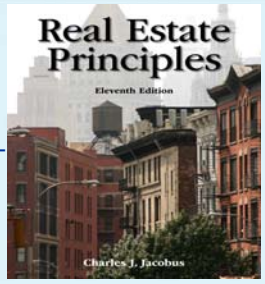
Chapter 18

Real Estate Appraisal



Purpose and Use of Appraisal

- Appraisal:
  - Set prices, to base loan values, set insurance premiums, set tax values
- Informal appraisal:
  - Estimate of value
- Formal appraisal:
  - Written statement of an impartial opinion of value based on analysis of relevant market information

Defining Value

- Fair Market Value (or just Market Value):
  the cash price that a willing buyer will pay to a willing seller given reasonable exposure of the property to the marketplace each with full information as to the potential uses of the property and neither under undue compulsion or hardship to act, no impediments as to title or terms.
- Nebraska common law definition:
  the price that someone ready to sell, but not required to do so, would be willing to accept in payment for the property, and that someone ready to buy, but not required to do so, would be willing to pay for the property.

Defining Value (b)

- Details of FMV:
  1) marketable title,
  2) elapsed time to close,
  3) motivation,
  4) informed sale/purchase,
  5) exposure to market,
  6) market terms,
  7) normal consideration (no special financing).

Valuation Process

- Step by step procedure refined by the Uniform Standards of Professional Appraisal Practice (USPAP)
  - Define problem
  - Conduct preliminary analysis/collect data
  - Estimate highest and best use
  - Estimate land value
  - Estimate improved property value
  - Reconcile results
  - Report conclusion

Value Approaches

Market Comparison	Comparable properties recently sold
Cost	Acquisition of land, build improvements
Income	Based on monetary return a property can generate

Market Comparison Approach

- Comps (usually 3 to 5)
- Sales records, where to find
- Adjustments
  - Market differences and time on market
  - Differences of amenities, physical features, terms
- **Adjusted market price** (of each property)
- Correlation process (assign weight to more similar property)

Market Comparison Sample

Line	Item	Comparable Sale A		Comparable Sale B		Comparable Sale C	
1	Address	1701 Brookside Ave.		1912 Brookside Ave.		1501 18th Street	
2	Sales price		$191,800		$188,000		$188,330
3	Time adjustment	sold 6 mos. ago, add 5%	+4,590	sold 3 mos. ago, add 2 ½%	+2,300	just sold	0
4	House size	160 sq ft larger at $60/sq ft	−9,600	20 sq ft smaller at $60/sq ft	+1,200	same size	0
5	Garage/carport	carport	+4,000	3-car garage	−2,000	2-car garage	0
6	Other	larger patio	−300	no patio	+900		
7	Age, upkeep, and overall quality of house	superior	−3,000	inferior	+800	equal	0
8	Landscaping	inferior	+2,000	equal	0	superior	−900
9	Lot size, features, and location	superior	−3,890	inferior	+900	equal	0
10	Terms & conditions of sale	equal	0	special financing	−1,300	equal	0
11	Total adjustments		−6,000		+2,500		−900
12	Adjusted Market Price		$185,600		$190,500		$187,430
13	Correlation process						
	Comparable A	$185,600 × 20% =		$ 37,120			
	Comparable B	$190,500 × 30% =		57,150			
	Comparable C	$187,400 × 50% =		93,700			
14	Indicated Value			$187,970			
		Round to		$188,000			

Cost Approach (1)

- Determine cost of land
  - Land is valued as vacant
  - Based on comparable market information

Cost Approach (2)

- Determine cost of building
  - Reproduction cost
    - Exact replica
    - Same or similar materials
  - Replacement cost
    - Today's prices and methods
    - Equivalent usefulness
    - Eliminates obsolete features
  - Square Foot Method
  - Cost Handbook

Cost Approach (3)

- Estimate depreciation
  - Physical Deterioration
    - Wear and tear
    - Acts of nature
  - Functional obsolescence
    - Outmoded/outdated
  - Economic obsolescence
    - External forces
    - Appreciation

Note: Depreciation may be expressed in other terms, "deterioration", "obsolescence" are two of many that may appear in tests and other texts.

