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The Valuation of a Non-stabilized Property by Discounted Cash Flow: Is it market value or investment value?

Abstract

This distinction between market value and investment value is particularly important in mitigating lending risk, especially in a fluctuating real estate market. In past real estate-focused economic downturns such as Savings and Loan/RTC experiences of the late 1980s/early 1990s through the "Great Recession" of the late 2000s/early 2010s, and now in the post-Pandemic era, commercial properties that defaulted were likely to be those on which the loan terms were based on appraisers, lenders, and owners speculative future leasing or unit sales assumptions such as for non-stabilized or value-add properties with prospective renovation/repositioning strategies, newly constructed income properties in lease-up, and residential subdivisions, and condominium conversions or new construction unit sell-offs.

The purpose of this paper is to address the potential that lenders are not basing their lending *on market value* but, rather, loan decisions of non-stabilized income-producing properties are structured on *investment value*.

Martin A. Skolnik, MAI

Email Marty@skolnikconsulting.com **Address** 3900 Cathedral Avenue
Washington, DC 20016

Introduction

In simple terms, a non-stabilized income-producing property on the date of value has a) certain-term income from existing leases, and b) the potential to generate additional lease income from space that is currently vacant but could be leased in the future, which appraisers typically analyze using a discounted cash flow model (DCF).[1] In today's practice, the present value of the model's net operating income (NOI) is called *market value*. However, as this paper will demonstrate, that is an incorrect interpretation of the definition of market value -- it is actually *investment value*. That is, the net present value of the present and future net operating income (NOI) in a DCF analysis of a non-stabilized property is the value solely to the current owner of the property (i.e., investment value), not market value (i.e., a value-in-exchange).

In contemporary appraisal practice, the relationship between definition and analytical structure has been blurred so this paper will attempt to draw a bright line between the two. To fully understand the distinction described above, the construct of discounted cash flow must be discussed in relation to the definitions of market value and investment value. As stated in *The Appraisal of Real Estate*:

> "In appraisal practice, the use of the term value alone is often incomplete and is a potentially misleading description of an opinion of the relative worth of an asset. In an appraisal, the term value is always accompanied by a modifier, e.g., market value, investment value, insurable value. Appraisers typically refer to a particular type of value rather than use the word value on its own. The different value types clarify whose opinion is relevant, under what specific circumstances, or for what purpose."[2]

[1] This bifurcation is similar to James A. Graaskamp's requirement in a consulting engagement of pension fund assets to unbundle the cash flow analysis into "assured" versus "unassured" components of the properties' value. It allowed the investor to determine the percentage of value derived from "contract leases and initial price versus speculative renewal assumptions and value appreciation."

See: "Property Level Performance Measurement: The Key to Understanding Implicit Financial Attributes", Riggs, Jr, Kenneth P., Jules H. Marling, JR, and Ryan W. Harms, *Real Estate Issues,* Counselors of Real Estate, Winter 2000/2001, Vol25:4

[2] Appraisal of Real Estate, 15th ed., p. 49.

This is not a paper that denigrates discounted cash flow analyses (DCF); a DCF can appropriately be used in many analyses of income-producing property but can be misused if the structure and assumptions of the DCF are not appropriately developed or applied.[3] This paper addresses the potential that lenders are basing their loan decisions on non-stabilized income-producing properties on a value derived from a misapplied and mislabeled methodology:

- Not a 'wrong' estimate of value, but a value derived from the appraiser's or lender's misinterpretation of the definition of market value which results in the application of an incorrect valuation methodology.
- Not that the opinion of value is erroneous and not that the appraiser's opinions and assumptions are faulty, but that they applied their assumptions and opinions in an inappropriate or incorrect valuation framework given the purpose of the appraisal and intent of the client.
- Not that a reviewer (i.e., loan officer or underwriter) might have a difference of opinion about the assumptions the appraiser made in their cash flow analysis, but that the appropriateness of the use of the cash flow analysis might not be germane to the appraisal problem at-hand.

But that:

- The appraiser's development and application of discounted cashflow methodology for non-stabilized properties has not been based on the client's required definition of market value.
- The appraiser inadvertently developed their value as an investment value but is telling the user of their report that it is, in fact, market value.
- The derivation of investment value versus market value tends to derive a valuation that is materially high and subjects the lender to elevated default risk.

