Market Value Test

Known to experts as one of the "bases of value", the notion of market value entered our professional vocabulary after 1990. There had been no open market before so market value was inexistent. We are aware that the surrogate called "circulation value" survived in the general mindset for a long time and it has not yet been totally given up in either regulations or legal documents, in particular.

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What everyone has understood is that we may still call it circulation value, but what we mean is nevertheless market value.

However, if the circulation value had something to do with circulation (likely of goods, similar to its counterpart tax, later renamed VAT), the market value should have something to do with the market.

But what does the market stand for in the context on this notion?

The Market

According to valuation standards:

"A market is the environment in which goods and services trade between buyers and sellers through a price mechanism. The concept of a market implies that goods or services may be traded among buyers and sellers without undue restriction on their activities. Each party will respond to supply-demand relationships and other price-setting factors as well as to their own understanding of the relative utility of the goods or services and individual needs and desires." SEV 100 General Framework, para. 10.

The definition above indicates that besides the existence of goods or services, we can only speak of a "market" only in the presence of buyers and sellers that may trade those goods or services without undue restriction.

"Markets rarely operate perfectly with constant equilibrium between supply and demand and an even level of activity, due to various imperfections. Common market imperfections include disruptions of supply, sudden increases or decreases in demand or asymmetry of knowledge between market participants. Because market participants react to these imperfections, at a given time a market is likely to be adjusting to any change that has caused disequilibrium. A valuation that has the objective of estimating the most probable price in the market has to reflect the conditions in the relevant market on the valuation date, not

an adjusted or smoothed price based on a supposed restoration of equilibrium." SEV 100 General Framework, para. 14.

Paragraph 14 reminds us of the fact that markets rarely operate perfectly and that perfectly is understood as the constant equilibrium between supply and demand and an even level of activity. That means that when a valuer is supposed to estimate the "market value", the valuer as well as the clients and designated users must consider these features of the market. This imperfect environment is actually the place where valuers look for the market data they need to estimate the "market value".

But what is this "market value" after all, beyond the definition found in the valuation standards and from there in all the valuation reports and most of the times in legal texts when they refer to asset valuation?

Market Value

Also according to valuation standards, the defining features of the market value are found in italics below.

The market value is the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

The definition of the market value shall be applied in accordance with the following conceptual framework:

a. *"the estimated amount" refers to a price expressed in terms of money payable for the asset in an arm's length market transaction. Market value is the most probable price reasonably obtainable in the market on the valuation date in keeping with the market value definition. It is the best price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer. This estimate specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale, or any element of special value;*

b. *"an asset should exchange" refers to the fact that the value of an asset is an estimated amount rather than a predetermined amount or actual sale price. It is the price in a transaction that meets all the elements of the market value definition at the valuation date;*

c. *"on the valuation date" requires that the value is time-specific as of a given date. Because markets and market conditions may change, the estimated value may be incorrect or inappropriate at another time. The valuation amount will reflect the market state and circumstances as at the valuation date, not those at any other date;*

d. *"between a willing buyer" refers to one who is motivated, but not compelled to buy. This buyer is neither over eager nor determined to buy at any price. This buyer is also one who purchases in accordance with the realities of the current market and with current market expectations, rather than in relation to an imaginary or hypothetical market that cannot be demonstrated or anticipated to exist. The assumed buyer would not pay a higher price than the market requires. The present owner is included among those who constitute "the market";*

e. *"and a willing seller" is neither an over eager nor a forced seller prepared to sell at any price, nor one prepared to hold out for a price not considered reasonable in the current market. The willing seller is motivated to sell the asset at market terms for the best price attainable in the open market after proper marketing, whatever that price may be. The factual circumstances of the actual owner are not a part of this consideration because the willing seller is a hypothetical owner;*

f. *"in an arm's length transaction" is one between parties who do not have a particular or special relationship, e.g. parent and subsidiary companies or landlord and tenant, that may make the price level uncharacteristic of the market or inflated because of an element of special value. The market value transaction is presumed to be between unrelated parties, each acting independently;*

g. *"after proper marketing" means that the asset would be exposed to the market in the most appropriate manner to effect its disposal at the best price reasonably obtainable in accordance with the market value definition. The method of sale is deemed to be that most appropriate to obtain the best price in the market to which the seller has access. The length of exposure time is not a fixed period but will vary according to the type of asset and market conditions. The only criterion is that there must have been sufficient time to allow the asset to be brought to the attention of an adequate number of market participants. The exposure period occurs prior to the valuation date;*

