From Our Readers

"Revisiting Market Value and Market Rent"

To the Editor

David Lennhoff, MAI, SRA, AI-GRS, and Richard Parli, MAI, address an important subject in "Revisiting Market Value and Market Rent" (Winter 2020), recognizing that the definitions we use are often taken for granted, and the importance of definitions is not sufficiently appreciated. Their article is directly related to my previous article on this topic, "Market Value: What Does It Really Mean?" published in the Summer 2018 edition of *The Appraisal Journal*.

While the article by Lennhoff and Parli addresses definitions of both *market value* and *market rent*, it focuses primarily on market value, which has a rich definitional history and has been the subject of debate for decades. Market rent, on the other hand, has had fairly superfluous treatment, with cursory one-sentence definitions in the 1975 and 1982 editions of *Real Estate Appraisal Terminology*, and similar treatment (using the alternative term *economic rent*) in the 1950 and 1962 editions of the American Institute of Real Estate Appraisers (AIREA) text *Appraisal Terminology and Handbook*. The current definition of *market rent* in the sixth edition of *The Dictionary of Real Estate Appraisal* is still one sentence, but with slightly more detail. The article's authors note that the Appraisal Institute board of directors in February 2020 approved a new definition of *market rent* that more closely parallels the current lending definition of *market value*, and this definition has been incorporated in *The Appraisal of Real Estate*, fifteenth edition.

It is important to note that the article focuses primarily on the market value definition used for mortgage lending, formalized with the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, presently codified in Title 12 of the Code of Federal Regulations. This is readily acknowledged by the authors, who state, "While there are alternative definitions that are applicable to different situations [for example the Uniform Appraisal Standards for Federal Land Acquisitions definition], the discussion … focus[es] only on the one that incorporates 'the most widely accepted components of market value.'" The problem, as addressed in my own article, is that there are a multitude of definitions of *market value* and *fair market value*, creating needless subjectivity and clear conflicts among the different definitions of this important term. Any effort to clarify the market value concept so it can be universally applied cannot ignore these other definitions that are used for a variety of purposes, including civil litigation, eminent domain, marital dissolution, property taxation and appeals, federal estate taxation, casualty losses, and financial reporting. While acknowledging that mortgage lending (and its corresponding value definition) comprises the lion's share of appraisal assignments, the discussion at hand is incomplete without considering the sheer number of and significant differences among competing definitions of *market value* and *fair market value*, particularly if the authors wish to propose a single new definition to replace those in current use.

The historical perspective on the current *market value* definition is useful, but not complete, nor completely accurate. It is important to understand that our conceptual understanding of market value dates to the late 1800s, with the neoclassical economists (particularly Alfred Marshall) finally proposing a unified theory of value encompassing both the cost/supply side and the price/demand side (the supply/demand curve, equilibrium price, and perfectly competitive market). One of the first articulated definitions of *market value* is found in an early 1900s eminent domain case in California (*Sacramento Southern Railroad v. Heilbron*), and it is this definition that survived for decades, appearing with little change in the 1950 and 1962 editions of AIREA's *Appraisal Terminology and Handbook*.

In referencing the definition proposed by William Kinnard, in 1971 (which I wish I'd known of so I could have included it in my own article), the authors note that the contemporaneous sixth edition of *The Appraisal of Real Estate* did not offer a formal definition, but merely three ambiguous alternatives. The three alternatives are identical to those in the 1950 and 1962 editions of the *Appraisal Terminology and Handbook*, and treat the topic of *market value* in much the same fashion as the current sixth edition of *The Dictionary of Real Estate Appraisal*, presenting alternative definitions in contemporaneous use, without advocating for a single definition that would be appropriate in all circumstances.

"The notion that current definitions of *market value* are quite similar is also dubious. The value standard regarding price (highest versus most probable versus no standard) is obviously one where current definitions diverge."