[3] For further background on practical development of DCF analyses, see the author's paper "Comments on Discounted Cash Flow Analysis" (Skolnik, Martin A., MAI. 1993. "Comments on Discounted Cash Flow Analysis." *The Appraisal Journal* 61 (3): 394–98.)

This paper will discuss why this is significant: That there is valuation and lending risk when appraisers mislabel an analysis as market value when, in fact, it was developed as investment value. Topics discussed in this article include:

- Definitions of market value and investment value, and how they differ
- The nature of a non-stabilized income-producing property
- Discussion of discounted cash flow analysis in relation to value definitions
- Conceptual scenarios to help the reader understand how these definitions and valuation methods affect value conclusions

Definitions of market value and investment value

The definition of market value typically used in contemporary real estate appraisals and mortgage lending contemplates the value of a property on the effective date as if the property transfers from a seller to a buyer with both parties typically knowledgeable and each acting in its own best interest.[4] It is a value-in-exchange.[5]

Appraisals for signatory agencies of the *Interagency Appraisal and Evaluation Guidelines* ("Guidelines") must be a written opinion of market value, must comply with the Uniform Standards of Professional Appraisal Practice ("USPAP"), and must contain sufficient information to enable the intended use of the appraisal to understand the

[4] Rather than re-iterate in the text of this paper the full definitions of Market Value, two of the current standard definitions used in contemporary appraisal practice can be found here:

"An Act To reform, recapitalize, and consolidate the Federal deposit insurance system, to enhance the regulatory and enforcement powers of Federal financial institutions regulatory agencies, and for other purposes", Public Law 101-73 (1989), 103 STAT. 375. Known as the *Financial Institutions Reform, Recovery, and Enforcement Act of 1989* (FIRREA),

and

Federal Deposit Insurance Corporation (FDIC), "*Appraisals*," 12 CFR Part 323.2 (August 20, 1990): Page 33888, https://archives.federalregister.gov/issue_slice/1990/8/20/33878-33890.pdf#page=11, accessed March 28, 2023. Known as *Interagency Appraisal and Evaluation Guidelines*.

[5] William M. Shenkel, "Value in Use, Value in Exchange, and Investment Value," *The Real Estate Appraiser and Analyst*, Society of Real Estate Appraisers: May-June 1980 p. 27-38.

report properly.[6,7] And, importantly, "…value opinions such as 'going concern value,' 'value in use', or *a special value to a specific property user* (emphasis added) may not be used as market value for federally related transaction" but "an appraisal may contain separate opinions of such values so long as they are clearly identified and disclosed."[8]

Additionally, the Interagency Guidelines state:

> "The estimate of market value should consider the real property's actual physical condition, use, and zoning as of the effective date of the appraiser's opinion of value. For a transaction financing construction or renovation of a building, an institution would generally request an appraiser to provide the property's current market value in its "as is" condition, and, as applicable, its prospective market value upon completion and/or prospective market value upon stabilization."[9]

For a property with "proposed construction or construction, partially leased buildings, non-market lease terms, and tract developments with unsold units," the Guidelines distinguish between as-is market value (i.e., the property's actual physical condition, use, and zoning) and prospective market value.[10] They distinguish "As Is" market value from "As Stabilized Market Value" as the difference between a current value and a prospective value conclusion.[11] The prospective market value "as completed" reflects the property's market value as of the time that development is expected to be

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[6] The agencies subject to the Guidelines are Board of Governors of the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA). "*Interagency Appraisal and Evaluation Guidelines*." 73 FR 77450 (December 10, 2010), Pages 77450-77473. https://www.federalregister.gov/documents/2008/11/19/E8-27401/proposed-interagency-appraisal-and-evaluation-guidelines (Accessed Jun 11, 2024).

[7] Federal Deposit Insurance Corporation (FDIC), "*Appraisals*," 12 CFR Part 323.2 (August 20, 1990): Page 33888, https://archives.federalregister.gov/issue_slice/1990/8/20/33878-33890.pdf#page=11, p. 7., Accessed March 28, 2023. Known as *Interagency Appraisal and Evaluation Guidelines, p. 7.*

[8] FDIC, p. 9.

[9] FDIC, p. 10.

[10] FDIC, p. 36.