Depreciation (cont)
A Loss in Value

- Actual Depreciation
  - Physical deterioration (curable & incurable)
  - Functional obsolescence (curable & incurable)
  - External or economic obsolescence (incurable only)
- Fictional Depreciation
  - IRS tax deduction

Cost Approach (4)

- Compute value of improvements
- Compute value of property

Cost of building
Less: depreciation
Plus: appreciation
Value of improvements

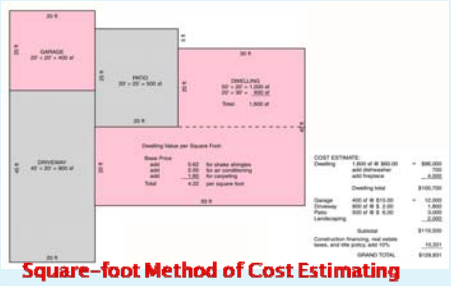
Add: value of Land

Value of Property

Cost Approach (review)

Step 1: Estimate land as vacant		$ 30,000
Step 2: Estimate new construction cost of similar building	$120,000	
Step 3: Less estimated depreciation	-12,000	
Step 4: Indicated value of building		$108,000
Step 5: Appraised property value by the cost approach		$138,000

Cost Approach
Square-foot Method



Square-foot Method of Cost Estimating

Income Approach Formula Variations

- Income ÷ Rate = Value
- Income ÷ Value = Rate
- Rate × Value = Income

Income Approach (1)

I ÷ R = V

Capitalization Rate

Income ($18,000)
Divided by
Rate (9%)
Equals
Value ($200,000)

Income Approach (2)

I ÷ R = V

Projected Income

- Projected or scheduled gross income
  - Obtained from review of Rent rolls based on full occupancy
- Deduct: vacancy and collection loss

Income Approach (3)

I ÷ R = V

- Operating Expenses
- Replacement Reserves
- Perform math for Net Operating Income (NOI)

- Consider past expense history
- Consider future expenses
- Do not add capital improvements (new amenities)
- Estimate annual amount to replace certain items

Income Approach (4)

I ÷ R = V

- Capitalizing Income
- Depreciation

- Perform I/R=V computations
- Consider mortgage expense
- Consider effect of depreciation and fictional depreciation (tax write-off)

Income Approach NOI

Scheduled gross annual income	$84,000	
Vacancy allowance and collection losses	4,200	
Effective gross income		$79,800
Operating expenses		
Property taxes	7,000	
Hazard and liability insurance	2,100	
Property management	4,200	
Janitorial services	1,500	
Gardener	1,200	
Utilities	3,940	
Trash pickup	850	
Repairs and maintenance	4,000	
Other	1,330	
Reserves for replacement		
Furniture & furnishings	1,200	
Stoves & refrigerators	600	
Furnace &/or air-conditioning	700	
Plumbing & electrical	800	
Roof	750	
Exterior painting	900	
Total operating expenses		$31,070
Net operating income		48,730

Operating expense ratio: $31,070 / $79,800 = 38.9%

Choice of Approaches
Market Approach

- Will produce values best for residential property
- Ideal when number of comparable properties sold
- New construction may not be represented by comps

Choice of Approaches
Cost Approach

- Used to value property without comps
- Used to value property without income streams
- Used to value property recently constructed or with "non-standard" construction

Choice of Approaches
Income Approach

- Properties used for investment purposes
- Apartment buildings, shopping centers, office buildings
- May be price per unit (apartment) or price per square foot
- May also determine if cheaper to build than buy

Reconciliation and Estimate

- Apply weight to each method as best fits the perceived market or the project
- Add the weighted values
- Arrive at Best Estimate or Opinion of Value
- NOTE: An appraisal does not take into consideration the seller's circumstances, or other subjective motivation. No guarantee of sale at appraised value nor guarantee of condition of property or future value. Not a loan guarantee (though may establish loan to value ratio), nor an Offer to purchase.

