adjustment would be appropriate. Consider the property owner who is faced with imminent foreclosure unless a sale can be consummated, thereby providing the funds necessary to satisfy the mortgage. The owner would certainly qualify as being under duress, but the consequential transaction would only be different from a typical arm's-length sale in exposure period and presumably sale price; that is, the owner would consummate a quick sale (through a reduced price), and the most probable selling price would be predicated on a quick sale. Again, a market value opinion should be equally flexible. As such, the current definition's reference to duress is unnecessary and confusing.

The *Uniform Appraisal Standards for Federal Land Acquisitions* (UASFLA) "set forth the guiding principles, legal requirements, and practical implications for the appraisal of property in all types of federal acquisitions."[20] The current edition includes the following *mandatory* definition of *market value*:

> Market value is the amount in cash, or on terms reasonably equivalent to cash, for which in all probability the property *would have sold* [emphasis added] on the effective date of value, after a reasonable exposure time on the open competitive market, from a willing and reasonably knowledgeable seller to a willing and reasonably knowledgeable buyer, with neither acting under any compulsion to buy or sell, giving due consideration to all available economic uses of the property.[21]

This definition has several elements that are unique to federal acquisition valuations. First and foremost, the provisions of the UASFLA require the value to be based on an economic highest and best use. Secondly, the appraiser must assume a reasonable exposure time has occurred but cannot link the value to a specific opinion of exposure time. This second requirement will necessarily result in a jurisdictional exception to the *Uniform Standards of Professional Appraisal Practice*, which requires, "when reasonable exposure time is a component of the definition of the value opinion being developed, the appraiser must also develop an opinion of reasonable exposure time linked to that value opinion."[22]

Most important to the topic of this article, however, is the specific wording "would have sold." Here it is clear the amount sought is to reflect prior exposure on the market preceding the effective date of value. This is quite different from the wording in the previously cited *market value* definition, which provides the value is what the property "should sell for after reasonable exposure."

18. See www.merriam-webster.com and www.businessdictionary.com.
19. There is also the possibility that the seller comes under duress during the marketing period. In such a case, the marketing period may be reasonable, but the sale price would indicate an outlier.
20. *UASFLA*, 2016 ed., 3.
21. *UASFLA*, 2016 ed., Section 1.2.4.
22. Appraisal Standards Board, *Comment* in Standards Rule 1-2, "Problem Identification," *Uniform Standards of Professional Appraisal Practice* (Washington, DC: The Appraisal Foundation, 2020), Lines 467–471.

Ramifications

The immediate question is, do these seemingly minor issues in the definitions matter? Yes, they do. First, these issues create confusion. Second, these issues mean it is unlikely that the value will be right because the valuation answers the wrong question. In an improving market it is likely the most probable selling price (the prospective value) will exceed market value. In a deteriorating market the opposite would be expected. In a flat market the numbers might be the same, but the conclusion would be similar to a situation in which the overall capitalization rate equals the overall yield rate (when income and value are expected to remain level over the projection/holding period). In such a case, the numbers are the same, but a capitalization rate is still not the same as a yield rate. As noted by Harold D. Albritton, "This question becomes of great concern when the subject of the appraisal is a specialized manufacturing facility, large resort, or other 'limited-market' property which may require one or more years to find a qualified purchaser."[23]

A New Definition of Market Value

Albritton was correct, and prescient, in concluding, "any estimate of market value must presume theoretical exposure has occurred by the appraisal date. Otherwise, the value must be projected to some future date and labeled something other than market value."[24] The prevailing definitions of *market value* and *market rent*, however, are not clear about this. The definitions in the UASFLA, on the other hand, are perfectly clear. Those definitions, however, contain some content that is specific to federal acquisition valuation and do not always apply to other valuation assignments. The prohibition on linking the value to exposure time, for example, would not work other than in federal acquisition situations. A new definition to replace the current, widely used definition is needed—one that is clear, concise, flexible, and universally applicable. Therefore, the following new universal definition for *market value* is proposed:

> The most probable price, as of a specified date, in cash or in other precisely revealed terms, for which the specified property rights would have sold assuming a specified exposure period in a competitive market, under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest.

