Chapter 126
Analysis of the Value and Price of Real Estate and Concurrently on the Appraisal of Mortgage Value

Wen Wang

Abstract Research Purpose: This research seeks to probe deeply into the internal relation between the market value and market price of real estate to provide the basis of a scientific "definition of value". Research Methods: Documentation and logic reasoning were employed. Research Results: In the practice of real estate appraisal, the standards for "market value" are not applicable to all appraisal projects; and for the appraisal of a single object, the value standards vary with the purpose of the appraisal even under the same market conditions. Research Conclusion: In appraisals for the purpose of real estate mortgage, market value standards should be applied, particularly during periods of irrational advance of the real estate market; but in appraisals for the purpose of real estate transfer, market value standards may not be applicable because a determination of the actual market price is required, which may agree with or deviate from the market value.

Keywords Real estate • Value • Price • Appraisal

126.1 Introduction

What is the value of real estate? What is the relation between market value and market price of real estate? Is it the market value or the market price that is revealed in the appraisal of real estate? Are market value standards applicable to all appraisal projects? These questions have been puzzling the appraisal community in the Chinese Mainland. In actual operation, "market value" standards are always adopted without regard to the purpose of the appraisal. In appraisals for such varied purposes as real estate transfer, mortgage, enterprise reformation and compensation

W. Wang (✉)
College of Urban Economic and Public Administration, Capital University of Economics and Business, Beijing 100026, China
e-mail: wangwen@cueb.edu.cn

J. Wang et al. (eds.), *Proceedings of the 17th International Symposium on Advancement of Construction Management and Real Estate*,
DOI 10.1007/978-3-642-35548-6_126,

for residence demolition and relocation, the same standards are adopted for value definition. Whether this practice is reasonable, whether the value definition should be the same for different appraisal purposes and how to scientifically specify the "value definition" have become the problems that the appraisal community most urgently needs to solve.

Starting with an analysis of the connotations of the word value, this paper probes into the real meaning of value revealed in the appraisal of real estate, then differentiates and analyzes some ambiguous concepts emerging in appraisal practice, and puts forward preliminary advice for standardizing the "value definition".

126.2 Analysis of the Value and Price of Real Estate

126.2.1 What Is Meant by "The Value of Real Estate"

Of value theories, the most prominent are the Marxist labor theory of value, the Western marginal utility theory of value and Marshall's equilibrium theory of price. The Marxist labor theory of value reveals the essence of value and its core viewpoint is that man's living labor is the unique source of value; in the Western marginal utility theory of value it is argued that the commodity value depends on people's perception and evaluation of the goods' utility and is determined by the marginal utility of the commodity, and "marginal utility" is taken as the yardstick for measuring the quantity of value; and in Marshall's equilibrium theory of price it is argued that, with the other conditions being unchanged, the value of a commodity is jointly determined by the supply and demand of the commodity and this theory explains the value of commodity through equilibrium price.

The aforesaid value theories reveal different connotations of the word value and lay different emphases on their research. The Marxist labor theory of value lays emphasis on the research of the "essence of value" while the marginal utility theory of value and the equilibrium theory of price lay emphasis on analyzing the quantity of value, and they all have the significance of being used as reference for guiding the current practice of real estate appraisal. But in practical appraisal, the appraisers pay more attention to the currency manifestation of the real estate value, i.e. the value that can be realized under certain market conditions, or the exchange value. Therefore, the "value of real estate" dealt with in the appraisal is closest to the value definition in the equilibrium theory of price.

Then, in what state is the value revealed in the appraisal of real estate and what types does it have? In fact, the value revealed in the appraisal is the price that is most likely to be realized under certain market conditions. So, the value of real estate can be classified according to the market conditions. Generally, the real estate market can be classified as normal or abnormal. Accordingly, the value revealed in the appraisal of real estate can also be classified as normal market value and abnormal market value. Presently, they are respectively called "market value and non-market value" [2] in the field of real estate appraisal, which mean the same as the aforesaid terms. To avoid confusion and misunderstanding in wording, they are hereinafter referred to as "market value and non-market value".

For the concept of the market value of real estate, there exist many definitions at home and abroad. The definition of market value used by the US federal institutions in financial regulation is: "Market value is the most probable strike price of a piece of real estate sold in a competitive and open market, where such a market has all the conditions needed for fair trading, both the buyer and the seller have given deep consideration and received sufficient information before taking action, and it is supposed that the price will not be subject to abnormal pressure [1]." In the textbooks designated for real estate appraisers' qualification test in the Chinese Mainland, the brief definition of market value is: "Market value is the price most likely to be voluntarily agreed by and between rational and cautious trading parties, who aim for their self-interested motives and have sufficient time to learn about the trading object and understand the market quotation" [2]. Although these two definitions are not identical in expression, they are basically identical in connotation, that is, what corresponds to market value is the price formed under the conditions of normal market (open trading) by the buyer and the seller who have sufficient market information and conduct the trading in a voluntary and rational manner, and they especially emphasize the normal market conditions and rational trading.

