Chapter 18
Real Estate Appraisal

LECTURE OUTLINE:

I. Appraising

A. Appraisal—estimate or opinion of value based on supportable evidence and approved methods

B. Regulation of appraisal activities—the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires appraisals performed as part of a federally related transaction be performed by a state-licensed or state-certified appraiser.

1. A federally related transaction is any real estate-related financial transaction in which a federal financial institution or regulatory agency is engaged.
2. Appraisals of residential property valued at $250,000 or less need not be performed by licensed or certified appraisers.
3. Nonresidential properties valued at above $250,000 require a certified appraiser.

C. Competitive market analysis (CMA)

1. Real estate licensees must be familiar with appraisal techniques to perform a competitive market analysis (CMA) when assisting a seller to set the listing price for a property.
2. CMA is not an appraisal; an appraisal is based on properties that have actually sold; a CMA is based on recently sold properties, properties currently on the market, and expired listings in the area.
3. Broker’s price opinion—less expensive alternative of evaluating property often used by lenders working with home equity lines, refinancing portfolio management, and collections; many are simply “drive-bys” that verify existence of the property, along with a listing of comparable properties.

II. The Appraisal Process (See Figure 18.1)

A. State the problem—what type of value is being sought?

B. List the data needed and the sources.

C. Gather, record, verify, and analyze the necessary data.
1. General data—national, regional, city, and neighborhood data; data about factors not located on the property
2. Specific data—data on the subject land and improvements
3. Both general data and specific data would include information regarding each of the three approaches to value.

D. Determine the highest and best use of the site.
E. Estimate the land value, usually by sales comparison analysis.
F. Estimate the value by each of the three approaches.
G. Reconcile the estimated values for the final value estimate.
H. Report the final value estimate.

III. The Uniform Residential Appraisal Report (see Figure 18.2)

IV. Value—monetary worth based on desirability

A. Characteristics of value ("DUST")
   1. Demand—the need or desire for possession or ownership backed by the financial means to satisfy that need
   2. Utility—usefulness for its intended purpose
   3. Scarcity—a finite or limited supply
   4. Transferability—the relative ease with which ownership rights can be transferred

B. Market value
   1. The most probable price a property will bring in a fair sale
      a. In a competitive and open market
      b. Buyer and seller each acting prudently and knowledgeably
      c. Price not affected by unusual circumstances
   2. Essential to determine market value
      a. The most probable price is not the average or highest price.
      b. The buyer and seller must be unrelated and acting without undue pressure.
      c. Both the buyer and the seller must be well informed of the property's use and potential, including its advantages and defects.
      d. A reasonable length of time must be allowed for the property to be exposed in the open market.
e. Consideration is paid in cash or its equivalent.
f. Price must represent a normal consideration, unaffected by special financing.

C. Market value versus market price
1. Market value—an estimate based on the analysis of comparable sales and other pertinent market data
2. Market price—what the property actually sells for; sales price

D. Market value versus cost
1. Common misconceptions that cost represents market value
2. Cost and market value *may* be the same if improvements are new.

E. Basic principles of value—primarily economic principles
1. Anticipation—value is created by the expectation that certain events will occur
2. Change—no physical or economic condition remains constant
3. Competition—interaction of supply and demand; excess profits tend to attract competition
4. Conformity—maximum value is realized if the use of the land is in harmony with its surroundings
5. Contribution—the value of any part of a property is measured by its effect on the value of the whole.
6. Highest and best use—the most profitable single use to which a property can be adapted
   a. Legally permitted
   b. Economically (financially) feasible
   c. Physically possible
   d. Most profitable (maximally productive)
7. Increasing and diminishing returns—improvements to land and structures will eventually reach a point at which they no longer increase property value
   a. Law of increasing returns
   b. Law of diminishing returns
8. Plottage—the merging or consolidation of adjacent lots held by separate owners into one larger lot may produce a higher total value than the sum of the two lots valued separately
9. Regression and progression—between dissimilar properties, the worth of the better property is affected adversely by the presence of the lesser-
quality property; usually, the higher valued property decreases significantly (regression), while the lesser-valued property increases slightly (progression)

10. Substitution—the maximum value of a property tends to be set by the cost of purchasing an equally desirable replacement

11. Supply and demand. Principle says value depends on the following:

   a. Number of properties available in marketplace
   b. Prices of other properties
   c. Number of purchasers
   d. Price buyers willing to pay

V. The Three Approaches to Value

A. The sales comparison approach (see Table 18.1)

1. An estimate of value is obtained by comparing the subject property (the property under appraisal) with recently sold comparable properties (properties similar to the subject).

