

# **SOLUTIONS IN DISTRESSED MARKETS**

**By**

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Distressed (depressed) market conditions pose significant challenges to valuers of real estate. The current body of valuation knowledge does not provide adequate quantitative tools with which to surmount such challenges. Relevant literature on the topic will be described and analyzed.

This article will examine and contrast relevant characteristics of distressed market conditions with those of more balanced markets.

In unbalanced markets, the principal difficulty facing valuers is clearly the relative dearth of observable evidence of pricing metrics employed by buyers and sellers. Nonetheless, useful data are indeed available and will be described and analyzed.

Three commonly-asked questions arise in such circumstances, specifically:

- Can valuers render reliable and credible opinions of value when markets are in stasis?
- Are sales transactions in distressed periods truly reflective of market value?
- Are sellers in distressed markets, by definition, under duress (i.e., being forced to sell rather than wait until market conditions improve)?

A thorough exposition of useful analytical considerations and problem-solving applications for the practitioner will be provided. Such applications will be supported by relevant valuation theory.

This treatise applies principally with income-producing real estate.

## Definitions

The following terms and their definitions are used herein:

- Depressed market-A market in which a drop in demand is accompanied by a relative oversupply and a decline in prices<sup>1</sup>. As used herein, distressed and depressed are synonymous terms.
- Buyer's market-A depressed market in which buyers have the advantage; exists when market prices are relatively low and declining due to an oversupply of property or a reduced number of potential buyers<sup>2</sup>
- Intrinsic value-The inherent worth of a thing; as contrasted with an empirical measure or an opinion of value, such as market value; a value considered to be inherently or internally associated with an object<sup>3</sup>

A distressed property may be, and indeed often is, located within a market that is not distressed; however, most properties are distressed in distressed markets. Since the valuer is concerned with the valuation of individual properties, the focus herein will be upon distressed properties in distressed markets.

## Manifestations of Distress

Distressed markets generally reflect the following characteristics:

- Sellers often have unachievable price expectations. Since a seller already owns the property, the only significant decision to be made is whether or not to sell at prevailing pricing.

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<sup>1</sup> Appraisal Institute, *The Appraisal of Real Estate*, 13<sup>th</sup> ed. (Chicago: Appraisal Institute, 2008); 180.

<sup>2</sup> Supra

<sup>3</sup> Appraisal Institute Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 5<sup>th</sup> ed. (Chicago: Appraisal Institute, 2010); 104

- Buyers, on the other hand, typically have several properties from which to choose, assuming some degree of geographic flexibility, and indeed may choose to do nothing. Buyers are unwilling to act without the realistic potential for returns commensurate with the degree of risk assumed in buying distressed properties in distressed markets. As noted by Anglyn<sup>4</sup>, buyers of distressed properties are typically entrepreneurs rather than institutional investors. Returns for such buyers must provide for adequate entrepreneurial incentive. Expectations for such returns are based primarily upon forecast asset appreciation.
- Revenue declines and increases in vacancy, credit loss, concessions, tenant improvement allowances, and leasing commissions are pervasive. It is not unusual for effective gross income to be less than expenses, resulting in negative net operating income (before debt service). In such situations, maintenance is often not performed, thereby creating deferred maintenance.
- Building owners have difficulty funding or financing tenant improvement allowances and thus compensate by using increased concessions.
- There is little or no leasing activity; that which does occur arises from lateral movement, as opposed to growth/expansion of existing tenants, new company formations, and in-migration of existing firms in other regions.
- Tenants often move up to better quality properties to take advantage of depressed rental rates, thereby placing greater downward pressure on rates and occupancy in lower quality properties.
- Existing leases are typically in excess of market rent.
- Existing tenants often demand that leases be modified to reflect lease rates that are closer to market rent.

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<sup>4</sup> Appraisal Institute, *The Appraisal Journal* (Spring 2005); 210-215.

- In retail properties, the vacation of anchor tenants often triggers co-tenancy clauses in the leases of non-anchor tenants. The tenants' options to vacate, in and of themselves, increase risk and diminish value.
- Debt capital, to the extent available, is scarce and expensive, with stringent underwriting standards.
- There are few sale transactions. Those that do occur are typically all-cash or involve seller financing.

### **Can valuers render reliable and credible opinions of value when markets are in stasis?**

Given the foregoing dynamics, one may rightly question whether accurate, credible value opinions may be rendered in such economic environments.

The answer is affirmative-credible, reliable value opinions can be derived. However, the valuer is required to develop and emphasize additional information to supplant observable market activity, i.e., sale and lease transactions.