Market Rent Issues

The newly adopted definition of *market rent* continues the problematic issue of exposure period and marketing time. As with the *market value* definition, the current *market rent* definition makes it clear that it is seeking an opinion of how much in rent the property *should bring* after being exposed to the open market.[25] However, unlike the definition of *market value*, the definition of *market rent* includes no reference to a reasonable exposure period so there is nothing to correct the reference to the future. Thus, the current definition indicates that it is future rent that is of issue and, consequently, a (reasonable?) marketing time should be associated with the rent. But no such treatment has been associated with market rent; instead, it is generally treated as if it had been subject to an exposure period and is therefore effective on the date of value. This treatment is inconsistent.

For instance, consider the appraisal of a vacant, multitenant building. After proper market analysis it is concluded that the building should capture 5,000 square feet of demand per quarter. Although unstated, market rent has an effective date contemporaneous with the valuation date. The question is whether the first portion of space is absorbed on the valuation date or whether it is absorbed at the end of the first quarter. That is, is it assumed that the space has been exposed to the market or is it assumed that the space must face a marketing period? This determination will clearly influence the value by influencing the length of the total absorption period. The impact could be compounded if market rents are chang-

23. Harold D. Albritton, "A Critique of the Prevailing Definition of Market Value," *The Appraisal Journal* (April 1980), 202–203.

24. Albritton, "Critique of Prevailing Definition of Market Value," 203. We would contend that this statement is equally applicable to market rent.

25. *The Appraisal of Real Estate*, fourteenth edition, adds confusion with the explanation that market rent is the "rental income a property *would* command." (Page 447)

ing—say increasing at 1% per quarter. In the latter case, the actual market rent should be concluded to be 1% higher when the space is actually absorbed and linked to a marketing period of one quarter. Therefore, the following new definition for *market rent* is proposed:

> Market rent is the most probable rent in cash that a property would have brought on the effective date of value assuming specific exposure in a competitive and open market and reflecting all conditions and restrictions typical of that market.

Conclusion

It is important to recognize that the terms *market value* and *market rent* as stand-alone terms are insufficient. Each requires the answer to the question, market value or market rent *of what*? If what is being valued is an empty building, then the market value would reflect that condition and the rent would be market rent. If the property is fully leased, and the market value is an opinion of the market value of the leased fee interest, then an adjustment for occupancy may not be necessary and the rent may be limited to contract rent.

Definitions are often taken for granted. They are recited and incorporated into appraisals without real thought as to their meaning. Inconsistencies and poorly constructed definitions survive for otherwise inexplicably long periods.[26] The ramifications are serious. Appraisers supposedly providing opinions about the same thing (type of value, category of asset, and rights appraised, for example) end up answering completely different questions. The reader, client, and public in general are left confused as to why the resultant numbers are so different. Public trust is diminished.

Cleaning up the definitions of *market value* and *market rent* is not that difficult. By doing so the confusion and uncertainty created by the careless wording are eliminated. The appraisal will be clear as to what is being estimated, and differences between otherwise well-prepared appraisals should be diminished.

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26. See discussion in David C. Lennhoff and Richard L. Parli, "A Higher and Better Definition," *The Appraisal Journal* (Winter 2004): 48–49.

Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute

- **Education**
  http://www.appraisalinstitute.org/assets/1/7/aiedcat.pdf
- **Guide Notes to the Standards of Professional Appraisal Practice**
  https://www.appraisalinstitute.org/assets/1/7/AI_Guide_Notes.pdf
- **Lum Library, Knowledge Base [Login required]**
  Information Files—Value
- **Property Rights Symposium Discussion Paper**
  http://bit.ly/SymposiumPaper