[11] FDIC, p. 39

completed and the prospective market value "as stabilized" reflects the property's market value as of the time the property is projected to achieve stabilized occupancy.[12]

Definitionally, investment value is distinguished from market value as it is the value to a specific individual or entity, not a value-in-exchange (i.e., market value):

> "…(I)nvestment value is the value of a property to a particular investor based on that person's (or entity's) investment requirements, rather than market norms. In contrast to market value, investment value reflects the subjective relationship between a particular investor and a given investment." [13]

Investment value is the value of a property to the investor "in light of its perceived capacity to satisfy that investor's desires, needs, or investment goals."[14]

And, although the development of an investment value and a market value may result in the same number, these two types of value and their concepts are not interchangeable and inherently reflect different lending and underwriting risks.[15] In a market value analysis, the property is assumed to be sold on the date of value (that is, market value is a 'value in exchange' and inherent in the definition is a hypothetical sale/transfer of the property on the date of value) and, as such, the former owner has no claim to any cash flow or lease proceeds after that date. Why then, does the standard discounted cash flow model assume that market value *includes* the present value of the future lease-up in the most probable price (i.e., market value) that the former owner receives?

Related, "use value" or "value in use" are not accurate descriptors of the results of a discounted cash flow of an unstabilized property since the DCF models inherently assume that the property will continue to be used/owned by the current ownership through the property lease-up. Although use value and value-in-use have somewhat similar definitions to each other, they are dissimilar enough from investment value to

[12] FDIC, p. 43

[13] Appraisal of Real Estate, 15th edition, p. 54

[14] Ibid.

[15] Appraisal of Real Estate, 15th edition, p. 416.

rule them out as a substitute for investment value.[16] That is, the most appropriate method of analyzing use value and value-in-use is the development of the Cost Approach, not an income capitalization analysis.[17]

Non-stabilized income-producing property and income distributions

The owner of a distressed or non-stabilized property faces two alternatives: 1) Dispose of the asset in its current, as-is distressed state or 2) Hold the property and devote effort (time, money, expertise, and patience) to stabilizing the property's occupancy and operations prior to eventual liquidation or long-term hold.[18] The difference between these two scenarios is the distinction between market value and investment value:

- In a non-stabilized property, leasing of currently vacant space after the date of value (i.e., prospective leasing) is due to the *buyer's* entrepreneurialism, not the seller's (i.e., current owners).

- If a prudent and knowledgeable seller / current owner had been able to lease the currently vacant space, it would have done so to maximize its revenue and economic position. As such, the incremental value of any leasing after the valuation date should accrue to the buyer, not the seller (i.e., current owner).

- If the seller is not the procuring cause of the future prospective tenants, the present value of this future cash flow should not be part of the price that the buyer would pay.

- The prospective leasing modeled in the DCF occurs in the future only due to the marketing, management skill, and efforts of the buyer so it is not evident why the buyer would include those benefits in the price it pays to the seller.

[16] The Appraisal of Real Estate, 15th ed, p. 52-53.

[17] Shenkel, p. 28 and p.38

[18] Larry Benveniste, Dennis R. Capozza, Roger Kormendi, and William Wilhelm, "Contract Design for Problem Asset Disposition," *Journal of the American Real Estate and Urban Economics Association*, 1994, v22,1: pp. 149-167.

- Market value is a value-in-exchange concept, not the value of the continued management and use by the current owner. Therefore, the result of a DCF that models certain-term current leases along with income resulting from prospective future leasing procured by the buyer is actually investment value to the current owner since it anticipates that the current owner will continue the leasing and, as such, is a *hypothetical value*. That is, the hypothetical condition is that the current owner will continue ownership and leasing efforts, and retain prospective future income themselves. However, in today's appraisal practice, this is erroneously called *market value.*[19]

Conceptual scenarios to illustrate valuation impact of prospective property changes after the valuation date

To better understand the issues, consider these three valuation scenarios:

Residential valuation scenario:

How would an appraiser develop the as-is market value of a house if it does not have a fireplace, but it has the ability to have one built at some point in the future?

- The subject property is a rowhouse in a community of 300+ entry-level townhouses that was developed 10 years ago with four basic home models.
- A prefab fireplace was an option that about 25% of the original owners had installed by the builder.
- All the home models can have a similar fireplace retrofitted/installed in the same/original location.

[19] Note: "Hypothetical value" cannot be market value since, by definition, they are based on conditions which are *contrary* to known facts about physical, legal, or economic characteristics of the property or the market; in contrast to Extraordinary Assumptions which have a basis in reality or are uncertain. That is, Hypothetical Conditions are knowingly false but used for the purpose of a limited analysis, whereas Extraordinary Assumptions are based on the appraiser's analysis but have some uncertainty.

