Distressed Sales: Anomaly or Market Value?

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The issues that arise from the effects of the dramatically shifting real estate market are becoming more and more evident as time passes, and market data is gathered and analyzed. One of the pressing debates that come as a result of this type of market is the usage of distressed sales as a measure of market value. Typically speaking the answer is clear, both by appraisal standards, and statutory requirements; distressed sales are not a true measure of market value. In fact, Idaho Code clearly reflects this ideology by its definition of an market value: "the amount of United States dollars or equivalent for which, in all probability, a property would exchange hands between a willing seller, under no compulsion to sell, and an informed, capable buyer, with a reasonable time allowed to consummate the sale, substantiated by a reasonable down or full cash payment" (I.C. § 63-201(14)). From this definition it would seem clear that one should not use a distressed sale directly when establishing the market value of a property.

However, as real estate markets have declined, it has been argued that the market can be so affected by the presence of distressed sales that the real market value may not deviate from distressed sale prices. As a result of this market environment, assessor's offices are continuously questioned whether or not they can, or should use distressed sales in the formulation of market value for tax purposes. Not surprisingly, there are a variety of opinions on this matter, and a great deal of debate regarding the amount of distressed transactions necessary to "become the market." Clearly, there is no exact answer to this problem, and the definition of true "market value" may be more convoluted than appraisal standards, or statutory requirements may indicate. Therefore, rather than trying to solve the issue of how many, or what proportion is necessary to become market value, it is better to explain and illustrate the effects of distressed sales on a market.

In the effort to pinpoint and illustrate the effects that distressed transactions have on a market area, I have provided an example market area, which has experienced, and continues to experience an ever-increasing population of distressed transactions. Throughout this example I refer to market transactions that meet the previously defined conditions of market value as "arms length," while those that do not as "distressed sales." In the subject market there were 1004 total sales compiled over an 18 month period, representing a sample size of approximately 14% of the total number of improved properties in this area. Of the total of 1004 sold properties, 129 were "distressed," while the other 875 were "arms length" transactions. While these numbers alone are a telling indication of the presence of a distressed market, it is not until you array and analyze these sales that you really see the true effects of distressed transactions on a market area.

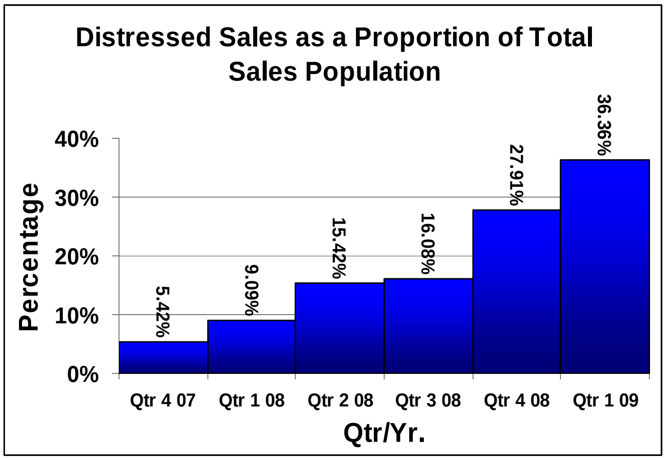

Figure 1. Proportion of Distressed Sales to Total Sales Population

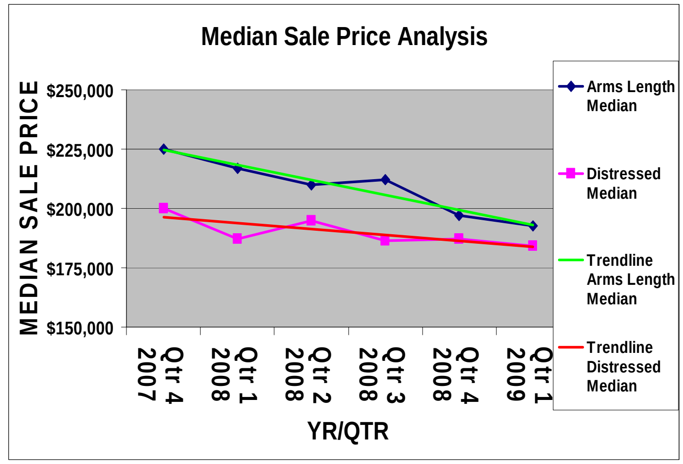

Figure 2. Median Sale Price Analysis Comparison (Distressed vs. Arms-Length)

Illustrated in Figure 1 is the number of distressed transactions as a percentage of the total number of sales. From this one can clearly see the ever-increasing trend within this market of distressed sales. In fact, over 36% of all transactions in this market area were by definition "distressed" in the 1st Quarter of 2009. The effects of this increasing population of distressed transactions are revealed in Figure 2 where median sales prices for arms length and distressed transactions are arrayed and compared by quarter. Analyzing trend lines applied in this graphic clearly shows the market effect of distressed sales. In fact, from this graphic it could easily be argued that distressed sales are a reflection of, or are very close to current market value, at least in this market area. This may beg the question that if this market is distressed, what effects does it have on the overall market area, within a jurisdiction, or greater geo-economic area? Answering this question requires greater depth of analysis, both on the micro and macro-market levels. Depending on the proportion and distribution of distressed sales, there could be broad ranging impacts on the greater real-estate market.

Overall, this article is not meant to be the end all of the debate of true market value, it does reveal some insight into the effects distressed sales may have on typical transactions within a given market area. Moreover, it reveals the propensity of sales level similarity between arms-length and distressed transactions in markets where large proportions of distressed sales occur. Most importantly, it reveals the necessity of identifying, stratifying, and analyzing distressed market transactions and their effect on the overall market. Happy Analysis!