h. *"where the parties had each acted knowledgeably, prudently" presumes that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the asset, its actual and potential uses and the state of the market as of the valuation date. Each is further presumed to use that knowledge prudently to seek the price that is most favorable for their respective positions in the transaction. Prudence is assessed by referring to the state of the market at the valuation date, not with benefit of hindsight at some later date. For example, it is not necessarily imprudent for a seller to sell assets in a market with falling prices at a price that is lower than previous market levels. In such cases, as is true for other exchanges in markets with changing prices, the prudent buyer or seller will act in accordance with the best market information available at the time;*

i. *"and without compulsion" establishes that each party is motivated to undertake the transaction, but neither is forced or unduly coerced to complete it.*

› Also, when the law makes reference to the market value, it actually asks the valuer to comply with the requirements laid out in the definition of the market value.

To put it in plain words, a market value only exists when it meets all the requirements set out in the valuation standards, which we quoted before.

That is to say that whenever a market value is estimated, the result obtained by the valuer must comply with the above requirements.

Also, when the law makes reference to the market value, it actually asks the valuer to comply with the requirements laid out in the definition of the market value.

In a nutshell, these requirements are:

Given that the market approach is one of the main valuation approaches and that, according to its name, it should result in the market value, it can only be used based on the market data valuers collect.

Consequently, for the valuation to result in the "market value", i.e. the value that corresponds to the requirements listed in the table below, the data valuers rely on must also comply with the same requirements.

What is the data valuers use?

"Real Estate Valuation", 13th edition, a book that is considered the "bible" of real estate valuation, issued by the US Appraisal Institute and translated by ANEVAR, specifies the following regarding the market approach:

"In the comparison approach, an opinion on the market value is formed based on the comparison between the subject property and similar properties that were recently sold, listed or already contracted, i.e. those for which a buying offer and a down payment were recently made. A major assumption in the comparison approach is the fact that the market value of a property can be supported by the study of the market reaction to comparable and competitive properties" (Chapter 13).

As we already know, in the market approach data can derive from sources such as recent sales or listings of similar properties. In other words, on transactions and /or listings. Is there a priority between them? Do we first consider the sales and then the listings or the other way round?

We can answer that, provided we examine the following:

1. The first two stages in the market approach are:

a. The competitive market research for properties that are similar to the subject property and were recently sold, listed or contracted.

b. The data are checked to see whether they are accurate and reflect arm's length transactions.

Table 1

No.	Mandatory requirement from the definition of market value
1	Special terms or circumstances
2	Effective date of price validity
3	Willing buyer
4	Willing seller
5	Arm's length transaction
6	Adequate marketing
7	The requirement for the parties to act knowledgeably, prudently and without compulsion

Checking the data can involve asking for additional information about the property and the market, which makes comparisons reliable.

2. The availability of access to the sales agreements and transaction-related details.

3. The availability of access to listings and listing-related details.

Consequently, the answer regarding priority depends on the availability of data access and the possibility to check the data.

To follow the logical frame of this article, I would come to a partial conclusion and say that in order to estimate the "market value" through the market approach, the data used in valuation, whether transactions or lists, must comply with the requirements set out in the definition of market value summarized in Table 1.

When these requirements are not met, data are useless, meaning that before we conclude on which kind of data is adequate (transactions or listings), we must apply the "market value test", i.e. the extent of compliance with the 7 requirements listed in the table above.

I will dwell on the application of the test in the next chapter, but before that I would like to single out some features of the real estate transactions and listings on the Romanian market and the availability of access to data for both valuers and users.

It is just as important to specify that even if the definition of the market approach presented above, taken from the "American bible", is universally recognized, its practical application is particular of each country, because each has specific features regarding access to data.

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Specifications from manuals or standards, which have been applied in Romania via the translation of their original versions, can only be interpreted if they relate to the particulars of the market reality where we find the assets whose *market values* are estimated. The adopted interpretation must enjoy general support from the professionals in the field.

Real Estate Transactions

They have represented a "Fata Morgana". There is much to say about this type of data, but I will stick to well-known and generally accepted conclusions:

› Public data that would allow for the use of comparable sales have not been available to valuers and designated users.