- The subject property does not have a fireplace, but it can be readily installed by the current owner or any subsequent owner.
- The cost of installing a fireplace similar to the original unit is $2,500.
- There are plenty of current/recent sales of homes in the subject neighborhood both with and without fireplaces to easily demonstrate that buyers will pay an additional $4,000 for a home with either an original or new/post-construction fireplace.

Residential Valuation Scenario Questions:

1. If the subject property does not have a fireplace, would a buyer offer a purchase price as if a fireplace already existed? No, obviously the buyer would not.
2. If the subject property does not have a fireplace, would the appraiser assume that the house would soon have a fireplace and add the value of the fireplace to the property in the development of the as-is estimate of market value? No, obviously the appraiser would not.
3. If the buyer of this property installs a fireplace next year for $2,500 and then resells the property afterward, who gets to keep the $1,500 increment in value? (That is, $4,000 contributory value minus the cost of installation of $2,500.)
    - The original seller? No.
    - The buyer, who is the actual creator of the fireplace? Yes

Clearly, the fireplace and its incremental value is a benefit that would accrue to the future homeowner that actually installs the fireplace, not to the current owner who only has the *potential* for installing the fireplace and it does not yet exist in the as-is valuation. The valuation benefit of the future fireplace installation is not part of the as-is market value of the property.

Office valuation scenario:

To see how this correlates to the discussion of discounted cash flow analyses of non-stabilized property, substitute "*non-stabilized office building*" for "*house*" in the above scenario and substitute "*100% occupancy*" for "*a fireplace*" and generate the following scenario:

How would an appraiser develop the as-is market value of a non-stabilized office building if it does not have 100% occupancy, but it has the ability to achieve it at some point in the future?

- Assume the current occupancy of this office property is 70% based on the ownership of Company A)
- Assume that today's buyer (Company B) creates 100% occupancy over the next 24 months for a cost of $400,000 (tenant improvements, leasing commissions, time value of money, etc.)
- Assume that the current buyer resells the property to Company C and that the market recognizes the incremental value from 70% occupancy to 100% occupancy to be $600,000.

Office Valuation Scenario Questions

1. Who gets to keep the $200,000 increase in value from today's occupancy of 70% to the future occupancy of 100%? Obviously, Company B (i.e., the current buyer) gets to keep the incremental $200,000 since they were the ones who did the work to increase the occupancy from 70% to 100%.
2. Is there any situation where Company A would get to share in the $200,000 that Company B produced? No, since Company A did not do the work of procuring those tenants.
3. If Company A does not share in the incremental future value created by Company B, why do appraisers model their DCFs of non-stabilized properties so that the present value of the lease-up of the vacant space (i.e., the

creation of the incremental value) ***does*** accrue in the market value (i.e., most probable sales price) that Company B would pay Company A?

Retail valuation scenario

Assume that the subject property on the date of value is a completely vacant 300,000 square foot community retail center that has 150,000 square feet of empty big box space as the anchor and 150,000 square feet of unoccupied in-line retail space. The potential buyer is an experienced retail owner/investor and has potential tenants in-mind to fill the space over the next few years:

- Assume that the buyer can lease the 150,000 square foot big box anchor within six months following the date of value, and
- The remaining 150,000 square feet of currently vacant retail space would be leased at a rate of 30,000 square feet quarterly for the five quarters following the leasing of the big box tenant.

Remembering that the property is 100% vacant on the date of value:

- Would the most probably sales price (i.e., market value) credit the current owner with the present value of the future income stream that they have not currently achieved and will not have any contribution toward? No, it would not.
- Would this new buyer do the calculus of their offering price that they will pay the current owner the present value of their future prospective leasing efforts and business acumen (i.e., the present value of a discounted cash flow analysis)? No, they would not.
- Would a discounted cash flow methodology be the best valuation methodology for this scenario, or would the most probably price be best reflected by an analysis of recent sales of other non-stabilized retail centers? The DCF would not be reflective of market expectations of the new buyer, and would erroneously credit the current owner with the present value of the future income stream.

Based on the author's experience, many (if not most) appraisers would develop a discounted cash flow model as the primary method to derive a value for lending purposes of the office and retail building in the above scenarios and label it market value, which illustrates the error of applying a DCFs to estimate the market value of a non-stabilized property.