The article states that the definition of *market value* in the 1975 edition of *Real Estate Appraisal Terminology* "has been carried forward, virtually untouched, as the current definition in *The Dictionary of Real Estate Appraisal*, sixth edition," noting also that "although there are many current definitions of *market value*, **most are quite similar** [emphasis added]." Both statements are incorrect. The 1975 edition of *Real Estate Appraisal Terminology* defines *market value* as "the highest price," while the referenced definition in the sixth edition of *The Dictionary of Real Estate Appraisal* defines *market value* as "the most probable price." This term makes the two definitions significantly different. It represents one of the key differences among current definitions of *market value* and *fair market value*—the value standard—whether it be *highest price*, *most probable price*, or *price* with no qualifier. The notion that current definitions of *market value* are quite similar is also dubious. The value standard regarding price (highest versus most probable versus no standard) is obviously one where current definitions diverge. The other concerns assumptions about the market where a hypothetical transaction is to take place:

- the relationship, knowledge, and motivation of the parties (buyer and seller);
- the terms of sale (cash, cash equivalent, or other terms); and
- the conditions of sale (exposure in a competitive market for a reasonable time prior to sale).

Examination of a sample of common *market value* definitions in current use illustrates the wide variation in normative conditions that attach to various *market value* definitions (see Exhibit 1 in "Market Value: What Does It Really Mean?").

It is noteworthy that Kinnard's proposed definition as well as the one published in the 1975 edition of *Real Estate Appraisal Terminology* represents attempts to clarify a definition that has mutated and replicated numerous times over the years, much as the authors are attempting to bring clarity and consistency with their own proposed definition of *market value*. Richard Marchitelli and Peter Korpacz attempted to do the same with their proposed 1992 definition that used "likely" instead of "most probable," and made few explicit assumptions about the market:

> The price in cash and/or other identified terms for which the specified real property interest is likely to sell as of the effective date of appraisal in the real estate marketplace under all conditions requisite to a fair sale.

The article by Lennhoff and Parli identifies additional deficiencies in the current definition of *market value* relative to timing, financing, exposure time, and undue duress. With respect to financing and exposure time, one or both of these elements are not even included in many common definitions (for example provisions related to California eminent domain, civil litigation, marital dissolution, federal estate tax, casualty losses, financial reporting, and global valuation); this again illustrates the incomplete treatment of the topic of market value without considering the range of definitions in common use.

The authors' issue with timing has to do with the word "should" in connection with "the most probable price which a property **should** bring," suggesting this somehow relates to a future time period as opposed to the time period immediately preceding the effective date. While it is true that "should" is sometimes used to express futurity, this is not the only way an auxiliary verb can be used, and it is not hard to conjure up the intended meaning of "should," in this context, as simply indicating probability or expectation—if all the conditions of the definition are satisfied, the most probable price is what should be expected at the effective date (not a prospective future date).

The discussion of undue duress is especially problematic, because this term is not actually part of the *market value* definition in the 1984 edition of *Real Estate Appraisal Terminology* cited in footnote 8, or the definition in the August 22, 1990, edition of the *Federal Register* cited in footnote 9. Moreover, the definition in the 1984 edition of *Real Estate Appraisal Terminology* differs in other respects from that reproduced on page 43 of the article and referenced in footnote 8. The term actually used in all known editions of *Real Estate Appraisal Terminology* is "undue stimulus" rather than "undue duress," which negates much of the authors' discussion of the word *duress*. ("Undue duress" appears in a generic definition of market value in *The Dictionary of Real Estate Appraisal*, sixth edition, and *The Appraisal of Real Estate*, fifteenth edition, but this definition is not citable for any standard purpose.) The term "undue duress" does not appear in any current definitions of *market value* used for financing and credit, published in multiple sections of Title 12 of the Code of Federal Regulations, all of which use the term "undue stimulus." The word *stimulus* is generally more applicable, since it can reasonably apply to anything that causes a response, either positive or negative.

"The simplicity of a single definition of *market value* is appealing, but *market value* and *fair market value* definitions are embedded in a plethora of codes, regulations, and court decisions across the country (and around the globe)."