Contrasting with market value, non-market value refers to all the other value types except market value, including quick liquidation value and irrational market value.

126.2.2 Relations Between Value and Price of Real Estate

With regard to the relations between price and value, the Marxist labor theory of value contains a brilliant exposition, that is, value is the foundation of price and determines price; price is the currency manifestation of commodity value and fluctuates with the fluctuation of value. Marx's value theory has the guiding significance for the correct understanding of the relations between value and price of real estate and these viewpoints have long been accepted by the people. But the questions remain, under different market conditions, what are the characteristics of the price manifested in different types of value? And, what on earth is the relation between market price and market value? I shall discuss these below.

1. Market Value and Long-term Equilibrium. According to the aforesaid definitions of market value, it is the price most likely to be agreed by and between both the buyer and the seller in voluntary trading under a series of supposed preconditions, that is, the "theoretical price" as often mentioned.

Whether the theoretical price exists in the actual market and whether it is the realizable price in the market or close to certain market price, to which the answer is affirmative. Then, in what state does the theoretical price correspond to the market price and when does the market price reflect the actual internal value of real estate?

The viewpoint that is universally accepted at present is that the market value corresponds to the equilibrium price. According to the Western theory of economics, the equilibrium price of real estate is the price formed when the market supply curve of real estate intersects with the market demand curve, that is, the price formed when the market demand quantity of real estate is equal to the market supply quantity. But it needs to be noted that market equilibrium can exist in several forms, namely, temporary equilibrium, short-term equilibrium and long-term equilibrium, and the prices in different cases of equilibrium are usually unequal. Then, to what equilibrium price does market value correspond? According to the aforesaid definitions of market value, the market value corresponds to the normal market conditions. This means only the price manifested when the market reaches the state of long-term equilibrium can really reflect the internal value of real estate. That is, market value corresponds to long-term equilibrium price.

2. Market Price and Temporary Equilibrium. Having made clear the connotations of market value and its corresponding relations with price, let us analyze the meaning of market price. The meaning of the market price of real estate is the common average price of certain pieces of real estate on the market and it is the abstract result derived from the great number of strike prices of such real estate [2]. So, market price also stands for the collective value judgment of market participants. But different from market value, the market to which market price corresponds includes both normal market and abnormal market; and the collective value judgment may be rational or may be irrational. When the market is in an abnormal state and the market participants are widely irrational, their collective value judgment will not reflect the internal value of real estate, and the market equilibrium at this time can only be temporary equilibrium and the market price corresponding to it will be the temporary equilibrium price.
3. Market Value and Market Price. From the above analysis, it can be seen that market value and market price are two concepts that interconnect with each other and differ from each other, and they respectively correspond to the prices of the real estate market in the long-term and short-term equilibrium states. Market price may tally with market value or may deviate from market value. When the main acts of participants in the real estate market are rational and real demand equals real supply, market price is close to its market value; but when the main acts of traders in the market are widely irrational or the market participants hold certain irrational expectations, market price will deviate from market value for a long period and to a great extent and its specific manifestation will be notably higher or lower than market value.

126.3 Analysis of Misunderstanding and Doubts in Actual Appraisal

126.3.1 Confusing Normal Market with Actual Market

In the appraisal of real estate, is the normal market price or the actual market price being appraised and how can one make the reasonable choice according to different appraisal purposes? These questions are not usually addressed in actual appraisal. For example, in the appraisal of land price, in whatever state the market is at the time of the appraisal, land price is invariably defined as the normal market price. But in fact, when the main market traders are generally in an irrational state at the time of the appraisal, the actual market price is not identical with the normal market price. Besides, in such case, it is not that the appraisal of all purposes should reveal their normal market prices. For example, an appraisal for the purpose of real estate transfer should take the actual market price as the standard because the actual market price stands for the price that is most likely to be realized under the market conditions at the time and tallies with the very purpose of the appraisal. The practice of confusing actual market with normal market in the appraisal can easily cause ambiguity in valuation.

126.3.2 Confusing Market Value with Market Price

In the appraisal practice in the Chinese Mainland, market value and market price are often inter-changeably used. In many appraisal reports, value is defined as the “market value of the appraised object under limited conditions”, but what is actually appraised is the “market price”. Even if the market is in an abnormal state at the time of the appraisal, the appraisal is still carried out according to the actual market price. In fact, when the market is in an abnormal state, market price may deviate from its market value and cannot really reflect the internal value of real estate. Therefore, when the market is in an abnormal state, if the appraisal is carried out without differentiating market value from market price, it will cause the appraisal results not to accord with the value definition.