› Out of fiscal reasons, the sellers and buyers attitudes were to refrain from making public the actual transaction prices.

› The sales prices in the agreements were influenced by the amounts resulting from notary expertise (notary grid) and did not mirror in all cases the amounts paid by the buyer and received by the seller.

› Currently, there are no databases where this data is fed and no project in the pipeline to deliver a national database that would collect such information.

› Enquiries by the real estate brokers or notaries on the subject of prices in the sales agreement have been given a cold shoulder.

› The recent years trend has been for smaller distortions in the agreement prices, given the legislation both on cash transactions and money laundering as well as the changes brought to the Fiscal Code on the amounts subject to transaction tax, which are no longer under the direct influence of notarial expertise.

The trend is encouraging, but the change involved is deep-going and relates both to a mind set and the legislation. That is why I believe that it will take a while before we can say that the prices found in the agreements, supposing they can be publicly accessed, are the actual amounts paid by the sellers.

To put it differently, assuming that starting tomorrow, we could access all real estate sales data, I doubt that the use of the agreement prices would pass the "market value test", i.e. would result in market values.

Listings

- Listings emerged and turned into data accessible to the public with the emergence and wide-scale use of the internet;
- Until 2-3 years ago, when valuation guidance notes were issued to complement international valuation standards, there was no practice whatsoever to check the data in the listings by phone or even physically;
- The applications made available by the cadaster office and the software allowing for the visualization of the properties have led to a change in the valuers' attitudes;
- Technological progress has enabled sellers and buyers alike as well as private investors to make available detailed data on the properties undergoing sale.

Data reliability has increased a lot in the past few years and, implicitly, so did the quality of valuation reports.

One thing we must bear in mind is that from its very emergence, the Romanian valuation market has relied on listings and it still does today. Valuation reports based on comparable listings only is fully compliant with valuation standards and Romanian realities.

A further argument is the **"market value test"** that I will introduce below and that I analyzed starting from the rather abstract statement that "the market value can be derived provided it meets all the conditions comprised in the definition of the **market value**." The statement is correct but rather hard to digest, that is why it remains a truism. Since I have already introduced the definition of the market value as well as the requirements therein, I have dug deeper into this statement and therefore proposed a test.

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The use of the test

Essentially, the "market value test" is an analysis that valuers should apply to any comparable and must have the following correct answer for the concerned comparable to be adequate for the market value estimation.

The correct answers must be understood in relation to points (a) - (i) from above, which are taken from the valuation standards and refer to the explanations pertaining to the market value.

Below are the most likely answer options for the use of a transaction or listing.

1. **Special terms or circumstances** – This requirement is aimed at the identification of an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale, or any element of special value.

- **The use of the transactions** – It is very difficult to know this information just by simply coming in the possession of a sales document. The category of special terms or circumstances also includes the prices stipulated in contracts, which were taken from the notary expertise. Unless the valuer becomes aware of the details of the transactions, acquired form either a seller or a buyer, the answer to this question is unlikely to be correct.
- **The use of the listings** – As long as we consider the list price confirmed by the seller, it is very likely that such a price is not affected by special terms or circumstances.

2. **Effective date of price validity** – This is the requirement that the amount should reflect the terms and circumstances of the market at no any other date but the valuation date.

- **The use of the transactions** – Though the sales agreement shows the date when the agreement was concluded, this is no guarantee that the price involved was not negotiated long time before. In order to meet this requirement of the test, the valuer must gain knowledge about how the price was actually set and whether it was valid under the market conditions at the valuation date.

- **The use of the listings** – Though listings are supposed to be valid at the valuation date, the valuer needs to examine and find information about how old the listing and consequently the price are and when the seller last updated it. Listings databases can generally provide such information.

3. **A willing buyer** - A buyer who is motivated, but not compelled to buy. This buyer is one who purchases in accordance with the realities of the current market and with current market expectations, rather than in relation to an imaginary or hypothetical market.

- **The use of the transactions** – This information is unlikely to be known and hence we cannot answer the test unless we can contact the buyer or learn details about the attitude of the buyer from the parties involved in the transaction as witnesses: notaries, real estate brokers, legal counselors, bailiffs.

