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What price should a buyer offer?

By Curtis Seltzer
Landthink contributor

(This is eighth in a series of articles about issues that sellers and buyers face when negotiating a purchase-offer contract for property.)

Sellers usually know more about the property they're selling than interested buyers. My advice to buyers is to try to level this information playing field by researching a property before submitting a purchase offer.

One thing that buyers generally never find out is how the seller set his asking price. And most buyers never bother to ask.

Occasionally, a smart seller will voluntarily disclose to buyers the path he followed to his asking price. These sellers arm themselves with arguably neutral sources, such as one or more appraisals, tax-assessed value from public records and individual asset valuations. They disclose how much they paid originally and what their tax hit is likely to be at their asking price. They have evidence showing local appreciation rates for properties they think are comparable to theirs.

I've found this approach to be very effective in anchoring negotiations around the seller's asking price, which is why smart sellers do it. Disclosure places the buyer under the burden of showing that the seller's documentation is wrong.

Far more often, however, a buyer is left to imagine how the seller set his asking price. Where buyers do their research, they may be able to track a seller's logic. If, for instance, the tax-assessed value is $200,000 and the asking price is $300,000, the buyer can feel reasonably confident that the seller added 50 percent to the tax-assessed value and will probably settle for $250,000, or 25 percent over the tax value.

If, in another example, the buyer pays for an appraisal, the buyer's appraisal value may come in at the same number as the seller's. In this case, the seller may have tacked on an additional 25 to 50 percent to see what the market might bring and cover his sale costs. If the buyer's appraisal is significantly lower than the seller's, the buyer should ask his appraiser to explain the difference. The buyer's appraisal may be more recent than the seller's or use different comps (which may be better or worse). It is also possible that the seller asked his appraiser to hit a high number, which the appraiser did.

Often, a seller uses one recent, nearby sale as the only peg around which to frame the worth of his own property and set its price. In this case, the buyer may have the job of persuading the seller that his one preferred comp is not as good as two or three others. This is a near-hopeless task. Beliefs in beliefs are very hard to change.

I've always found it worthwhile to ask the seller or the agent working with the seller how they arrived at the asking price. This may or may not produce useful, truthful information. The broker might say something to the effect that the asking price was set in terms of current market values. The seller may say something like that he just feels it's worth the price he put on it. But every once in a while, someone on the seller's side actually helps a seller by disclosing a thought process that a buyer can reproduce and test.

What should a buyer do when his appraisal and the seller's agree on current market value? The answer depends totally on whether the appraisal value matches the value of the property to the buyer. If it does, the buyer should offer the consensus number. If the buyer's valuation is lower than the market valuation, he should offer his price and explain why.

The buyer's valuation of a property produces a buyer's price, which is what the property is worth to the buyer.

The distinction between current market value (or appraisal value) and value to the buyer (buyer's price) is crucial. A property fairly and honestly appraised at $1 million may only be worth $700,000 to a particular buyer, given his plans, resources and assessment of the property's pluses and minuses. Appraisals often neglect to properly value certain land assets and don't inspect improvements for defects in operating systems. Appraisals are good at showing what one property is worth in terms of recent sales of several similar others, but they are not very good at determining the intrinsic net value of a property by researching its individual assets and problems.

So let's say that the seller has set an asking price of $1.2 million on 500 acres.

My immediate intuitive response is that this seller wants $2,000/acre, or $1 million, gross. Any time I see an "orphan uptick" on an asking price, I adjust down to the nearest big round number as a chainsaw method of cutting to where I think the seller probably wants to wind up. By this way of thinking, $79,000, gets cut to $75,000; $750,000 goes to $700,000, $7.5 million to, maybe, $6 or $6.5 million. This approach tells me nothing about what the property is worth to me, only what might be the seller's settle price. And it should be obvious that my intuition may be dead wrong. The only way to know for sure is to ask the seller after finding out as much as possible about the property and the seller's motives and ways of thinking.

When "crafty" sellers price property like gasoline per-gallon -- $159,900 -- I always helpfully refer to the asking price as $160,000. By framing the asking price at what it really amounts to, it feels easier to bargain it down. The bump up to $160,000 makes it obvious to both of us that the price -- $159,900 -- is too high. Exaggerating it makes that point—at least that's how I see it. The higher number -- $160,000 -- allows the seller to feel that he is giving a big concession to make the deal. A $20,000 concession sounds a whole lot bigger than $19,900.

But all speculation that a buyer might do about what a seller wants from a sale is beside the point—the buyer's price.

Buyers should pay the price that's right for them in light of the property's assets and problems, their resources, needs and plans. Buyers should understand that in almost every instance alternative properties are available that will satisfy most, if not all, of their needs. If a seller rejects a buyer's offering price without opening negotiations, the buyer should move on rather than negotiate himself down to a lower offering price.

So I approach finding an offering price by researching the property and figuring out what it's worth to me—my buyer's price. I will look at tax-assessed value and appraisals, but only for context. Those numbers are not particularly relevant to the valuation exercise that I am going through.

A buyer who offers somewhere around his buyer's price should be prepared for rejection, because it's often substantially lower than the asking price. Nothing is wrong with that.

I also spend time figuring out what the seller has in the property, what his after-tax net is likely to be under various price scenarios and what his motivation is for selling.

Determining the intensity of seller of motivation is the key that can unlock a seller to a buyer's price. A not-very-motivated seller won't turn that key.

I also try to figure out what kind of negotiator is on the other side. Is he afraid to negotiate, evidence for which is that he announces that his asking price is take-it-or-leave-it? Is he experienced in give-and-take bargaining? Is he likely to stick with what he says or slide around?

A buyer, having determined his buyer's price, can low-ball it a bit in order to come up, or walk the seller through his reasoning as a way of justifying a take-it-or-leave-it offer. My buying strategy is almost always to get negotiations going. The more that process develops the more invested in its success each side becomes…and the more likely a deal will be struck.

With ridiculously inflated asking prices, I offer a defensible low-ball price—often more than half off. It does a buyer no good to meet an inflated asking price half way, because you will end up overpaying.

Here's an illustration. Let's say the seller has put $1.2 million on his 500 acres and my research shows that the property is fairly appraised at $450,000 but it's only worth $325,000 to me, I might offer $300,000 to get things started and include a letter explaining my offer. The seller may reject me out of hand, but if he's carried his property for a while, needs to sell and knows that he's way overpriced, he might come back with something that moves in my direction. I look for terms that help him. If the seller doesn't get close to $325,000, it's not a good deal for me no matter how much he comes down from $1.2 million. In this example, I keep in mind that the seller should have started at maybe $500,000, not $1.2 million.

The buyer-determined buyer's price provides a rational, defensible anchor for negotiating. It may not get to a deal, but it will protect a buyer from making a foolishly overpriced purchase.

I've never discovered a simple, quick-and-dirty formula for coming up with an offer. If you apply a fixed rule -- offer 25 percent less than the asking price and settle for 15 to 20 percent less -- you're playing the seller's game.

Each property is different. So buyers need to trust their research and their method for determining the right price for them. Never buy property without determining a buyer's price.