The authors' proposed new universal definition of *market value* is certainly a worthwhile contribution to the continuing discussion of this issue, using "most probable price," and adding a number of normative conditions, including financing, exposure, competitive market, and prudent, knowledgeable and self-interested parties. And there can be no disagreement that appraisers valuing the same asset at the same effective date, and with the same assumptions and conditions, can indeed come up with different numbers ("or answering completely different questions," as stated in the article). I would not necessarily agree, however, that "cleaning up the definitions of *market value* and *market rent* is not that difficult." The simplicity of a single definition of *market value* is appealing, but *market value* and *fair market value* definitions are embedded in a plethora of codes, regulations, and court decisions across the country (and around the globe). The role of the appraiser in this discussion has been usurped by the courts, regulators, and others, and it is not realistic to think that these definitions could be easily changed to conform to a new universal definition of *market value*. However, what the appraisal profession can do is provide guidance on what the market value concept really means, and how the various definitions can be interpreted, reconciled, and applied to provide consistent results. One might hope that the Appraisal Institute could take the lead with respect to this important issue.

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Authors' Response

We appreciate the careful reading of our article by Mr. Sanders and his contributions to the history of both the market value and market rent terms. Furthermore, he has highlighted the "plethora of codes, regulations, and court decisions across the country (and around the globe)" that define *market value*. The appraisal profession, of course, is not responsible for this plethora, but it is responsible for consistency and clarity in applying definitions. Like Mr. Sanders, we hope the Appraisal Institute will continue to take the lead.

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Richard L. Parli
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To the Editor

In "Revisiting Market Value and Market Rent" (Winter 2020), the following two statements are made: "Public trust is diminished," and "In an improving market it is likely the most probable selling price (the prospective value) will exceed market value."

There is no question that public trust is diminished when appraisals are driven by a results-oriented conclusion. Too often appraisers confuse what their role is. Rather than reporting what the market did, they seem more interested in what they think the market should do or should have done. Suggesting that the selling price will exceed the market value is but one example of this. The mistake is largely the result of the abandonment of the legal and traditional definition of *fee simple absolute*. Also, there has been a hijacking of the *leased fee* definition in recent years along with a misapprehension of what market rents are. Market rents are rents freely negotiated between two knowledgeable parties in the open market. There can be no such thing as a current, freely negotiated, rent that is above market. While the rent may be higher than other current rents and more than what the appraiser thinks should have been paid, it is still a market rent. This appraisal fallacy leads to the results often seen in taxation litigation where an appraiser will value a property at significantly less than its actual sale price. In a freely negotiated sale, to use an actual case as an example, a $100 million office building appraised at $70 million because the rents were allegedly "above market." It is further argued that the most creditworthy companies pay above market rent. The public trust is diminished when faced with such arguments that the best companies pay more for their products or rents than non-creditworthy companies.

The misuse of business enterprise value (BEV) is another example of appraisals deliberately undervaluing real estate for taxation purposes. When markets are good, a huge portion of the value is called BEV. Will these appraisers be consistent in this COVID-19 era and say huge declines in occupancy and rents is a result of a business value decline? Is consistency too much to ask?

When appraisers substitute their opinion of what rents should be for what they actually are, appraisers have lost their way and forgotten their role. Tortured explanations of why these things are done represent sophistry masquerading as erudition.

In my view, to restore public trust in its profession, the appraisal industry needs as a start to arrive at or return to a sensible definition of *leased fee*.

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Authors' Response

We appreciate the reading of our article by Mr. Scheve. His primary point seems to be, with respect to both rent and sales, if "freely negotiated between two knowledgeable parties in the open market," they are equal to market rent and market value. Furthermore, he asserts, appraisers should not substitute their own opinions "of what rents should be for what they actually are…" These statements, however, reflect a fundamental misunderstanding of exactly what an appraisal is: "the act or process of developing an opinion of value; an opinion of value."[1] Although we would agree that current rent/sale prices can be good indicators of market, they do not always equal it. They should be adjusted just as you would adjust a comparable sale/rental. If every freely negotiated rent or value were market, there would probably be no need for a real estate appraiser. Furthermore, if "there can be no such thing as a current, freely negotiated rent that is above market," then it follows that there can be no above-market rent. Appraisers encounter above-market rent (and below-market rent) every day, all freely negotiated, and account for such in the appraisal process, either through adjustment or elimination. This is no fallacy.

