

**Abstract**

## Two Philosophies of Value

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What is your view of the appraisal concept we call "value" and/or "market value?" Do you view this concept as a real thing that can be discovered in the marketplace? In other words, is this concept an objective reality that one can estimate or derive with relative certainty from real data and facts? Or is this concept strictly a mental name or label... for a numerical result that we derive from our subjective consciousness? How should this concept be viewed by our profession in today's world? That is the issue of this article. It is an issue of philosophy and the nature of reality as we perceive it. And the issue affects how we develop our reports and present our conclusions to our clients.



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He received his M.A.I. and S.R.P.A. designations in 1974 from the Institute of Real Estate Appraisers and the Society of Real Estate Appraisers. He studied with the late Professor James A. Graaskamp at the University of Wisconsin - Madison. He taught economic history, money and banking, and real estate valuation concepts at Waukesha County Technical Institute and Madison Area Technical Institute from 1979-1984.

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There are two broad philosophies of value that one can discern in any serious discussion with practicing consultant/appraisers. For purposes of simplification we can categorize these two philosophies as Objective (outer) and Subjective (inner). The concept of value that a particular consultant/appraiser holds will affect the type of value derived and the data analyzed and included in the report prepared for a client.

Those who hold to the Objective concept of value believe that value can be measured, estimated, or calculated from evidence in the marketplace. The appraiser/consultant will seek evidence of sales, costs, and/or income/expense data to estimate the market value of the subject property. This value conclusion is then presented to the client (who engaged the appraiser) as a point estimate or a range of numbers. The client (let's assume a lender) will then use this value conclusion as the basis for a decision about the size of loan to be funded on this property. The client/lender often refers to this issue as the loan to value decision. To determine the market value of an income producing property, the consultant/appraiser will often use a methodology like the DCF (discounted cash flow) model, the Band of Investment methodology, or the Direct Capitalization methodology.

For those who hold to the Objective concept of value, the purpose and function of every assignment is usually to estimate some aspect of value, usually market value. Market value is presumed to be an Objective reality that is "out there" in the marketplace to estimate, calculate, or measure. Value under this philosophy could be defined as "a reality that is determined from specific data (called facts) that are available to everyone who searches for this evidence." An example of the Objective mindset can be experienced and visualized by the following assumed dialogue between a client and the appraiser:

*Client:* We need to know the value of our office building on Market Street so we can obtain a maximum first mortgage loan from our bank. Could you provide us with the current market value? Our lender claims that we can obtain an 80 percent loan after this value has been objectively established.

*Appraiser:* No problem! We have a number of sales transactions of similar properties that recently sold in that

neighborhood so we will use this objective data to estimate the market value for your property. We also have accumulated lots of income and expense data...from actual operating statements...that will help to establish an objective economic value. So by using the Sales Comparison Approach and the Income Approach we can estimate the market value for your lender.

*Client:* Can we use your report and value estimate to support a selling price for the property also, if needed?

*Appraiser:* Yes, this would be appropriate. The definition of market value used by most appraisers can also be stated as the most probable selling price for your property, given knowledgeable buyers/sellers, etc. And since the value estimate is objectively derived from the marketplace, the estimate is valid for various functions and uses.

*Client:* Please prepare your report as soon as possible so we can begin the process of securing a first mortgage loan. We may decide to sell this property later for the value you estimated.

The above dialogue is typical communication that this author experiences when dealing with clients who desired to mortgage or sell their existing property. This dialogue is based on the philosophy that value or market value can be objectively determined from market data obtained from other participants in the marketplace. Within this philosophy is the assumption that value is something that exists and thus can be determined by experts who can properly analyze and process this data.

The other philosophy of value, is generally referred to as the Subjective (inner) concept of value. Those who hold to this philosophy, believe that value is derived by the subjective assumptions of individuals in the marketplace. It is then quantified in a currency of the realm (dollars for most U.S. transactions). Value is not viewed as being "out there" as the Objective school maintains, but is derived from human mental processes (which are subjective and personal). Therefore, a given property could have many different derived values. Each value derived would vary depending on the underlying subjective assumptions adopted. Under this philosophy, value could be defined as: a result based on assumptions. Value is not

"out there" to discover, find, or determine; but is merely a mental concept used as a name to specify a result derived by specific human beings or decision-makers. Human beings and their mental assumptions would be central to the derivation of any value conclusion. And one's perspective can make a significant difference in the value derived.