Although these three simple scenarios are fraught with generalizations, it demonstrates a non-complicated way of the fallacy in current appraisal practice of allocating the incremental value created by lease-up of vacant space to the current market value of an income-producing property. As will be shown, this methodology that adds future potential contributory value of actions that occur after the date of value by a future buyer produces investment value, not as-is market value.[20]

This is an important concept since lenders depend on an accurate estimate of as-is market value as security for the loan. In part, a lender is seeking the value that a property would sell for today if that lender foreclosed on the property and had to sell it in the market. Prospective absorption of vacant space and/or material renovations are not as material to the lender in foreclosure since they are not part of the collateral securing the loan.

That said, there is nothing wrong or incorrect with using investment value (i.e., prospective stabilized or as-complete value) in certain non-lending situations. For example, an asset manager or owner might want to know how the value of their property might change as market conditions change, as the property leases up, or as improvements are made to the property to evaluate its ownership or lending risk. These users need to understand how these property changes over-time affect cash flow and net present value but that is not "value-in-exchange" (i.e., market value); it is investment value.

[20] Most appraisal engagements for mortgage lending clients are focused on the as-is estimate of market value since the property in its current condition, situs, and economics is the security for the potential loan. As mentioned in a previous footnote, this concept is fundamental to the definition of market value promulgated by the Interagency Appraisal and Evaluation Guidelines (FDIC, 2010). Typically, the date of value is current to the date of the property inspection.

Background to Discounted Cash Flow Analysis

Discounted cash flow analysis (DCF) is a much-used analytical tool in the appraiser's toolbox, mostly applied to the valuation of multiple tenant income-producing properties. It can be used either as a stand-alone valuation technique in the Income Approach or it can be used in conjunction with a direct capitalization analysis. The appraisal community applies DCF analyses to try to mirror the methodologies and thought processes of the real estate community (i.e., asset managers, lenders, buyers, sellers, and developers of retail, apartment, office, flex/warehouse, and land subdivisions) who use this analytical technique in their day-to-day due diligence.

The traditional discounted cash flow model that appraisers use when analyzing income-producing properties was originally created as an investment model to estimate the present value of cash flows for business and stock/equity valuation for investors, not real estate value.[21] Over time, the real estate appraisal community has adopted this cash flow model and applied it to estimates of market value for lending and transaction purposes but there is a flaw in their approach: For non-stabilized properties, as discussed, a discounted cash flow model with lease-up does not yield market value but investment value, and has the tendency to materially overvalue these properties creating valuation risk and lending risk for mortgage lenders (as will be shown later in this paper).

One of the primary underlying causes of appraisers equating the results of a discounted cash flow to market value could be their incorrect inference of the general term "value" to generally mean "*market value*" and/or "*as-is market value*". As stated in *The Appraisal of Real Estate*:

> *"Value can have many meanings in real estate appraisal. The applicable definition depends on the context and usage. Value is commonly perceived as the anticipation of future benefits. Because value changes over time, an appraisal reflects value at a particular point in time. Because value is an economic concept, the monetary worth of property, goods, or services to buyers and sellers is an expression of value. In an appraiser's identification*

[21] John Burr Williams, *The Theory of Investment Value,* (Amsterdam: New Holland Publishing Company, 1938).

> *of the objective of an appraisal, the term value is not used alone. Rather, it is accompanied by some form of modifier. To avoid confusion, appraisers do not use the word value alone. Instead, they refer to market value, fair value, use value, investment value, assessed value, and other specific kinds of value. Market value is the focus of most real property appraisal assignments."* [22]

This is an important construct in the development of this paper and in how appraisers have misread their base text materials. The definitions and explanations of discounted cash flow, direct capitalization, and concept of the Income Approach in *The Appraisal of Real Estate* talk about value *generally* and not specifically to the type of value (i.e., market value, investment value, assessed value, etc.). It appears, though, that the appraisal community has erroneously presumed the term "*value*" in *The Appraisal of Real Estate* to mean "as-is market value" in mostly all lending contexts and, as a result, misapplied the fundamentals of discounted cash flow analysis for non-stabilized property. A market value appraisal differs from an analysis of investment market value and might require different perspectives on rent growth, occupancy variances, cyclical cash flow projections and other analytical considerations.[23] Appraisers have taken to assume that any present value from a DCF is a reflection of *as-is market value*, which is not an accurate representation of value in general and DCFs in particular.[24]

The Principle of Anticipation

The Principle of Anticipation, which is the cornerstone of the Income Approach, states "that value is created by the expectation of benefits to be derived in the future."[25] And, "value is created by the anticipation of benefits to be derived in the future."[26] But,

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[22] Appraisal Institute, p. 20-21.

