

## Which Value?

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Declining conditions in the capital markets and deteriorating property fundamentals continue to put stress on commercial real estate loan portfolios. Regulatory requirements and internal bank policies often require reviewing the value of underlying real estate assets to support making prudent business decisions. Various concepts of value have evolved to respond to differing business situations. It is important to understand and clarify what type of value estimates are necessary based on the business problem to be solved.

Banking regulations require the use of Market Value to support real estate loan originations. Market Value is defined in the Federal Register<sup>[1]</sup> as: "The most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale..." It includes the following implicit assumptions:

- The price is not affected by undue stimulus.
- Buyer and seller are typically motivated.
- A reasonable time is allowed for exposure in the open market.

This concept is fine for lending and regulatory purposes, but in times of economic stress like today, it may not provide the information needed to make certain business decisions. What if "reasonable exposure time" is determined to be 18 to 24 months, but this is a classified loan and a Special Assets officer needs to know what this property would sell for in a compressed timeframe, say 6 months?

In this situation, it would be useful to know the Disposition Value of the property. Disposition Value as defined<sup>[2]</sup> differs from Market Value regarding the following explicit assumptions:

- Consummation of a sale within a future exposure time specified by the client.
- The seller is under compulsion to sell.
- An adequate marketing effort will be made during the exposure time specified by the client.

There may be times when we need to know what a property would sell for in a highly compressed timeframe, say 30 days. This would call for an analysis of the Liquidation Value of the property. Liquidation Value as defined<sup>[3]</sup> differs from Market and Disposition Values in the following explicit assumptions:

- Consummation of a sale within a short time period.
- The seller is under extreme compulsion to sell.
- A normal marketing effort is not possible due to the brief exposure time.

Sometimes it may be useful to understand what a property would be worth to the current

owner, or to the current tenant, or to a particular investor. This situation calls for an estimate of the Investment Value of the property, which is defined as<sup>[4]</sup>: "The value of a property interest to a particular investor or class of investors based on the investor's specific requirements." It should be noted that 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.

Accounting standards require a presentation of the Fair Value of assets. FAS 157 defines Fair Value<sup>[5]</sup> as: "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Conceptually this is similar to Market Value; however, the lack of clarity in its definition can lead to various interpretations when it is applied. For example: Is Fair Value based on cash or its equivalent? Does it assume a reasonable exposure period? Does it assume the seller and buyer are typically motivated? Differing answers to these conceptual questions could lead to a wide array of conclusions.

Market conditions continue to make it extremely challenging to estimate today's value of real property. We can, however, help the process by being very clear about which concept of value will best solve our current business issue.

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<sup>[1]</sup> (12 C.F.R. Part 34.42(g); 55 *Federal Register* 34696, August 24, 1990, as amended at 57 *Federal Register* 12202, April 9, 1992; 59 *Federal Register* 29499, June 7, 1994)

<sup>[2]</sup> Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 5th ed. ( Chicago : Appraisal Institute), 2010.

<sup>[3]</sup> Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 5th ed. ( Chicago : Appraisal Institute), 2010.

<sup>[4]</sup> Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 5th ed. ( Chicago : Appraisal Institute), 2010.

<sup>[5]</sup> Financial Accounting Standards Board, FAS 157

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