In the absence of transactions, one must gather data regarding buyers' required rates of return, namely overall capitalization and yield rates. Primary sources are brokers and investors for similar properties. Such data are best derived from interviews. While survey data are useful, the range of reported rates is generally wide (400-600 basis points). Further, the information is, to a degree, dated upon publication because of the time needed to conduct, amass, and analyze the results as well as the time required to publish the survey. The advantages of interviews are the timeliness of the data received and the probable narrow range of rates derived there from. "Real time" data are quite important in distressed markets, particularly when market conditions are continuing to deteriorate.

Credible and reliable valuations in distressed markets are inordinately based upon return-driven analyses.

## **Are sales transactions in distressed periods truly reflective of market value?**

The answer to this question depends upon whether the standards by which market value is defined are met. The elements of most definitions that are of particular importance in considering transactions in distressed markets are as follows:

- Reasonable exposure time
- Seller acting prudently, knowledgeably, and without undue duress in own best interest
- Payment made in cash or cash-equivalency, unaffected by special or creative financing

For reasons previously cited, the focus of analysis in such transactions is on whether sellers' behavior was in material conformity with the above criteria.

Exposure time is a function of both price and property type. An inordinately short exposure time may be an indicator that the price is not reflective of market value.

The determination as to whether the seller in a particular transaction acted prudently, knowledgeably, without duress, and in its best interest can realistically only be made by interviewing parties to the sale. The fact that the seller was a financial institution that acquired the property by foreclosure or deed-in-lieu of foreclosure is not prima facie evidence of duress or imprudence. Such a determination requires further investigation.

The provision of seller financing is generally an indication that price may well have been influenced by this factor. Sellers expect to receive payment in cash at closing and only provide financing in order to facilitate the sale. The provision of seller financing strongly suggests that alternative sources were unavailable. Thoughtful analysis of, and adjustment to, transactions for this influence are necessary.

Some may argue that sales of distressed properties in distressed markets cannot be reflective of market value since market conditions are not "normal". This begs the obvious question-what are "normal" market conditions? Valuation literature supports the position that markets are dynamic, obviously in varying degrees. Change is constantly occurring. If markets are in fact dynamic and ever-changing, what then is "normal"? Further, what evidence exists that what was "normal" in the past is or will be "normal" now or in the foreseeable future? It is a question that cannot be conclusively answered.

Some in the real estate sector sometimes refer to the "intrinsic" value of real estate. This too is a spurious notion. Real estate has value only to the extent that it provides an economic good. Further, such value accrues from purchasers' perception of future, not past, benefits. Prices paid reflect nothing more than buyers' calculi as to the magnitude and current worth of such benefits.

### **Are sellers in distressed markets, by definition, under duress?**

There are several reasons why owners sell real estate. Being forced to sell is only one such reason.

Owners often choose to sell during distressed market conditions based upon their perception that the proceeds from sale can be more profitably invested elsewhere. Furthermore, as Hanford<sup>5</sup> notes, "...what evidence is there...to prove that none of the sellers believe the market may deteriorate further?"

The professional valuer is therefore obligated to interview the parties to transactions being considered in order to determine whether particular sellers were under duress.

### **Problem-solving Applications**

The following techniques and considerations are offered for use in applying the three valuation approaches to value.

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<sup>5</sup> Appraisal Institute, *The Appraisal Journal* (October 1991); 448

### *Sales Comparison Approach*

The obvious difficulty in applying the sales comparison approach in distressed markets is the dearth of recent evidence of market behavior, i.e., sale transactions. It is thus important to find a methodology by which to adjust older transactions for changes in market conditions. Such methodology must of course capture the expectations of potential market participants.

Techniques based upon differences in net operating income between the comparables and subject are flawed for two reasons, namely:

- Such a technique is necessarily based upon conclusions reached in the income capitalization approach, which erodes the independence of the two approaches.
- Contributors to changes in market value include changes in both net operating income and return requirements. Adjustments based upon only one of these elements clearly do not capture the total magnitude of change.

Value changes are typically driven by changes in market rent, vacancy and credit loss, net operating income, and rates of return (overall capitalization and yield rates). Because of the mathematical relationship of such elements, adjustments based upon changes in one element may not fully reflect the degree of decline in values due to distressed market conditions.

An alternative technique for developing such adjustments involves the application of direct capitalization at the *market or submarket level*, as of the dates of sale of the comparable data. The results are then compared with those reflective of similar market data, as of the effective date of valuation, for the same market or submarket, with the percentage differential providing indications of appropriate market condition adjustments.

The data for the market or submarket may be derived from published surveys. In larger markets, data regarding average rental rates, vacancy rates, expenses, and overall rates are available. Reliability is likely to be enhanced by use of data that best fit the comparable properties (e.g., those of the submarket versus larger market, by building class, etc.). The use of market averages is logical, absent compelling reasons for using indications above or below the averages. One must be mindful of unwittingly and indirectly capturing factors other than market conditions in making such adjustments. Differences in, e.g., location, age/condition, and occupancy should be reflected in separate adjustments.