- **The use of the listings** – It is based on the reasonable assumption that the buyer's willingness is shaped by the market conditions and that there are no general grounds to suppose that by using an offer the transaction will not involve a "willing buyer".

4. **A willing seller** – A willing seller is neither an over eager nor a forced seller prepared to sell at any price. The willing seller is motivated to sell the asset at market terms for the best price attainable in the open market after proper marketing, whatever that price may be.

1. **The use of the transactions** – This information is unlikely to be known and hence we cannot answer the test unless we can contact the seller or learn details about the attitude of the seller from the parties involved in the transaction as witnesses: notaries, real estate brokers, legal counselors, bailiffs.

› Effective date of price validity – This is the requirement that the amount should reflect the terms and circumstances of the market at no any other date but the valuation date.

- **The use of the listings** – It is based on the reasonable assumption that the buyer's attitude is willingness provided that the listing terms should allow to contact the seller and gather the necessary information.

5. **Arm's length transaction** – Is one between parties who do not have a particular or special relationship, e.g. parent and subsidiary companies or landlord and tenant, or persons from the same family, that may make the price level uncharacteristic of the market. The market value transaction is presumed to be between unrelated parties, each acting independently.

- **The use of the transactions** – In some situations, the information regarding the link between related parties is easy to check (if they are companies from the same group, a landlord and a tenant or if the seller and the buyer have the same

Table 2 – Market Value Test

No.	Mandatory requirement from the definition of market value	Correct answer
1	Special terms or circumstances	No
2	Effective date of price validity	Valuation date
3	Willing buyer	Yes
4	Willing seller	Yes
5	Arm's length transaction	Yes
6	Adequate marketing	Yes
7	The requirement for the parties to act knowledgeably, prudently and without compulsion	Yes

surname). In other situations, we need one of the parties directly or indirectly involved in the transaction to provide additional information and confirm the relation. In case the information is confirmed, the transaction is no longer an arm length's transaction and it cannot be used in market value estimation.

› **The use of the listings** – As long as the input data is the listing price, without knowing who the buyer is, but supposing one who is willing and also independent from the seller, it is rather easy to consider that the listings meet this requirement.

6. **Adequate marketing** – It means that the asset would be exposed to the market in the most appropriate manner to effect its disposal at the best price reasonably obtainable in accordance with the market value definition.

› **The use of the transactions** – Again, this information can be found only if we are aware of the circumstances in which the transaction was concluded. i.e. we do not use only the information comprised in the sales agreement, but we must obtain from the persons that played a direct role in the transaction the confirmation of the additional information regarding the market exposure of the transaction object.

› **The use of the listings** – The existence of a listing already equals a first step towards an adequate marketing on condition this information is found in a source available to the public, it can be checked and is not a notice posted by a bailiff, for instance.

› I already explained that I suggest to use this test, i.e. to answer the 7 questions correctly for each of the comparables that will be used in the valuation report when the scope of work comprises market value estimation.

7. **The requirement for the parties to act knowledgeably, prudently and without compulsion** - Presumes that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the asset, its actual and potential uses and the state of the market as of the valuation date. Each is further presumed to be motivated to undertake the transaction, but neither is forced or unduly coerced to complete it.

› **The use of the transactions** – These requirements ask again for knowledge about the details behind the sales agreement and make it very difficult to use the sales agreement as such, to validate the market value estimation by comparison.

› **The use of the listings** – The aspects linked to this last requirement may be checked with the seller; the supposition that the buyer will comply with these aspects is reasonable and highly likely.

We may see from the above that when we use the transactions it is very difficult to argue the successful completion of the "market value test". I would rather state that the use of transactions has not and does not lead to the market value estimation except for very rare cases that must be adequately argued.

Conclusions

I already explained that I suggest to use this test, i.e. to answer the 7 questions correctly, for each of the comparables that will be used in the valuation report when the scope of work comprises market value estimation.

The test is considered "a pass" if the answer to each of the questions replicates Table 2.

One incorrect answer makes a comparable property unusable to estimate the market value.

I believe that the analysis above stands for:

1. A demonstration of the fact that we made the right decision 25 years ago to use listings as comparables. It was the only decision that could be applied to estimate the market value.

2. A new tool available to the valuers, helping them to look further into the selection of comparable properties.

Time will tell if this second conclusion will find its practical application. ■