Reconciliation (example)

Market Approach	$180,000 x 75% = $135,000
Cost Approach	$200,000 x 20% = $ 40,000
Income Approach	$160,000 x 5% = $ 8,000
Final Indicated Value	$183,000

Types of Appraisals and Reporting Options Under USPAP

- Types of Appraisals
  - Complete appraisal
  - Limited appraisal
- Reporting Options
  - Self-contained appraisal report
  - Summary report
  - Restrictive report

Formats of Appraisal Reports

1. Letter report
2. Form report
3. Narrative report
4. Review appraisals
5. Real estate analysis

Appraiser License

- Certified General Appraiser
- Certified Residential Appraiser
- State licensed appraiser
- Provisional licensed real estate appraiser
- Appraiser trainee

Competitive Market Analysis

- Competitive Market Analysis (CMA)
  - Not an appraisal method
  - Agents use to list and sell residential property
  - In Nebraska agents may charge for service
- Select comparable homes
  - Recent Sales
  - On market, and Off market (note: these would not be included in formal appraisal)
- Buyer Appeal
- No objective adjustments only subjective

Competitive Market Analysis Worksheet

Competitive Market Analysis Gross Rent Multiplier

- Used like CMA for income producing property
- Divide Sales Price by Gross Rent of comparables equals GRM
- Multiply Gross Rent by GRM to arrive at market price of subject property
- GRM does not consider vacancies, expenses, and other expenses

Gross Rent Multiplier (continued)

Building	Sales Price	Gross Annual Rents	Gross Rent Multiplier
No.1	$245,000	÷ $34,900	= 7.02
No.2	$160,000	÷ $22,988	= 6.96
No.3	$204,000	÷ $29,352	= 6.95
No.4	$196,000	÷ $27,762	= 7.06
As a Group:	$805,000	$115,002	= 7.00

Principles of Value

- Principle of Anticipation
- Principle of Substitution
- Highest and best use of a property
- Principle of competition
- Principle of supply and demand
- Principle of change
- Principle of contribution
- Principle of conformity

Principles of Value

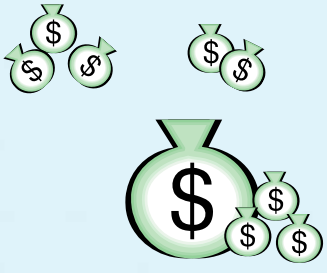
Anticipation	Price affected by expected future benefits
Substitution	Maximum price is cost of similar property
Highest and best use	The use that gives the greatest value (competition). Consideration of immediate future uses.
Supply and Demand	Large supply lower price, low demand, lower price
Diminishing returns and Contribution	Try to invest at $1 for $1 value

Characteristics of Value
DUST

Demand	Need or desire for good/service
Utility	Ability of good/service to fill need
Scarcity	Good/service must be in short supply
Transferability	Good/service must be available to market

What is "Value"

- Market value
- Assessed value
- Insurance value
- Loan value
- Estate tax value
- Plottage value
- Rental value
- Replacement value



Economic Markets

- Buyer's market – excess supply of housing for sale.
- Seller's market – demand exceeds supply.

Professional Societies

- The American Institute of Real Estate Appraisers (AIREA)
  - MAI
  - SRA
- Society of Real Estate Appraisers
- NATIONAL Association of Independent Fee Appraisers
- Farm Managers and Rural Appraisers
- National Society of Real Estate Appraisers
- American Society of Appraisers

Key Terms

- Appraisal
- Capitalize
- Comparables
- Cost approach
- Depreciation
- FIRREA
- Gross rent multiplier
- Highest and best use
- Income approach
- Market approach
- Market value
- Operating expenses
- Scheduled gross, Projected gross
- USPAP