The following is an example of the development of a market condition adjustment for a single comparable transaction using the afore-described technique.

<b>DEVELOPMENT OF ADJUSTMENT FOR MARKET CONDITIONS</b>			
<b>Component</b>	<b>Market Conditions 2<sup>nd</sup> Qtr 2008</b>	<b>Market Conditions 2<sup>nd</sup> Qtr 2010</b>	<b>% Change</b>
Average Rent/SF	\$23.00	\$20.00	-13%
Average Occupancy Rate	10%	15%	+50%
Average Imputed EGI/SF	\$20.70	\$17.00	-18%
Average Expenses/SF	\$8.75	\$9.10	+4%
Average Imputed NOI/SF	\$11.75	\$7.90	-34%
Average Overall Cap. Rate	6.5%	8.0%	+23%
Imputed Value/SF by Direct Capitalization	\$183.83	\$98.75	-46%
<b>Concluded Adjustment for Market Conditions</b>			<b>45% (Rd.)</b>

The argument may be made that this technique is based upon “abnormally” distressed conditions and that the results represent an over-adjustment for this factor. The responses to such an argument are two-fold:

- As asserted earlier, one cannot convincingly support the view that current conditions are “abnormal” because “normality” itself cannot be proven. The rate and timing of recovery from current distressed market conditions may or may not mirror past recoveries. As proof, one need look no further than the economy of Japan since the 1990s.



- Investors' expectations regarding future increases in rent and occupancy and declines in returns are reflected in overall rates of capitalization. If purchasers anticipate rapid recovery, these expectations will be reflected in such rates. Of course, the reverse is also true.

The accuracy of this technique depends in part upon the similarity of the properties included in the survey(s) to the property being valued. For example, the utilization of survey data of multi-tenant office properties will likely not reflect an appropriate market condition adjustment for single-tenant office properties that are leased on a long-term basis to an investment grade tenant.

In the absence of recent comparable data, valuers should incorporate current listings of similar properties in the sales comparison approach. All other factors being equal, listings obviously reflect the upper limit of value.

#### *Income Capitalization Approach*

There are several considerations relevant to this approach when used in markets that are distressed.

The valuer can make profitable use of lease proposals that were not accepted by prospective lessees of the building being valued. The lessor's proposed rate and terms represent the upper limit of market terms while the lessee's counter offer(s) serve to support opinions of the lower limit, if not market rent and terms themselves. As with buyers, tenants generally have many alternatives from which to choose.

Interviews with leasing agents for the subject are particularly important during periods of distress. Such sources may provide useful opinions regarding achievable rates and terms together with the forecast period for the absorption of vacant space. Analyses of the terms of recent leases also yield insight into market rent and terms.

In distressed markets, above-market contract lease rates are usually pervasive. Such terms clearly represent higher degrees of risk than market or below-market leases. Such risk arises due to the increased likelihood of default and/or tenant-driven demands for modification. Therefore, the valuer should interview property management regarding:

- Delinquencies
- Requests for rent reductions by existing tenants
- Other information regarding possible tenant changes, even if anecdotal

In analyzing the subject’s rent roll, careful consideration should be given to the degree by which contract rent exceeds market rent, since risk is positively correlated with excess rent. The following reflects a rent roll with significant excess rent.

Suite No.	Size (SF)	Contract Rent	Market Rent	Excess Rent
100	3,500	\$112,000	\$70,000	\$42,000
101	11,500	382,000	230,000	152,000
102	7,000	112,000	140,000	-28,000
103	15,000	150,000	300,000	-150,000
104	12,500	372,500	250,000	122,500
<b>Totals</b>		<b>\$1,128,500</b>	<b>\$990,000</b>	<b>\$138,500</b>

A cursory view of the above reveals aggregate excess rent that is 14.0% greater than market rent. While nominally true, the calculation of excess rent *should not be based upon offsetting below-market rent against excess rent*. In such instances, risk is not linear. The risk of default or tenant-driven lease modification is significantly greater than the reduction in risk inherent in below-market leases. Based upon this reasoning, effective excess rent is \$316,500 per annum or 32.0% greater than market. A fundamental question to be researched is whether potential investors include excess rent in pricing decisions and if so, the extent to which such rent is discounted.

In properties with low occupancy, the estimation of a market-supported differential between value "as is" and "as stabilized" is of great importance. The failure to account for the greater risk inherent in successfully achieving stabilization as forecast will result in the over-valuation of the property. In the discounted cash flow analysis technique, this risk may be manifest by use of an appropriately higher yield rate in the "as is" premise vis-à-vis that used in the "as stabilized" premise.

