Adjusting for conditions of sale

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Elements of comparison are the characteristics or attributes of real properties and transactions that cause the price to vary. When completing an appraisal that compares the real property being appraised to similar real properties that have sold on the open market, the appraiser must consider what elements of comparison caused the price to vary.

Elements of comparison include real property rights conveyed, financing terms, conditions of sale, market conditions, location, physical characteristics, economic conditions, use, and non-realty components of value.[1]

This article deals only with conditions of sale, which is also referred to as motivation.[2]

Conditions of sale relate to the decision-making process. For what reason does a real property owner decide to market his real property and, once disposal is decided, what marketing method is to be employed?

Market value is defined as the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.

Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

i. buyer and seller are typically motivated;
ii. both parties are well informed or well advised, and acting in what they consider their best interests;
iii. a reasonable time is allowed for exposure in the open market;
iv. payment is made in terms of cash in Canadian dollars or in terms of financial arrangements comparable thereto; and
v. 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.[3]

Once a real property has sold, the appraiser must analyze conditions of sale. If it is determined that the transaction is at arm's length, at least two questions must be addressed:

1. Why did the owner sell the real property? (reason to sell)
2. How was the real property sold? (marketing method)

There are several possible considerations why a vendor would dispose of his real property (there are others):

1. death (estate)
2. a person being transferred
3. a person wishes to move to rented premises
4. a person wishes to retire
5. a person wishes to acquire a larger or smaller real property
6. a mortgage default
7. the real property is declared surplus
8. a matrimonial dispute
9. asset management
10. realty tax arrears collection

Most purchasers brag about getting "a real steal," inferring that the real property was purchased for less than market value. Comments such as ... *an executor was eager to settle an estate, it was a divorce, the vendor was in financial difficulty, it was a power of sale,* etc., are perceived reasons why purchasers (and some appraisers) think discounting occurred.

Is it valid to make an adjustment for reason to sell? Does a rational vendor accept less than the fair market value when disposing of real property to strangers?

The answer is no, of course not.

It is reasonable to assume that normal folks (vendors) do not give real property equity gifts to strangers (purchasers). Therefore, it is improper to make an adjustment for reason to sell. An appraiser making an adjustment for conditions of sale, reason to sell, is arguing that the vendor gave a benefit or a gift to a purchaser. An appraiser would have to be very creative when explaining an adjustment for a perceived condition of sale that relates to reason to sell. The argument is probably not going to be credible.

A real property sold pursuant to a power of sale clause may sell for less than fair market value, but it does not sell for less because of conditions of sale (reason to sell). If it sold for less, it is probably due to another element of comparison, the real property's condition.

A mortgagee is granted the real property when the mortgage is registered and the mortgagor, the real property owner, retains an equity of redemption right. The mortgagee is a willing seller because it knew it had a default power of sale remedy when it placed the mortgage. However, a mortgagee in possession must return equity to the mortgagor and, as such, has a responsibility to sell the real property for its fair market value. In the vast majority of cases, the mortgagee does sell the real property for fair market value. If not, there is a good chance the mortgagor will sue for his lost equity.

In the majority of power of sale situations, the real property owner is in financial difficulty and does not make the mortgage payment. In many cases, the owner defers maintenance and strips the real property of cash flow. Deferring maintenance results in the real property being in poor condition. Sometimes vandalism occurs because of lack of management. The real property is then viewed by the open market as requiring capital expenditure over and above the purchase price, and a purchaser will want an entrepreneurial return on that capital expended. The buyer does this by estimating the current market value and deducting the estimated costs to complete repairs. These costs normally include an entrepreneurial profit.

If a real property does not suffer from deferred maintenance and is, therefore, in good condition, the open marketplace does not adjust the price for condition of the real property.

If the real property is income-producing, the deferred maintenance is usually more severe than if the real property is not income-producing. Detached single unit residential dwellings are normally purchased to provide a residential amenity and do not generate income when owner occupied. Experience has shown that income-producing real property suffers a greater degree of deferred maintenance than detached single unit residential dwellings in a power of sale situation. The income stream may also have declined as a result of vacancy brought on by the deferred maintenance.