Clients who engage consultant/appraisers under this concept of value recognize that any value conclusion is only valid if all the underlying assumptions are understood and accepted. Value is viewed, therefore, as a potential monetary outcome given the specific assumptions adopted. And the process of report writing would need to focus on the client's problem, perspective, and decision-making issues (e.g., the loan amount, terms, and conditions for the property under evaluation if the report is being prepared for a lender/client). If the report is being prepared for a seller/client, then another set of questions and assumptions would need to be analyzed and processed. Also, the perspective of a seller could be much different from a lender resulting in a whole new set of underlying assumptions. One key difference in the two philosophies of value is that the Objective school assumes that value exists as a real thing and therefore, all clients could utilize this value if they needed this result. The Subjective school would maintain that value is a derived result of a person's mental thinking and is, therefore, unique for each client and is derived uniquely by each consultant/appraiser from specific assumptions. The underlying assumptions would be central to any value conclusion derived. And changing the perspective or viewpoint from which assumptions are adopted could also materially change the outcome. A lender may view the assumptions (say income/expense assumptions) much differently than a seller, etc.

Another mindset that can help to explain this difference in the understanding of value would be the concept of External and Internal realities. External realities, for consultant/appraisers, would be the building and site under evaluation (i.e., an office building in a suburban location). The building, all the fixtures and personal property within this building, and the site would be viewed as physical things that exist in space and time. Thus, one can label these realities External (they exist). However, the value of this building and site is in the mind of human beings (say the consultant/appraiser and/or the client/decision-maker). Value would be viewed as a non-physical/internal concept or

notion that has no external reality. So value, under this mindset would be subjective and personal to the person doing the derivation. Value would not be viewed as some thing that exists or that can be discovered (objectively). Philosophically, value would be viewed as a mental concept derived from a particular perspective and then expressed as a tentative result or conclusion.

Now, what is the significance of these philosophies on the practice of consulting/appraisal assignments in the marketplace? I maintain that the significance is substantial. If value (let's assume market value) is not "out there" to determine, then the focus and function of a particular assignment changes. In lieu of estimating the unique market value of the subject property, we would focus on the particular decisions that our client (let's assume a lender) is concerned about. For example, if a lender/client calls us and requests a report on a particular property (let's assume a proposed office building), we would need to ask a whole new set of questions to get to the crux of the problem. Valuation would be viewed strictly as a "tool" to help with the decision-making issues of the client. Following is a hypothetical dialogue between a lender/client and a consultant/appraiser given a particular problem situation. Keep in mind that every assignment between a client and a consultant/appraiser would involve a different set of decision-making issues and problems. So dialogue with the client becomes paramount in this process. And developing a scope of work would come only after the problem and decision-making issues were fully understood.

*Assumption:* Let's assume that a developer/borrower has submitted an application for a first mortgage loan of \$8 million on a proposed 100,000 s.f. office building.

A typical dialogue between the client and consultant/appraiser might be as follows:

*Client:* This is xyz lender calling in regard to your interest in a consulting/appraisal assignment on a project in your area. We have received an application for an \$8 million loan on a proposed office building.

*Consultant/Appraiser:* Can we ask you a few questions about this assignment? Where does one get all the details about this project? What would be the terms of this

proposed loan? Who will be reading and making decisions from this report? And what questions and issues are you concerned about?

*Client:* You can obtain all the information about this project from the developers at their office location. The current terms for this type of loan would be 6 percent with 30-year amortization. Generally, we require a debt coverage ratio of 1.25 on this type of property. The reason for the report is to make a decision about the maximum supportable loan that we can fund upon completion and rent-up. Our Board is concerned about the quality of this project, the rent structure proposed, the lease conditions and clauses, the marketing time necessary for rent-up, the net operating income (NOI) that this property will generate upon reaching stabilized occupancy, and the competition within this general market area. We plan to fund the loan after completion and occupancy.

*Consultant/Appraiser:* Do you need a value conclusion for this assignment or would you prefer to derive your own investment value after determining the maximum supportable loan for this project? Since there will be no transfer of ownership involved with this loan application, I presume that you do not need a market value opinion? Is this correct?

*Client:* Yes, my concern is the maximum supportable loan for this project over the longer term. Our Board of Directors will review your report and assumptions and decide the maximum loan to fund. Once we determine the stabilized NOI for this property, we then divide this amount by the debt coverage ratio of 1.25 to derive the annual debt service amount that this property will support. We then divide this amount by the annual mortgage constant to obtain the maximum supportable loan. We then capitalize the cash flow at a 10 percent equity dividend rate to derive the value of the equity position. The addition of the maximum supportable loan amount and the equity position results in our investment value for lending purposes. You can derive your conclusion of investment value also, if you like, using the assumptions that you deem appropriate. Since market value assumes a transfer of ownership (which is not involved in this situation) we do not need your

opinion of market value (most probable selling price). Our intention is to encumber the property with a loan to the existing borrowers. And our desire is to fund a prudent loan amount given the risks involved with this property. Your estimate of NOI will be crucial in this process. If a foreclosure event were to occur in the future, then we would request an opinion of the most likely selling price (market value) at that time. But that is not the problem, nor our concern, at this time.