In direct capitalization ("as is" premise), one should use an overall rate derived from recent sales of similarly distressed properties. If such data are unavailable, one may deduct a market-derived provision for entrepreneurial incentive as well as the cost to achieve stabilization from the value "as stabilized". The calculation of a deduction for the costs to attain stabilization using the yield rate from the DCFA ("as stabilized" premise) will almost certainly understate the appropriate deduction. The argument could be made that such costs should not be discounted at all, thereby increasing the size of the deduction. However, an entrepreneurial incentive should be considered as well in order to adequately reflect purchasers' return requirements.

As noted earlier, purchasers of distressed properties are typically entrepreneurs rather than institutional investors. Such buyers expect to be well rewarded for the greater risks assumed. It is the dollar amount of such profit rather than profit as a percentage that is important to such investors, as noted by Anglyn<sup>6</sup>.

Potential sources of market-derived rates of returns are investors and brokers for properties similar to that being valued. These sources may also provide valuable insight into market expectations for future rental growth rates and absorption. While survey data are available, such data generally reflect wide ranges and are somewhat dated, given the time required to gather and publish the surveys, factors that diminish the usefulness of the information. Furthermore, most survey data reflect those of institutional investors for stabilized properties.

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<sup>6</sup> Appraisal Institute, *The Appraisal Journal* (Spring 2005); 210-215.

Properties that have inordinately high expense ratios, such as older, 2nd or 3<sup>rd</sup> tier hotels and skilled nursing facilities, have much greater risk, particularly when market conditions are continuing to decline. For such properties, small changes in gross revenue have a great effect upon net operating income. This effect is similar to that resulting from high leverage. Indeed, properties with *both* high expense ratios and high leverage are truly high-risk investments, particularly in distressed markets.

In distressed markets, assessed values for property taxation are often significantly above market value. If the sale of the subject (the underlying premise of market value) will likely result in a lower assessed value, the valuer should reflect this in estimating tax expense. This is easily done by adding the tax rate to the overall capitalization rate, and dividing net operating income before deduction for property taxes by the "loaded" overall rate. The result multiplied by the tax rate is a supportable estimate of such expense. In using this technique, net operating income should be on an "as stabilized" basis, as are all other elements of revenue and expense. For properties in states that allow for only small annual increases in taxes (e.g. California), one may reasonably base tax expense upon the "as is" value. In such instances, property tax expense used in calculating the reversion in the discounted cash flow analysis should reflect the "as stabilized" premise, assuming stabilization is forecast to have occurred by the reversion date.

### *Cost Approach*

Application of the cost approach in valuing properties in distressed markets is fraught with difficulties.

In such situations, there are likely to be few, if any, sales upon which to base an opinion of site value. Current listings may be used to indicate the upper limit of value but provide scant evidence of market value. One may base such an opinion upon the forecast value of the site at the time that development is warranted, discounted to the effective date by a yield rate reflective of the uncertainties of such a forecast. A value opinion so derived is likely to be weakly supported.

An equally intractable problem exists in quantifying external obsolescence. In distressed markets, such obsolescence almost always exists. A threshold question to be answered is whether the obsolescence is temporary (until market recovery) or long-term (permanent). It is of course possible that both temporary and long-term external obsolescence may be present in a particular property.

Further, some valuers quantify external obsolescence using components of the income capitalization approach<sup>7</sup>. Although an acceptable methodology, it results in interdependence within the approaches. Finally, since external obsolescence impacts only the improvements, the allocation of total external obsolescence to that attributable to the improvements is complicated by the afore-mentioned lack of land sales.

For the above reasons, the cost approach is unlikely to provide a reliable and credible value indication in distressed markets. The omission of this approach is supportable if investors do not place emphasis there upon. Investors are sometimes interested in estimates of site value plus replacement cost in order to understand the cost differential between buying an existing building and constructing a new one.

## **Summary**

Valuation in distressed markets requires consideration of many factors that are not present during periods of relative market equilibrium. The process is impeded by the lack of observable inputs. Nonetheless, there are tools available to the valuer by which to generate credible, market-based opinions. However, the rote application of appraisal methodologies is insufficient and will likely result in inaccurate opinions.

It is essential that the valuer develop "real time" market inputs that reflect potential purchasers' expectations. The most frequent complaint from users of valuations of properties in distressed markets is that value opinions are insupportably high and not reflective of buyers' pricing metrics. The need for rigorous "real time" research and sound judgment is thus essential.

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<sup>7</sup> American Institute of Real Estate Appraisers, *The Appraisal Journal* (October 1988); 451-455

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