126.3.3 Adopting the Same Standard for Transfer and Mortgage Appraisals

In actual appraisal, the appraisal purposes or the market conditions are usually not differentiated and the same standard is adopted for the value definition. For example, the market value standard is adopted for both transfer appraisal and mortgage appraisal. Is this practice reasonable? Let us first analyze which standard should be adopted in appraisal for the purpose of real estate transfer, market value or market price? As discussed above, what the appraisal for the purpose of transfer reveals is the price that is most likely to be realized under the market conditions at the time of the appraisal. Whether the market is in the normal state or in the abnormal state, it should be subject to the market conditions at the time. Therefore, in such a case, the value definition should be specified as appraising the market price of real estate, and it may not reflect market value.

But in appraisal for the purpose of mortgage, as the disposal of real estate assets occurs at some time in the future, there may be a rather long time interval from the time of appraisal. During this period, changes may occur in the conditions of the real estate market and there exist quite a few uncertain factors. To guard against the credit risks in real estate and on the principle of prudence, the value definition should be specified as appraising the market value of real estate, particularly when the real estate market is in a period of irrational advance at the time of the appraisal, the market value standard should be adopted rather than the price under the market conditions at the time. However, when the real estate market is in a period of recession and the market price is notably lower than market value, the market price should be appraised.

126.4 Conclusions

1. Market Value and Market Price Should not Be Used Inter-changeably. From the aforesaid analysis, it can be seen that market value and market price are two concepts that interconnect with each other and differ from each other. The market value of real estate refers to the price formed by the buyer and the seller in voluntary and rational trading under normal market conditions, and it corresponds to the price formed when the real estate market reaches the state of long-term equilibrium. If the market value standard is adopted in the appraisal, what the appraisal result corresponds to will be the normal market price. Even if the market is in an abnormal state at the time of the appraisal, it should also take the normal market conditions as the supposed precondition.

   The market price of real estate is the price of the appraised object that is most likely to be realized at a certain time under actual market conditions, and it corresponds to the temporary equilibrium price of the real estate market. As the actual market may be in a normal state and may be in an abnormal state at the time of the appraisal, market price may tally with market value but may also deviate from market value for a long period and to a great extent, and they should not be used inter-changeably.
2. Market Value Standards Are Not Applicable to All Appraisal Projects. In the appraisal of real estate, not all project appraisals seek to reveal the internal value and real value of real estate. In some cases, the client only requires the appraisal of the actual market price of real estate rather than market value. For example,

during a period of irrational advance of house market prices, a certain resident entrusts an appraiser to appraise his house property for the purpose of transfer. According to the appraisal purpose, the client requires appraisal of the price of the appraised object that is most likely to be realized in the trading under the current market conditions (abnormal market). In such a case, if the appraiser still carries out the appraisal according to market value standards, it will be notably lower than the actual market price and this obviously goes against the client's real purpose.

3. Value Standards Vary with Different Appraisal Purposes. Even for the same appraised object and under the same market conditions, the value definition may vary with different appraisal purposes. The most typical case is where, during a period of abnormal advance of real estate market prices, the value definition of the same appraised object may differ greatly in its transfer price appraisal and mortgage value appraisal. As discussed above, with regard to appraisal for the purpose of transfer, what the client is interested in is simply the current market price of the real estate rather than its internal market value. But the appraisal for the purpose of mortgage is different because the time of guaranty disposal is often inconsistent with that of the appraisal. During the intervening period, there may be great changes in the conditions of the real estate market. To guard against the credit risks of the bank and on the principle of prudence, the market value standards should be adopted in the appraisal.
4. Value Definition Determines Appraisal Thinking and Method Choice. It is universally recognized that, during a period of great fluctuation in the real estate market, especially when there exist bubbles in the market, the first choice of appraisal method should be the income approach and then the cost method, and the market comparison approach should be avoided as much as possible. In fact, this viewpoint may not be correct and the crux lies in how to choose the value standards in value definition, "market value" or "market price". If the market value standards are adopted in the appraisal, the aforesaid viewpoint is undoubtedly right. But if, according to the client's needs, what is appraised happens to be the price (such as transfer price) of real estate in the current market conditions, the aforesaid viewpoint may be questioned. Because what can best reflect the actual market price is still the price of comparable transactions that have recently occurred, as far as the appraisal of actual market price is concerned, the first choice should still be the market comparison approach rather than the income approach even in abnormal market conditions.

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