[23] Daniel L. Willison, "Toward a More Reliable Cash Flow Analysis," *The Appraisal Journal,* Appraisal Institute: v 67/1 (January 1999) 75-82

[24] Professional experience of the author from developing, reviewing, and teaching discounted cash flow analyses of income-producing property for over forty years.

[25] Appraisal Institute, *The Appraisal of Real Estate*, 15th ed. (Chicago: The Appraisal Institute, 2001), p. 335.

[26] Appraisal Institute, p. 22.

which value: Market value? Investment value? Value-in-Use? Prospective market value? Hypothetical as-is market value?

It is important to note that in its definition of anticipation, *The Appraisal of Real Estate* does not distinguish between market value, investment value, or use value nor does it distinguish between current/as-is value vs. a prospective value. Unfortunately, it is a well-entrenched misconception in the appraisal industry that the Principle of Anticipation implies that *any* future benefits accrue to yield market value. That is not true. Market value is what a buyer would pay for, not just the result of a mathematical formula or algorithm.

The current application of the discounted cash flow methodology in estimating market value for non-stabilized properties erroneously allocates the entire future benefit of cash flow solely to the seller (i.e., current market value) but since the benefits of future absorption actually accrue to the buyer, this is investment value, not market value. As a buyer/client asked the author:

> *"Why would I pay the seller for some mythical lease-up that they won't even be involved with? Why should your appraisal of market value be based on anything but current income? Why does the seller get credit for my marketing expertise and the work I will be doing?"*

Lenders should be concerned if the security for their loan is based on anything other than what the property could sell for on the date of value and should not be based on speculative present value of activities that the borrower may never attempt and that a future borrower might forgo. The cash flow to repay the debt service should be based on actual income and expenses, not based on prospective activities that elevate the lending risk of the collateral.

When a person buys an income-producing property that is operating at stabilized occupancy, what income do they receive? The buyer gets the right to receive the net monthly income from the in-place leases and their renewals plus the right to receive any appreciation/depreciation from their purchase price to the sales price at the date of sale. Their purchase price will be based on this anticipated income stream.

When a person buys an income-producing property that is operating at less than stabilized occupancy, what income do they receive? The buyer has the right to receive the income from the existing leases, plus any lease income they receive as a result of their entrepreneurial lease-up of the vacant space, plus the receipt of any appreciation/depreciation from their purchase price to a future sales price. The seller, however, does not have the right to receive income from the leases that are not in place at the date of sale.

But wait, what about….

Highest and Best Use

Some appraisers contend that a discounted cash flow with lease-up *is* market value because the DCF method conforms to the Highest and Best Use conclusion in the appraisal.[27] That is, that a lease-up of the now-vacant space over time produces the maximally productive use of the property, which is a greater return than only considering the certain-term / current leases to value the property.

Although this is mathematically true, the application of future prospective rental income in an as-is appraisal is in conflict with the definitions and requirements of the Interagency Guidelines, which is controlling in an appraisal of the as-is value of a property for lending purposes. That is, legal/statutory definition of market value helps define the appraisal concept of Highest and Best Use, not the other way around.

Extraordinary assumptions and hypothetical conditions

As defined in the Uniform Standards of Professional Practice:[28]

[27] Personal experience of the author.

[28] *Uniform Standards of Professional Appraisal Practice*, 2020-2021 ed. (Washington, DC: Appraisal Foundation, 2020), p. 4.

- Extraordinary Assumption: "An assignment-specific assumption as of the effective date regarding uncertain information used in an analysis which, if found to be false, could alter the appraiser's opinions or conclusions."

- Hypothetical Condition: "A condition, directly related to a specific assignment, which is contrary to what is known by the appraiser to exist on the effective date of the assignment results but is used for the purpose of analysis."

The appraiser's use of an Extraordinary Assumption or a Hypothetical Condition to develop a discounted cash flow appears to be contrary to the Interagency Guidelines requirement to value the property's "actual physical condition, use, and zoning as of the effective date" of the appraisal.

