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## Reading the Writing on the Wall Interpreting Real Estate Data in Declining Markets

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*There seems to be a lot of gloom and doom in the air of late, as existing homesales are down nationally and inventories are swelling. Appraisers, cutler explains, need to be aware of the indicators that point to declining markets, and understand the factors that can obfuscate these indicators.*

By Patrick Butler

Currently, there is a great deal of talk about the national real estate market. Most will recognize that rapid increases in value are a thing of the past and inventories are getting worrisome. The forecasting adjustment is unique to relocation appraising, and relocation appraisal users should expect to see a greater use of negative forecasting adjustments as a result of these trends.

The problem is that a slowing marketplace may be difficult to pick up on at first glance, and experienced relocation appraisers should have procedures in place to identify the first hints of a market slowdown in their area. This article will talk about some of the market indicators that appraisers and appraisal users should be aware of and some of the problems that can occur when trying to analyze those indicators.

### New Construction Data Sources

The new construction market often can provide the first indication of a slowing market. That is because builders obviously have a larger inventory of houses to sell compared to an individual homeowner, and a declining market can affect them in a more significant way. Builders also are more apt to have a larger volume of potential homebuyers view their houses on a weekly basis in comparison to individual homeowners. This gives the builder's sales staff a better chance to gauge the market in a more meaningful way. These factors emphasize the importance of analyzing the actions of builders' marketing efforts to get a glimpse of the upcoming market.

However, builders do not like to "show their hand" when it comes to offering sales concessions to buyers or lowering their prices. Often, the first reaction of a builder to a slowing market is the offering of special financing. This can take the place of temporary or permanent interest rate buy downs, the offering of low down-payment financing, or more liberal qualification guidelines. If an appraiser is not analyzing the financing offered by builders, then this important indicator of a slowing market might be missed.

It is extremely important that appraisers do not allow the builder's sales office to select the data the appraiser is going to use. Far too many builders will supply the appraiser only with a sheet of paper with a brief synopsis of the sale. If the appraiser does not have access to the entire file, including the sales contract and any important riders, then major sales concessions can be missed. The best situation is when the builder's office allows the appraiser to have access to the entire filing cabinet full of sales. That way, the appraiser can look for sales concessions that otherwise would have been overlooked.

### A Verification is Important and Required



Our office has encountered plenty of problems trying to solicit sales-comparable data from builders' sales offices. Even when an office cooperates, we still verify the details with publicly available data.

For example, we will get a copy of the actual deed and transfer tax declaration from the recorder's office. This allows us to verify the sales price with 100 percent certainty. If there are any hidden concessions, we usually will find a discrepancy at this point. There also is typically a delay between the date of a real estate closing and when the actual deed gets recorded—sometimes this means that the most current new construction sales cannot be verified.

In my market, the delay sometimes can last up to a couple of months during the busy summer season. This creates a rather ironic situation in that the best comparable data may be data that is a little bit older than desired. The Uniform Standards of Professional Appraisal Practice (USPAP) require that appraisers verify their sales data. So your best appraisers might be using slightly older sales data because that is the best data that can be verified. The most current builder's sales, if not verified, may be very misleading.

As the market continues to decline, builders typically will advertise more significant financing concessions in their advertising. Appraisers should be reviewing these ads on a weekly basis to pick up on any trends. Eventually, it may be necessary for builders to start offering free improvements such as fireplaces, central air-conditioning, or perhaps basement upgrades. These more significant concessions are clear indicators of a declining market. Finally, as the market trends into an obvious decline mode, you will see builders eventually lowering their prices.

### **Analyzing Marketing Times**

An analysis of marketing times is something that all appraisers should be doing for every appraisal. A lengthening of marketing times is one of the market indicators that may be a precursor to a declining market. There usually will start to be a spread between the days-on-market of recently sold properties as compared to the days-on-market of active listings. This factor can affect the forecasting adjustment in the appraisal. The days-on-market (DOM) statistic is an important one, yet sometimes there are problems with the way in which different appraisers acquire and analyze this important data.

Some multiple listing services (MLS) will allow a broker to re-list a property that already had been on the market for a period of time. This essentially will reset the marketing time statistic back to zero. For example, if a property was on the market for six months and re-listed, then the marketing time still will show up as zero with the new listing. If this happens frequently enough in a declining market, then it would appear that the market is in better shape than what is indicated by the data. This is precisely why some brokers will re-list a shop-worn property.

Some MLS are aware of this glitch and have programmed their software so that the previous days-on-market number gets carried forward so that the cumulative total matches reality. Even the MLS systems that carry the days-on-market forward sometimes can get fooled if there is a certain amount of delay in between the two listings, or if a new brokerage company takes the second listing.

There are a number of solutions for this problem. First, every appraiser must know for certain how his or her MLS handles the days-on-market statistic so that he or she can manually input this data into a spreadsheet in case the MLS is not providing cumulative days-on-market statistics. Second, appraisers should be perusing individual sales in the MLS manually so they can pick up on any properties that were listed more than once.

The appraiser also must be aware if there are perhaps some properties that had an extended marketing time simply because they were overpriced to begin with, and not because the overall market was in decline. This question usually is answered by calling one of the market participants who was involved in the suspect sale. This is the sort of analysis that sets appraisers apart from automated valuation systems and for which good relocation appraisers earn their reputations.

