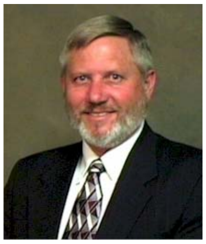

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Lack of Comparable Market Data

I recently was asked to review an appraisal of an interesting property that was done for a divorce. The property was a mountain "cabin" on about five acres that was partially constructed. The appraiser used only a cost approach with an estimated value for the land. Finding sales comparables for a partially completed mountain cabin apparently was sufficiently daunting that the appraiser simply stated that no market data was available and eliminated the market approach. Regardless of what is being appraised, recent sales of similar properties generally provides the best indication of market value. So, what should an appraiser do when market data appears to be unavailable?

IRS Revenue Ruling 59-60, often considered the "Bible" for business appraisers, suggests that when data is not available for a specific type of company, that the search be expanded to those in similar industries. In a similar manner, when data for properties in a specific area or for a specific type of property is not readily available, the search conducted by real estate appraisers should be expanded as needed until relatively similar data can be located. The challenge for appraisers is to determine what adjustments are reasonable, given the differences between the properties when less than ideal comparables are the only sales available, and then how to make these adjustments to the comparable data that is available from these expanded searches. In these cases, the appraiser must use his or her best judgment to make appropriate adjustments, as often times there is no hard market data available as support. Obviously, the more dissimilar the comparable data from the subject, the less weight that should be placed on conclusions reached using that data. However, whenever possible, market data should be used to at least support the value conclusion reached using the other approaches.

Coming back to the mountain cabin example. After my review, I was asked to appraise the property myself. I found that there was considerable data available in the market area for land sales – thus, developing a market value conclusion for the five acres on which the cabin was being built was not a problem, and should have been done in the initial appraisal. By expanding my search, I found a few sales of partially completed cabins and some completed cabins as well. Adjustments made to these comparables provided good support for the conclusion reached using the cost approach.

Another recent example that shows the importance of market data is an appraisal of a vacation home on Payette Lake in McCall. The client paid almost one million dollars to have the home built on leased land. Another appraiser concluded at a value for the improvements of about one-third of the amount paid ((using the cost approach only)). I was asked to appraise the property as well. My cost approach conclusion came in about two-thirds of the amount paid. In order to support this value, I used the sales of other similar homes on leased land and some sales on land owned subtracting out the land value to arrive at the value of the improvements. While I would have been uncomfortable using the sales comparison approach alone, this conclusion supported my cost approach conclusion and provided a well-supported market value as a result. The analysis indicated that the amount paid to the contractor to construct the home was likely more than the market would support for similar properties.

The above example outlines another reason why the inclusion of the market approach is essential, when possible. The amount paid for a property or the cost to build a structure does not necessarily equate to market value. It is possible, and not that uncommon, to “over improve” a building by including components with at large costs that the market simply will not pay for. For example, a few years ago I was asked to appraise the largest building in Idaho County – a very large industrial building that was located in a very rural part of the county. It had been built by an individual well known for income tax avoidance for his company. At the time I took on the appraisal assignment, the property owner was incarcerated for income tax evasion (and later for threatening the life of the judge and the prosecutor). The building’s market value was substantially less than the value derived from a cost approach – because of its location. The size and scope of the building, given its surroundings, was simply not appealing to virtually any potential buyer.

While the market approach is a valuable tool, in some situations (notably the appraisal of holding companies) it may simply not be applicable, and the cost approach may be the only applicable approach as market data that is even somewhat similar simply cannot be located. In these situations, the market approach is generally used to value the underlying assets and the cost approach is used to value the holding company. Such situations aside, if it is possible to perform the sales comparison approach, even in a limited manner, it is important that it be considered by the appraiser – for support of the other approaches, even if little to no weight is actually given to the method.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**

Sincerely,

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