Additionally, the Appraisal Institute makes this distinction regarding Extraordinary Assumptions:

> "An extraordinary/special assumption is an underlying premise of the assignment, something that is believed to be true for the sake of the analysis, but whether it is in fact true is uncertain. The condition or premise is presumed to be true as of the effective date, not after or before. So, it is specific to the assignment and pertinent as of the effective date only. *Conditions presumed to be true after the effective date are projections, not assumptions* (emphasis added)."[29]

Since future rental income, lease-up, changes in expenses, etc., are not in-place on the date of value, the Appraisal Institute would define these items as 'projections' and not subject to the application of an Extraordinary Assumption.[30] And, clearly, an

[29] Appraisal Institute, "*Common Errors and Issues: 2020*". Chicago, IL. https://www.appraisalinstitute.org/getmedia/074443e6-ea72-4309-87ad-32c1f549be6a/common-errors-issues.pdf Accessed June 10, 2024.

[30] An example of an Extraordinary Assumption would be that there is information that the appraiser has an uncertainty about on the date of value and then makes a conclusion (i.e., an assumption) about that uncertainty. For example, suppose the property is a gas station and the lender or owner have not completed an environmental evaluation of the property to determine if there are any petroleum leaks from the underground tanks. The appraiser can make an Extraordinary Assumption that the tanks do not leak but also state in the appraisal that if the tanks are found to have been leaking as of the date of value, then the appraised value might not be valid. This is an example of a "condition presumed to be

appraisal with a Hypothetical Condition is not an as-is estimate of the market value of the property as it actually exists on the date of value.

Conclusion

We have all done it. When shown a misconception or an error or a flaw in our appraisal methodology from a client, an oversight board, or a new employer, we sometimes have said, "Well, that's the way I was taught 20 years ago by my mentor." Or "That's the way I have always done it." Or "None of my clients ever objected to this method." But that does not make it appropriate to the valuation engagement at-hand. This article has discussed a common misconception that appraisers make when valuing non-stabilized income-producing properties that might result in material valuation risk to a lending client: Conflating market value with investment value.

The distinction between market value and investment value is not just a minor nomenclature issue or only a definitional disagreement. This is a potentially serious problem that has ramifications throughout the appraisal and lending communities. Appraisers are taught very early in their careers that there are differences and nuances between the different concepts/types of value (i.e., market value, investment value, use value, assessed value, insurable value) and that they must be clear in the appraisal of which type of value that the client has asked the appraiser to estimate for the subject property.

Lenders need to rely on market value – that is their mandate/requirement. If appraisers say something is market value, i.e., then it should, in fact, *be* market value and not some other type of value. A lender would not lend on insurable value or assessed value, why would it lend on investment value?

In the demonstrative scenarios outlined in Tables 2, 3, and 4, there is a material difference between as-is Market Value ($7,500,000) and investment value ($14,670,000) and prospective market value at stabilization ($17,190,000). If the appraiser mislabels his/her value definition and reports investment value instead of market value to the

true after the effect date…" Prospective lease-up is presumed to occur *after* the date of value and is, by definition, a projection not an assumption.

lender, and then if the buyer defaults on that loan, the lender is stuck with a significant loss between actual market value and what it lent on.

That said, there is nothing wrong or incorrect about providing a client with market value as well as prospective market value and/or investment value. For a lender, a comparison of these data points helps identify potential lending risk and might offer solutions for mitigating that risk.[31]

During the Resolution Trust Corporation (RTC) period of the late 1980s and early 1990s many of its foreclosed properties were originally appraised using discounted cash flow analyses with projected rents under the guise that those values represented market value. However, when the RTC had to resell these properties after default, the market only recognized that the value of the property was derived from the leases in-place, not on market projections.

Lenders need an accurate estimate of market value not investment value mislabeled as market value. The appraisal community needs a fundamental clarification to one of its basis analytical techniques, the discounted cash flow analysis, to reflect that it has been promulgating incorrect terminology, methods, and techniques. Textbooks, teaching materials, and seminars should reflect that there is a specific and potential risky difference between generating a market value estimate versus investment value in the application of the discounted cash flow model.

Appraisers owe it to the lending community and to the public at large to accurately report values that conform to the accepted definitions, and not to erroneously repeat the methodological mistakes of the past.

[31] Skolnik, Martin A. "*Incorporating a Discussion of Risk in Appraisals: A New Direction for the Appraisal Industry*." Appraisal Journal, Chicago. Vol. 87, Issue 4. (Fall 2019): 256-263.