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Appraisal Report: Understanding the Buyer's Perspective

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The purpose and function of the relocation appraisal is to estimate the most probable sales price for a transferee's primary residence conditioned on a reasonable period of market exposure. Understanding the dynamics of the subject marketplace that provide the context within which value is determined is critical to the valuation process. This is the first in a series that will focus on the role of the buyer's perspective in the real estate market. This column will explore how the buyer's perspective influences market trends.

Real estate markets naturally tend to seek a balance between the opposing interests of buyers and sellers in the marketplace. Buyers want the lowest price possible, and sellers want the highest. "Ideal" real estate markets (markets free from unusual external influences) are predisposed to price levels that maximize returns to the seller while remaining affordable to the potential buyer.

When this balance exists, the resulting market price often is referred to as an "equilibrium price." To visualize this, picture an old-fashioned "tug-of-war" with the buyers in a particular marketplace on one end of the rope and the sellers on the other. The relative position of the center of this rope is the "balance point," which represents the corresponding market price at a given point in time.

As mentioned, under ideal market conditions, these opposing forces will have equal strength and a tendency to offset one another. This state of equilibrium is typified by relatively stable market prices that drift with inflationary trends. However, should those pulling one side of the rope become more powerful than those pulling the other, the equilibrium becomes disrupted, shifting market prices in favor of the side with greater strength. A classic example of this is a market in which the demand for homes exceeds the supply of available properties. Under such circumstances, sellers will attempt to capitalize on their new-found strength by becoming less flexible in negotiations and, as a result, exert upward pressure on market prices. In essence, they will attempt to pull the center point of the "rope" in their favor--toward higher market prices.

Buyers, on the other hand, naturally will attempt to resist this pressure. Should the underlying strength of the market continue, however, buyers soon will reach a critical point in price negotiations where they must decide whether to continue to resist or yield to sellers' attempts to increase market prices. This decision ultimately hinges on the collective ability of buyers to afford higher prices in combination with their expectations of future market price trends. Given buyers' ability to afford higher prices and their expectation of higher prices in the future, market prices likely will increase. Absent both of these conditions, however, buyers likely will continue to resist upward price pressures, resulting in a decrease in homesale activity. Their continued resistance ultimately will threaten the market's strength.

The lesson to be learned is that buyers ultimately determine market prices and, consequently, trends in market values. This is even more evident in a deteriorating market in which the supply of homes for sale exceeds the corresponding demand. Under these circumstances, buyers have greater strength in influencing the trend in market prices, as they pull the center point of the "rope" in their favor toward lower market prices. These are the same dynamics that are in place in the aforementioned appreciating market; buyers must be willing to pay higher prices in order for those higher prices to occur.

Thus, without an intimate understanding of the buyer's perspective, i.e., ability to afford higher prices, future expectations of market performance, the appraisal process becomes detached and arbitrary, which threatens its validity and value to the corporate relocation process. The challenge facing the relocation appraiser, then, is to "get in touch" with the buyer's perspective. In this sense, the relocation appraiser can be likened to a real estate detective conducting an investigation to gain the information necessary to frame the valuation problem within the context of the buyer's perspective. At the same time, the client's challenge is to understand the importance of effective appraiser selection criteria and realize that some residential appraisers may lack the skills and training necessary to undertake this relatively complex valuation problem.

Expanding the customary appraisal investigation of comparable sales data to include a profile of typical buyers can provide insight into their mindset in the marketplace. The buyer's previous places of residence, family composition, and employment can provide a good starting point for developing this perspective and aid in developing a profile of the typical potential purchaser for the subject property. Additional knowledge of the alternative neighborhoods and competing listings these buyers considered, together with the specific reasons for selecting these properties and neighborhood locations, will provide clues as to the relative market dynamics in place. An investigation of the competing listings and the specific motivations of individual sellers will further assist the appraiser in gaining this market perspective.

Additional areas for consideration include how a shift in market conditions may color a buyer's perspective and affect the appraiser's market analysis. The selection of competing listings and comparable sales, as well as the significance of REO properties, new construction, property condition, and incurable problems also are subject to great variation as the buyer's perspective changes. Future columns of "The Appraisal Report" will address the influence of the buyer's perspective on these specific issues.

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