In many cases, a real property owner facing a power of sale situation will strip the building of fixtures and chattels. When these real properties are put on the open market, they sell for a fair market value that has been adjusted by the open marketplace to reflect its condition and income stream.

It may be proper for an appraiser to utilize a similar real property sold under power of sale as a comparable, making normal adjustments for the various elements of comparison. The reason to sell may not be a supportable element of comparison.

Now consider marketing method.

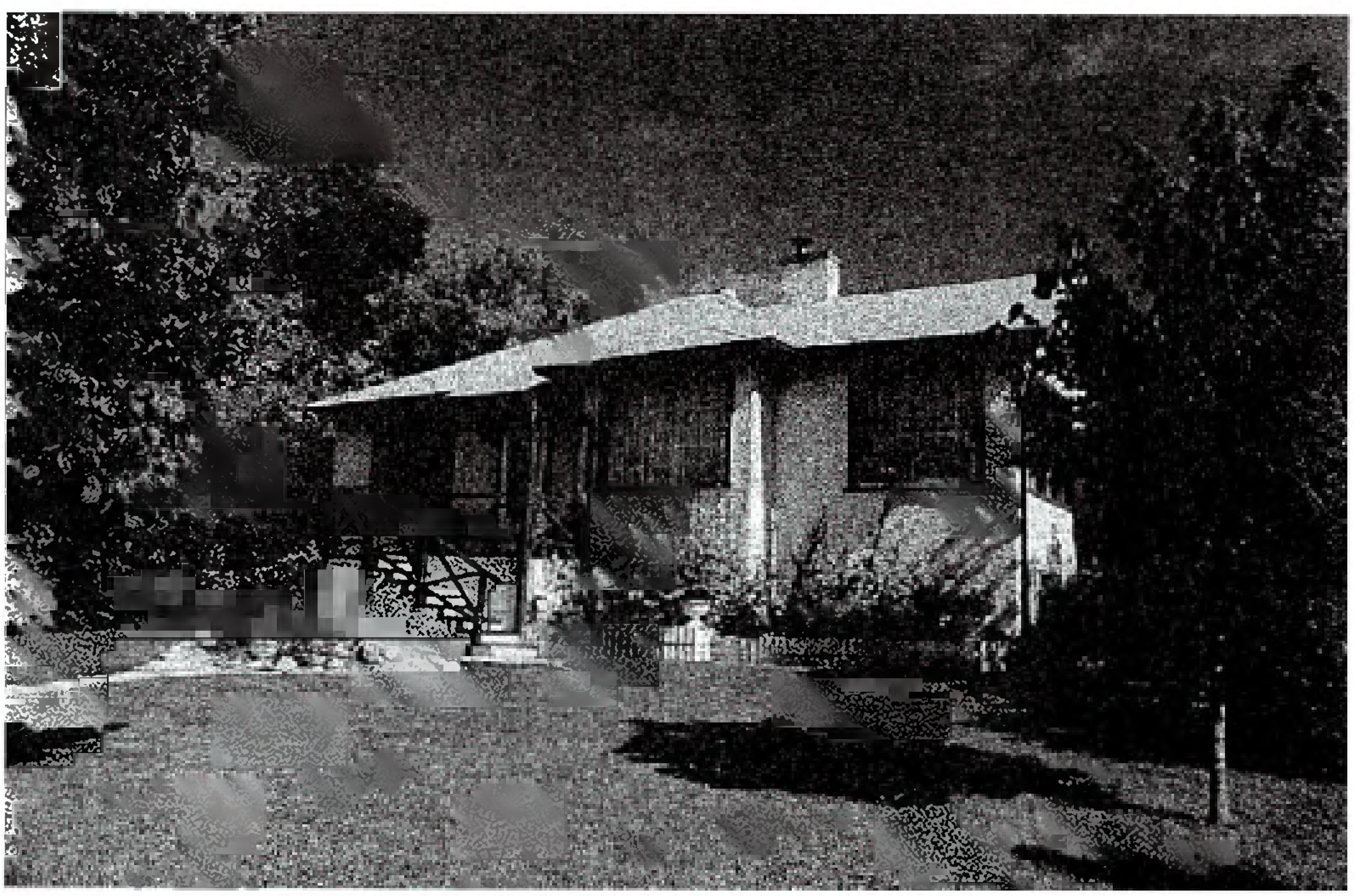
MLS[4] listing

Each Canadian province regulates the marketing of real property in that province. The majority of Realtors[5] are members of a local real estate board, a provincial real estate association, and the Canadian Real Estate Association. There were 70,427 realtor members of the Canadian Real Estate Association in 1997. They generated $58,0434 billion in real property transactions in 1997 selling 370,081 real properties. The Canadian Real Estate Association has been collecting comprehensive national statistics since 1956.

An MLS listing is a contract between the real property owner and a Realtor. MLS means multiple listing service. The listing is made available to all members of the local real estate board on a co-operative basis. Listing real property on the MLS system allows all members of a local real estate board to competitively market the real property. Realtors compete with each other to sell real property, and the Realtor is only paid a commission if the real property is sold. The real property competes with similar real properties also listed on the MLS system.

The listing Realtor must use his or her best efforts in marketing the property. Marketing methods may include newspaper advertising, lawn signs, flyers, radio, TV, and the Internet.

There is an effective negotiating process wherein the Realtor negotiates between the real property owner and possible purchasers. An *Agreement of Purchase and Sale* can be conditional upon satisfactory mortgage financing



There are many reasons why real property owners decide to market their properties.

being arranged or upon other events occurring within a specified period of time.

Marketing via MLS provides ultimate open market exposure.

Exclusive listing

An exclusive listing is a contract between the real property owner and a Realtor. The listing is not made available to members of the local real estate board, although the listing Realtor may grant permission to a competing Realtor to market the listing. There is limited Realtor competition to market the real property. The Realtor is only paid a commission if the real property is sold. The real property does not fully compete with similar real properties listed on the MLS system.