*Consultant/Appraiser:* According to the Uniform Standards of Professional Appraisal Practice (USPAP), we can call this assignment an appraisal/consulting report. The primary objective of this report is to assist you and your Board (the intended users) with relevant information and data so that you can make your decisions on this proposed loan transaction. This is the problem at hand and my scope of work will reflect this problem situation. I look forward to your letter of engagement, after which I will provide you with my scope of work and the estimated date of delivery of my report. Please keep me informed about any changes or new terms that you might negotiate with the developer/borrowers. We can derive different numbers and conclusions depending on the assumptions we adopt and the scenarios that seem appropriate.

*Client:* We look forward to your report. Please keep us updated on your progress.

The above dialogue illustrates the dynamics between a typical client and a consultant/appraiser given a particular problem situation. As you can discern, the focus of the dialogue is upon the decision-making issues of the client not the market value of this property. Deriving the market value of this property is not viewed as an objective reality and is thus not the crux of the problem to be evaluated. The crux of the problem, in this situation, is the loan amount to be funded on this property in the future. So the dialogue assumed a subjective concept of value that would be derived after the maximum loan amount had been determined by the consultant/appraiser. And this result would be valid only for this particular client, therefore subjective.

One might conclude by saying that under the subjective (inner) concept of value, the consultant/appraiser looks at the problem

with a different mindset. This mindset assumes that value is subjective and strictly an inner reality. This results in a different set of questions to be answered and a different report for the client. The typical report that would be prepared under the objective view of value, would ignore the lender's decision-making questions and issues, and proceed directly to the process of estimating the unique market value for this property. This report would include all sorts of data that may not be relevant for the particular problem at hand. And the viewpoint or perspective of the client would not be considered as the primary focus. Also, the definition of value would more than likely be the definition of market value used by most appraisers that assumes a transfer of ownership as the central tenet in the definition. Hypothetical buyers and sellers would also be assumed. The decision-making issues of the client/lender would be ignored as irrelevant since the objective of the assignment would be discovering the unique market value of the subject property. A value that is assumed to exist within the marketplace and that can then be presented to the client as a point estimate or range.

Hence, the philosophy of the consultant/appraiser does have a major impact on the type of report that is generated. Is the concept of value an objective (external) reality or is this concept a subjective (internal) reality that varies from client to client, appraiser to appraiser, and assignment to assignment? Each philosophy of value would result in a report that could be significantly different in presentation and information. Which philosophy is more realistic in today's world?

I would suggest that the following eight principles (expressed as questions) be followed prior to writing any report for a client. These principles assume that all value conclusions are derived from internal mental processes of the consultant/appraiser.

1. What is the problem at hand?
2. Whose viewpoint or perspective should be adopted?
3. What judgments and questions need to be explored?
4. What assumptions seem appropriate for this problem situation?
5. What premise results from the above steps?
6. What derivation process seems appropriate for this assignment?
7. What conclusion results from this process?
8. What alternative scenarios and assumptions could be adopted in this situation?

If all the above information were given more serious consideration by consultant/appraisers in the field, then I would wager that the reports we prepare would be more meaningful and relevant for all clients who engage us. Also, the public trust in our profession would improve substantially as our reports would be meaningful for the decisions that the client must make. I would also suggest that an internal (subjective) concept of value is more realistic in today's world. As consultant/appraisers we deal with both external realities (the physical property) as well as internal assumptions that determine our loan amount and our value conclusion.

Some sources of information used by this author include the following Web sites: [www.criticalthinking.org](http://www.criticalthinking.org), [www.realdatal.com](http://www.realdatal.com), and [www.workingre.com](http://www.workingre.com). Philosophers who have supported the subjective concept of value include Ludwig Von Mises, the Austrian School of Economics, Socrates, Plato, and Descartes. Sources for the objective concept of value include most of the current appraisal organizations such as The Appraisal Institute, The Society of Real Estate Appraisers, and The Appraisal Foundation. Current trends within the appraisal/consulting profession suggest that a new scope of work rule will develop in the near future that will tend to support a more subjective concept of value or at least a value conclusion that is structured after the specific problem and decision-making issues have been identified.