Realty often involves many transactions—both rents and sale prices—that are freely negotiated, in both parties' best interests, but not at market, as that term is defined in appraisal. A good example would be a sale/leaseback. Although these transactions are freely negotiated and in the interest of both parties, they are often not at market. Build-to-suits are equally vulnerable to not being at market. Both parties may be fine with what is being paid, but it is unlikely the market would feel the same. It is certainly not our argument that "the best companies pay more for their products or rents than non-creditworthy companies." Rather, often the rent paid by the best companies fits their business model, regardless of the rent's relationship to market rent. The whole concept of *investment value* bears this out. *Investment value* is defined as "the value of a property to a particular investor or class of investors based on the investor's specific requirements. Investment value may be different from market value because it depends on a set of investment criteria that are not necessarily typical of the market."[2] We suggest Mr. Scheve look carefully at his statement, as its most important component—"the open market"—seems to be lost in his interpretation. Two parties freely negotiating a rent or a value may have very legitimate reasons for agreeing to something that does not represent what would be negotiated on the open market.

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1. Appraisal Standards Board, "Definitions," *Uniform Standards of Professional Appraisal Practice*, 2020–2021 ed. (Washington, DC: The Appraisal Foundation, 2020), 3.
2. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), s.v. "investment value."

To the Editor

Thank you to David C. Lennhoff, MAI, SRA, AI-GRS, and Richard L. Parli, MAI, for their article "Revisiting Market Value and Market Rent," (Winter 2020), in which they identify some problems inherent in various iterations of value definitions. Since market value and market rent are opinions of applicable markets and appraisers develop opinions of those opinions, the authors have actually addressed standards for appraising.

"A market value appraisal assumes that the exposure time of the hypothetical sale was sufficient to have produced a sale at market value; the assumption of any exposure time beyond sufficient is irrelevant."

Every appraisal is based on a hypothetical sale of the property appraised that is assumed to have occurred as of the effective date (moment) of the appraisal. A market value appraisal assumes that the exposure time of the hypothetical sale was sufficient to have produced a sale at market value; the assumption of any exposure time beyond sufficient is irrelevant. The article's suggestion for the hypothetical sale includes "assuming a specified exposure period," a requirement that admittedly conforms to the current Uniform Standards of Professional Appraisal Practice (USPAP).

Logic allows only three types of exposure time: excessive, insufficient, and sufficient; the last is explained above. Excessive exposure time might cause long-marketed properties to be considered old news and to face market nonchalance that can result in less than market value prices; such prices are casually described as "getting a deal." Excessive exposure time may affect price but has no effect on market value.

Insufficient exposure time is another matter. Simply put, assuming an insufficient exposure time in the hypothetical sale usually results in an appraised value that is less than that which would have been a traditional market value based on a sufficient exposure time.

Ergo, if the hypothetical sale was based on exposure time that was assumed sufficient to have resulted in a sale at market value, there is no practical or functional need to estimate a specified exposure time other than the current USPAP pronouncement. For market value appraisals, developing or reporting estimates of exposure time are of no value to the appraisal process or to intended users (although the absence of such estimates in appraisal reports are viewed by some reviewers as USPAP violations).

With the exception of exposure time, the authors' standards are excellent for sophisticated users and for withstanding legal scrutiny. However, another group of intended users, i.e., less-experienced individuals and employees of smaller businesses and smaller governments, often have little understanding of the appraisal process or the reasoning that reports of appraisal are intended to convey. The following is intended to address the needs of the latter.

Changes in market conditions can affect the value of properties in that market. Abrupt changes in markets (December 7, 1941; September 11, 2001; the COVID-19 pandemic) can cause abrupt value changes, so the moment of the appraisal should always be considered in value conclusions.