Finally, relocation appraisal users should be asking their appraisers how they derived their marketing time estimates. If you see some large discrepancies between multiple appraisers then some of the above factors may be in play.

### **Inventory Levels**

Inventory levels are extremely important in a declining market. Most relocation appraisers will conduct an absorption analysis that illustrates how long it will take to sell the existing stock of active listings. Two competent appraisers can derive very different results in this analysis depending on how large of an area they pull their data from. One thing I learned from my years in selling real estate is that the market for a particular house typically is much larger than just its own subdivision.

It was rare for a buyer to want to buy in only one subdivision—most had a wider area of interest. As appraisers, we always try to choose comparable data from the subject's immediate subdivision, and that is good idea for value purposes. However, many times, it is important to look beyond the subject's immediate subdivision when deciding what other properties will be in competition with the subject property.

Failing to do so often will result in an appraiser not realizing the vast amount of competitive properties that may be out there as inventory levels increase in a declining market. Consequently, the appraiser may fail to make a large enough forecasting adjustment in order to achieve the goal of a sale within the typical 120-day time period.

### **List-to-Sales Price ratios**

A list-to-sales price ratio simply is a ratio that compares a property's sales price to its list price. For example, a property listed at \$200,000 that ultimately sells for \$196,000 is said to have a list-to-sales-price ratio of 98 percent.

List-to-sales-price ratios typically start to get lower when a market starts to decline. In effect, sellers are initially reluctant to lower the list price of their houses but eventually are forced to sell at a lower price. This ratio can be misleading if taken verbatim from an MLS report. Remember the problems with re-listed properties and how those affected the marketing time statistics? Well, when a property gets re-listed at a lower asking price, the list-to-sales-price ratio also can be skewed.

For example, let us say a property is initially listed at \$250,000, but does not sell. Its list price later is reduced to \$230,000 and it sells at \$225,000. The MLS will report the list-to-sales-price percentage as 97.8 percent based on the last (\$230,000) list price. Yet, the list-to-sales price ratio is 92 percent if you compare it to the property's original list price. This anomaly must be considered when an appraiser analyzes market data. Again, an experienced appraiser should be aware of these sorts of data analysis problems and not be fooled into just accepting the standard report results from the MLS without analyzing the raw data.

### **Do Not Believe Everything You Read in the Newspaper**

The relocation appraisal process encourages interaction between the appraiser and transferee. The transferee is encouraged to provide any market data that he or she wants the appraiser to consider, and this request usually initiates some conversation about the current market.

One thing that becomes apparent to most relocation appraisers is that transferees sometimes are influenced too much by what they read in the newspaper. One popular real estate statistic that is reported is the change in median value for a particular real estate market. Everyone needs to be aware that the change in median value can be unduly influenced in an upward direction when more expensive houses get built in a particular market.

For example, let us say there is a city with an older housing stock that does not sell too often, but generally sells in the low \$200,000 range when it does. Now a builder comes in and starts to build and sell a lot of houses in the \$400,000 range. It is possible that the median value of housing that is selling is perhaps in the \$350,000

range, and the increase in median value of 75 percent gets reported in the newspaper. Does this mean that the existing older housing stock has appreciated by 75 percent? No—however, it may be coincidental in some markets that the appreciation rate is the same as the change in median value. Yet too many people are influenced by the reported changes in median value because this statistic is one that commonly is used. And the change in median value often is meaningless in a market where newly constructed houses are being sold at a much higher price and volume compared to the existing housing stock. Appraisers, transferees, and users of relocation appraisers should be careful not to be misled by a change in median value if it is not applicable for the subject property.

### Experience is Everything

Appraisers are required to have geographic competency. Part of this competency is gained through experience by appraising a number of houses in a particular area. Most appraisers doing relocation work also will be developing appraisals for the lending industry. This will allow an appraiser to become more intimate with the details of particular builders as they get orders for appraisals in different subdivisions. So, when a relocation appraisal comes along, the appraiser already should be familiar with the actions of the builders in the local market.

Experienced appraisers also realize the importance of networking with their peers. Most of us have formed relationships with nearby appraisers with whom we share data. This provides another good source for concession information. If an appraiser gets an order in a subdivision in which they are unfamiliar, they can call a few peers who might already have completed appraisals in that subdivision. This usually is accomplished by appraisers having met each other through professional appraisal organization meetings.

Furthermore, appraisers constantly should be collecting market data for the service areas in which they work. Hopefully, it has become obvious that experienced appraisers have a lot of data-gathering tools at their disposal. The success in measuring subtle changes in the marketplace comes about as a result of an appraiser being active in his or her market, networking with peers, and constantly monitoring changes. The first time an appraiser analyzes the market should not be when he or she first gets a relocation appraisal order.

As interest rates rise, and the market slows down, you might want to review the credentials of your appraisers. You also can interview them and ask them what sources they use to monitor the market, and estimate any needed forecasting adjustments. You also can ask what they do to develop and maintain relationships with their peers, who can be useful. I believe the responses you get from different appraisers will make it pretty obvious who has been doing their homework.

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