

How do foreclosures affect the value of homes in a real estate market?

By

Bill Groover, PhD, CRS, GRI, CLG,

To fairly and accurately understand how foreclosures are affecting the housing market, you need to consider several things. First, how do Appraisers determine a house's value? Then you need to know how distressed properties factor into their thinking. If you are a Buyer, you need to look at this information and some other realities in order to have the big picture. And finally, I include some afterthoughts for REALTORS[®].

I. A Primer on Appraising

Appraisers arrive at a "fair market value" of a home by looking at several things, beginning with the sales contract on the subject property, and continuing with recent sales in the neighborhood. They also look at what isn't selling, and **if and when appropriate**, they look at distressed sales.

When comparing houses, Appraisers want to start with "matched pairs." Matched pairs are houses that are pretty well equal in size, lot, condition, amenities, and location (ideally, same subdivision). If they have a subject and three or four matched pairs among recent sales, comparables or "comps," they will look at each house's sale price and then start adjusting them. If the subject house is 1800 SqFt, and one of the pairs is 1950 SqFT and sold for \$250,000, that would be \$128/SqFt. Since the second house is 150 SqFt larger than the first, the Appraiser would likely subtract \$19,000 from the \$250,000 price the larger house got to make the two houses more equal. If the subject house has a one car garage and the norm for the neighborhood is a two car garage and the comp house has a two car garage, the Appraiser would want to know what the market is paying for the larger garage and subtract that value from the comps price. Values for these features are available from professional trade publications. Likewise, if the subject is the only one with ceramic tile flooring in the kitchen and bathrooms, the Appraiser will add some value to the comp houses. Many factors will be looked at, including the condition of the roof, the presence or absence of a deck or screened in porch, additional entrances to the house, and landscaping. While Appraisers are extensively trained to make all these value adjustments, they know the best comps are the houses that are most closely matched and require the fewest adjustments. After adjusting the comp houses to be as much like the subject as possible, the Appraiser then adds or

subtracts all the modifications and gets an estimated comparison value for each comp, weighs them according to their individual value as a matched pair, and averages them to get an estimated value for the subject. All of these steps are taken following the guidelines and directives of the *Uniform Standards of Professional Appraisal Practice*, or USPAP. (NOTE: Please understand this description of an Appraiser's work only skims the surface, but is fairly accurate for what can be described in about 400 words.)

II. Distressed Sales as Comps

If a comp house was in foreclosure, it was likely sold "as is," whereas the other houses are usually sold under contracts that guarantee certain "warranted systems (i.e., electrical and plumbing)" were functional. An "as is" contract or house would not be as valuable as a warranted house. How much that value difference would be is a rather subjective amount and depends on more factors than can be delineated in one short article. Also, most people going into foreclosure do not fix up their houses to go on the market. The best foreclosure houses typically need paint from front door to back, and new carpet. Also, in a "short sale," it is common knowledge that the Lender is "motivated" and is willing to take less than what is owned on the property. Lenders want to "get rid" of the property. That knowledge alone will drive down the offered price. All of these issues devalue a property. And finally there is the "stigma factor" associated with a foreclosed home. Many Buyers just won't even look at a house in foreclosure (see **Buyers and Foreclosures** below).

Thus a distressed house can require a lot of adjustments to match it up, and dollar amounts for these adjustments can be impossible to estimate. It is much easier to estimate the added value of a screened in porch than to estimate how much the stigma of foreclosure is costing that Seller. ***Appraisers do not use distressed sales as comps if they do not have to, and if less than 15% or 20% of the recent sales were foreclosures, they usually don't have to give them equal weight with the other sales.***

Therefore all of these factors need to be taken into account when comparing the value of a house that is not in foreclosure to one that is. It is not be totally inappropriate to estimate ***foreclosure houses typically get at least 5% to 15% less than they would get if they were not in foreclosure, their Sellers were not under duress, and they were fixed up to be competitive on the market.*** Also, in general, unless the majority of houses on the market in a given subdivision are distressed sales, foreclosures should not be used to set the value of non-foreclosure homes. If an Appraiser has several good matched pairs that are not distressed, they will choose them. Otherwise they are comparing rotten apples with oranges. To quote an Appraiser: "If we don't feel the short sale or foreclosure is at market value, we do not have to put weight on it. "

In other words, just because one lucky Buyer got a great deal and bought below market doesn't mean all others get to expect the same thing. Or, again to quote an Appraiser, ***“ONE SALE DOES NOT A MARKET MAKE. If there is one foreclosure and five arms length transactions, we are not going to place a significant amount of weight on the foreclosure.”***

Think with me logically for a moment. Appraisers know they could be drug into court to defend their appraisals. Do you think they want to sit on a witness stand protected by objective, published, accepted values for adding to or subtracting from the value of a property, or do they want to defend their more subjective estimates, which they know the Plaintiff's Attorney will be calling W.A.G.s?