The listing Realtor must use his or her best efforts in exposing and marketing the real property. Marketing methods may include newspaper advertising, lawn signs, flyers, radio, television, and the Internet.

There is an effective negotiating process wherein the Realtor negotiates between the real property owner and possible purchasers. An *Agreement of Purchase and Sale* can be conditional upon satisfactory mortgage financing being arranged or upon other events occurring within a specified period of time.

Marketing via an exclusive listing provides open market exposure although exposure is less than marketing via MLS.

Private marketing

Private marketing occurs when a vendor decides not to use the services of marketing experts such as Realtors. There is no listing contract and no exposure to the MLS system. There is no Realtor competition to market the real property. There is no commission paid if the real property is sold. The real property does not fully compete with similar real properties listed on the MLS system. Marketing methods may include newspaper advertising, lawn signs, flyers, radio, television, and the Internet. There is no negotiating process wherein a third party negotiates between the real property owner and possible purchasers. An *Agreement of Purchase and Sale* can be conditional upon satisfactory mortgage financing being arranged or upon other events occurring within a specified period of time.

Private marketing provides limited open market exposure.

Public auction

Marketing via a public auction is an exclusive contract between the real property owner and an auctioneer who can also be a Realtor. The contract is not normally made available to members of the local real estate board. There is no salesperson competition to sell the real property. The auctioneer is usually paid a commission if the real property is sold, although a set fee may be negotiated. The real property does not fully compete with similar real properties listed on the MLS system. Marketing methods may include newspaper advertising, lawn signs, flyers, radio, television, and the Internet. While there is third party (the auctioneer) bidding encouragement, there is no effective negotiating process wherein a third party, such as a Realtor, negotiates between the real property owner and possible purchasers. A decision to purchase must be made on the spot. A successful bid is usually for cash although, in some cases, the bid can be conditional upon arranging satisfactory mortgage financing. However, an auction normally does not permit a condition for another event occurring.

Marketing via public auction provides limited open market exposure.

Tender process

A private or public tender process appears to be the preferred method of governments when they sell real property. There are *Acts* that call for disposal via the public tender process.