2. The factors for which adjustments to the comparable properties are made

   a. Property rights—in cases where less than the full bundle of rights is involved
   b. Financing concessions—events such as differences in mortgage loan terms or owner financing
   c. Market conditions—interest rates, supply and demand, and other economic indicators
   d. Conditions of sale—motivational factors such as foreclosure or a sale between family members
   e. Market conditions since date of sale—changes in economic conditions between the date of the sale of the comparable property and the date of the appraisal
   f. Location—compensate for locational or neighborhood differences
   g. Physical features and amenities—physical differences between the comparable properties and the subject

3. A dollar value is assigned to each difference between the subject property and the comparable properties.

4. Adjustments are made as follows:

   a. If the comparable property is better than the subject property, or has a feature that the subject property lacks, the value of the comparable is decreased accordingly.
   b. If the comparable property is not as good as the subject property or lacks a feature that the subject property has, the value of the comparable is increased accordingly.
B. The cost approach (see Table 18.2)

1. Steps in the cost approach to value
   a. Estimate the value of the land as if it were vacant and available to be put to its highest and best use.
   b. Estimate the current cost of constructing the building(s).
   c. Estimate the amount of accrued depreciation resulting from physical deterioration, functional obsolescence, and external obsolescence.
   d. Deduct the accrued depreciation from the estimated construction cost of new building(s).
   e. Add the estimated land value to the depreciated cost of the building(s) and site improvements to arrive at the total property value

2. Reproduction cost versus replacement cost
   a. Reproduction cost—the current cost of a duplicate of the subject property, including both the benefits and the negative features of the property
   b. Replacement cost—the current cost of improvements with utility or function similar to the subject property

3. Determining reproduction or replacement cost new
   a. Square-foot method—based on the average cost-per-square-foot or cost-per-cubic-foot of recently built similar structures; also called the comparison method
   b. Unit-in-place method—replacement cost based on the construction cost per unit of the structure's components
   c. Quantity survey method—the cost of the raw materials plus the cost of the construction labor plus indirect costs
   d. Index method—a factor representing the percentage increase or decrease in construction costs to the present time is applied to the original cost of the improvements

4. Depreciation—loss in value of an improvement due to all cause
   a. Physical deterioration—normal wear and tear
      (1) Curable—repairs that are economically feasible
      (2) Incurable—repairs that are not economically feasible
   b. Functional obsolescence—outmoded items and poor design
(1) Curable—outdated physical or design features that could be replaced or redesigned economically
(2) Incurable—outdated physical or design features that could not be replaced or redesigned economically or physically

c. External obsolescence—incurable, because it is caused by a problem external to the property and, therefore, beyond the property owner's control

5. Depreciation is usually calculated on a straight-line basis (economic age-life method), the assumption being that depreciation occurs at an even rate over the structure's economic life.

6. Cost approach used for appraising newer or special-use buildings, such as schools, churches, and public buildings.

C. The income approach—based on the present value of the rights to future income (see Table 18.3)

1. Income divided by rate equals value
2. Steps in the income approach to value

   a. Estimate the annual potential gross income—income from all sources, including rent, concessions, and vending
   b. Deduct for vacancies and rent loss to obtain the effective gross income.
   c. Deduct the annual operating expenses to obtain the annual net operating income; does not include
      
      (1) Debt service (principal and interest payments)
      (2) Capital expenditures/capital improvements
   d. Estimate the price an investor would pay for the income produced by this particular type and class of property.
      
      (1) Compare the annual net operating incomes of recently sold similar properties to the sales price of those properties.
      (2) The annual net operating income divided by the sales price results in the capitalization ("cap") rate.
   e. Apply the capitalization rate to the subject property's annual net operating income to obtain an estimated value.

3. Gross rent multipliers and gross income multipliers—informal substitutes for income capitalization (see Table 18.4)
a. Gross rent multiplier (GRM)
   
   (1) Used for one-to-four residential units
   (2) Based on the gross monthly rent of recently sold similar properties
   (3) The sales price divided by the gross monthly rent results in the gross rent multiplier

b. Gross income multiplier (GIM)
   
   (1) Used for five or more residential unit properties and commercial properties
   (2) Based on the gross annual income (from all sources) of recently sold similar properties
   (3) The sales price divided by the gross annual income results in the gross income multiplier.

D. Reconciliation—obtaining the final value estimate by analyzing and weighing the findings from the three approaches

1. The three approaches to value usually produce three different indications of value.
2. All three should be used in estimating the final value.
3. The three indications of value are not averaged.
4. Depending on type of property, one approach would be given more weight than others.