In actuality, any appraisal can only be retrospective—i.e., a value conclusion as of a stated point in time that is before the moment of the report, or prospective—i.e., a value conclusion as of a stated point in time that is after the moment of the report, albeit our industry seems to use a "recent point-in-time" option.

The following, based somewhat on Lennhoff and Parli's suggestions, are intended to contribute to a broader user understanding of reports of appraisals. These standards are captioned to clearly state the value that has been appraised.

Appraised Retrospective Market Value. Appraised retrospective market value is the most probable price for which identified property rights were assumed to have sold in a hypothetical sale that occurred in a competitive market as of a specified date under all conditions requisite to a fair sale, including the following:

1. Both the hypothetical buyer and the hypothetical seller were assumed to have been typically motivated and to have acted prudently, knowledgeably, and for self-interest;
2. The exposure time of the hypothetical sale was assumed sufficient to have achieved a sale at market value;
3. Payment in the hypothetical sale was made in cash in US dollars or in the local currency, or in precisely revealed terms equivalent to cash; and
4. The price of the hypothetical sale was subject to actual market conditions prevailing as of the date of valuation and was unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

When an appraisal is based on "special or creative financing or sales concessions granted by anyone associated with the sale," such terms should be defined. Prospective valuations (i.e., valuations as of future dates) require separate standards, which are somewhat based on the four elements mentioned above for appraising retrospective market value.

Appraised Prospective Market Value. Appraised prospective market value is the most probable price for which identified property rights are projected to sell at some time in the future in a hypothetical sale that is assumed to occur in a competitive market as of a specified date under all conditions requisite to a fair sale, including the following:

1. Both the hypothetical buyer and the hypothetical seller are assumed to be typically motivated and to act prudently, knowledgeably, and for self-interest;
2. The market-exposure time of the hypothetical sale was assumed sufficient to have achieved a sale at market value;
3. Payment in the hypothetical sale is to be made in cash in US dollars or in the local currency, or in precisely revealed terms equivalent to cash; and
4. The price of the hypothetical sale will be subject to market conditions projected as prevailing as of the date of valuation and will be unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Retrospective market value and prospective market value both require an explanation that any changes in market conditions between the moment of the appraisal and the moment of the report may call for a market conditions adjustment.

Valuation standards for other situations exist. Since there is a conflict between the highly similar liquidation value and disposition value standards as currently defined in *The Dictionary of Real Estate Appraisal*, the following proposal combines those standards and removes the conflict.

Appraised Retrospective Quick-Sale Value. Appraised retrospective quick-sale value is the most probable price that a specified interest in a property should have brought in a hypothetical sale in a competitive and open market as of the effective date of the appraisal under the following conditions:

1. Both the buyer and the seller were assumed to have acted prudently, knowledgeably, and for self-interest;
2. The buyer was typically motivated;
3. The client-specified exposure time in the hypothetical sale defined the hypothetical seller's motivation and was insufficient to have allowed an adequate marketing effort that would have resulted in a sale at market value;
4. Payment in the hypothetical sale was made in cash in US dollars or in the local currency, or in precisely revealed terms equivalent to cash; and
5. The price of the hypothetical sale was subject to market conditions prevailing as of the date of valuation and was unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Should a prospective appraised quick-sale value be needed, adapting the standards should be self-evident. In conclusion, a few additional words of explanation are of no consequence to the cost or effort of report preparation and would provide additional clarity in the opinion of value. I hope this further stimulates thinking on value standards.

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Authors' Response

We appreciate the careful reading of our article by Mr. McDonald, and we thank him for the insights he offers in his Letter to the Editor. Our goal in writing the article was to clear up the definitions of *market rent* and *market value* in hopes of reducing the differences between otherwise well-prepared appraisals by equally qualified appraisers. Mr. McDonald sought to contribute to our objective by targeting a "broader user understanding of reports of appraisals." He has, in our opinion, achieved that goal.

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