Marketing via the tender process does not involve a third party, someone with marketing expertise. The tender process usually excludes members of the local real estate board and there is no salesperson competition to sell the real property. No one is paid a commission if the real property is sold. The real property does not fully compete with similar real properties listed on the MLS system. Marketing methods may include newspaper advertising, lawn signs, flyers, radio, television, and the Internet, although marketing is usually limited to one or two newspaper advertisements. There is no effective negotiating process wherein a third party, such as a Realtor, negotiates between the real property owner and possible purchasers. There is little incentive for a possible purchaser to make an offer to purchase, as the tender process usually states that the lowest or highest offer may, or may not, be accepted. A potential purchaser makes one decision and, once the decision to purchase is made, the purchaser has no further decision to make. A successful tender must be for cash although, in some cases, the tender can be condi-

TABLE 1

Market Value Item	MLS	Exclusive	Private	Auction	Tender
Competitive Market	Yes	Limited	Limited	Limited	Limited
Open Market	Yes	Yes	Yes	Limited	Limited
Third Party Negotiations*	Yes	Yes	No	No	No
Typical Motivation	Yes	Yes	Yes	Yes	Yes
Reasonable Exposure Time	Yes	Yes	Yes	No	No

*all conditions requisite to a fair sale

From multiple listing services to private sales and auctions, the method of sale is an important consideration.

tional upon arranging satisfactory mortgage financing. The tender normally does not permit a condition for another event occurring.

Marketing via the tender process provides very limited open market exposure.

Each marketing method is analyzed in relation to the definition of market value (see Table 1). One can argue that third party negotiations are not embodied in the definition of market value. I believe the statement "under all conditions requisite to a fair sale" includes the negotiation process. Negotiating is an intricate part of the open market process.

Marketing a real property on the MLS system will result in the broadest, competitive open market exposure, hence the best opportunity to obtain fair market value. A reasonable marketing time is typically three months although this can vary depending on the real property type.

Does real property exposed to a limited market sell for fair market value? Perhaps, but it may sell for less (possibly more). Vendors do not list exclusively very often, most prefer the MLS system. Real property may sell for less than fair market value when the real property has not been properly exposed on the open market.

A large track of farmland was sold at an auction in 1977. While there was a crowd of about 30 people, only two were bidding. One bidder took the other aside and paid him $25,000 cash to stop bidding. It would be difficult for an appraiser to argue that the transaction was in a competitive, open, and fair market.

If the marketing method is the private or public sealed tender process, the very least open market exposure will be obtained. Usually, there is a reserve bid, but there may not be an asking price. The prospective purchaser is not permitted to negotiate. Negotiating is an intricate part of the open market process.

While committees (governments) and their bureaucrats argue that the sealed tender process is the best marketing method, it is not. The following quote, author unknown, comes to mind when I think of the government decision-making process: "... a committee is a group of well intentioned folks who set out to design a horse and invariably end up with a camel."

Determining an adjustment amount may be very difficult if the marketing method was the tender process. The solution may be to not include, in an appraisal report, the similar, sold real property or, if it is used, place little weight on it.

An appraisal textbook suggests "... a sale may be transacted at a below-market price if the seller needs cash in a hurry."[6] This may be correct. However, if this transaction is used, the appraiser must not make an adjustment for reason to sell, rather it must be for marketing method. Was the exposure time reasonable? It is reasonable to conclude marketing time was certainly not reasonable if the vendor needed cash within one week.

This article makes no attempt to consider all possible conditions of sale. It is reasonable to conclude that a credible argument supporting an adjustment for condition of sale, reason to sell may be very difficult to support. However, an adjustment for condition of sale, marketing method is probably much simpler to support and certainly will be much more credible. ✦

Endnotes

1. *The Appraisal of Real Estate, Canadian Edition*, 1992 Appraisal Institute, page 363.
2. *Basics of Real Estate Appraising*, Appraisal Institute of Canada 1992, page 237.
3. *USPAP*, The Appraisal Institute of Canada, 1997 Edition.
4. Registered Trademark, The Canadian Real Estate Association.
5. Registered Trademark, The Canadian Real Estate Association.
6. *The Appraisal of Real Estate, Canadian Edition*, 1992 Appraisal Institute, page 370.

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