III. Buyers and Foreclosures

Buyers need to know, if they want to pay foreclosure prices, they need to make an offer on a foreclosure house, and wait anywhere from one to six months for an answer from the selling Lender. When a Buyer presents an offer to a Seller, typically there is a deadline of twenty-four hours or so in which the Seller must respond or lose the offer. Banks don't respond so quickly. I've seen a bank sit on an offer for a month before they even order a "Broker's Price Opinion" with which to compare the offer. They appear to be quiet patient in hopes someone else will bring them a better offer. The Buyer who waits even two months for a selling bank to accept an offer risks losing their rate lock ([see my blog on Interest Rates and House Prices](#)). And while waiting on a dream deal they can lose out on many great deals. "The perfect is the enemy of the good." ***Saving money on a foreclosure can be a very expensive proposition. As one Appraiser said, "Buyers salivate over the prices, then die of thirst waiting for an answer from the bank."***

Offering a Seller who is not in foreclosure a price like they are is similar to trying to win the lottery. It can happen, but don't count on it. And trying to find a good REALTOR®. To help you can be tough. The experienced and knowledgeable professionals know they can waste a lot of time helping an unrealistic Buyer pursuing their dreams. They have to invest their time into the Buyer in the hopes they will eventually catch a Seller who is desperate and will sell way below market. I've learned. Even though there are very few Buyers out there, I will let Buyers intent on saving a bundle waste someone else's time. I want to work with Buyers who want a bargain, but will pay a fair price.

IV. Real Estate Professionals and Foreclosures

For a real estate sales profession to include foreclosed houses in the neighborhood comps to show a Buyer without pointing out the disparity in value is misleading at best and malpractice at worse. Personally I usually leave foreclosures out of my comps, or report them separately with a brief caveat pointing out the difference.

When I am working with a Buyer who wants a major bargain, I sit down with them and make sure they understand the problems and the risks involved with their plans. In all investments, rewards and risks are related. If they want the big reward of a huge savings, they have got to be prepared to suffer the huge losses associated with the rewards, such as the cost if interest rates go up a half percent while they wait, or the cost of losing some very good deals while they are holding out for that dream deal. If saving big bucks buying foreclosures was a sure thing, everybody would want in, and there would be no real advantage left.

I will also go over all the comps for the neighborhood with the Buyer. I may point out that on occasion a lucky Buyer finds a distressed Seller who is willing to sell way below market for whatever reasons. As their REALTOR[®], I am happy to get them a tremendous bargain if it is possible. But, they cannot expect it. If they are determined to get the best deal anyone has gotten in that neighborhood, then the Buyer needs to understand that virtually everything that sells is a bargain today. And I've got to determine how much of my time am I willing to spend gambling on them winning a lottery?

Conclusions:

If an Appraiser has sufficient matched pairs to use, the foreclosures in the neighborhood may be mentioned in the report, but they will not be the first chosen comps to determine the value of a house. If you think you can use houses in foreclosure to define a market, please remember to begin your statement with the words: "Once upon a time . . .," or, if you are former military, "Now this ain't no s_ . . .!"

DISCLOSURES (i.e., the Fine Print): I am licensed in Florida as a Real Estate Broker and as a Mortgage Broker. I am not certified or licensed as an Appraiser, a Lawyer, an Accountant, or a Financial Planner.

I admit up front I have a vested interest in what I am writing and saying, but that interest doesn't mean I am wrong. What I have written is my personal opinion, typically backed up with experience and statistics taken from the Tallahassee Board of REALTORS[®] Multiple Listing Service, the TBR Market Trends and Statistics Committee, and/or the Tallahassee Real Estate Blog. I will say in writing this blog I consulted with several Appraisers and I did do some additional reading and researching. So I am not just shooting from the hip.

I would add, however, if you simply dismiss my thoughts because you don't like them, you need to have some damned good reasons and facts to support your argument. I would suggest you need better information than what I offer to discredit me. The desire a Buyer has to believe they should be able to buy a top quality house for the same price as a foreclosure (or even lower since EVERYBODY knows prices everywhere are still falling) does not constitute truth. If you think your desires do constitute truth, you probably need to be in counseling for other things, too.

Everyone should know backward looking statements about housing prices and mortgage interest rates are not guarantees that future prices and rates will behave the same way. No one actually knows what prices and rates will be in the near future, much less in six months or a year. Consult your Attorney, Certified Public Accountant, Appraiser, or someone else you can hold liable and responsible for financial and especially income tax advice. If you take my advice and make money, I have no claim to a percentage. And if you lose money, the same non-existent claims apply.

Thank you, Bill Groover