Unit 16: Real Estate Appraisal

LECTURE OUTLINE

I. Appraising

A. Appraisal is an opinion of value based on supportable evidence and approved methods

1. Appraisal report provides detailed market information.
2. Appraiser is an independent professional who provides an unbiased opinion of value.
3. Appraising is a professional service performed for a fee, which must not be based on the value of the property appraised.
4. Appraiser Independence Requirements (AIR) were created by Fannie Mae.

B. Regulation of appraisal activities—Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires appraisals that are part of a federally related transaction to 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 $400,000 or less need not be performed by licensed or certified appraisers.
3. Fannie Mae will not require a new appraisal for a limited cash-out refinance.
4. Nonresidential properties valued above $500,000 require a certified appraiser.

C. Appraiser qualifications

1. Appraisal Qualifications Board (AQB) of the Appraisal Foundation sets state licensing and certification criteria for appraisers.
2. *Uniform Standards of Professional Appraisal Practice (USPAP)* has been created by Appraisal Foundation.
3. Appraisal Practices Board (APB) of the Appraisal Foundation provides guidance on valuation methods and techniques.

D. Organizations for appraisers

1. American Society of Appraisers
2. American Society of Farm Managers and Rural Appraisers, Inc.
3. Appraisal Institute

4. International Association of Assessing Officers
5. International Right of Way Association

E. Comparative market analysis (CMA)

1. Real estate licensees must be familiar with appraisal techniques to perform a comparative market analysis (CMA) when assisting a seller to set the listing price for a property.
2. CMA is based on recently sold properties, current listings, and expired listings.

F. Broker's price opinion is a less-expensive alternative for evaluating property that is 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 16.1)

A. Define the problem. What type of value is being sought?

B. Determine the scope of work.

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. Form opinion of value by each of the three approaches.

G. Reconcile values for the final opinion of value.

H. Report final opinion of value.

I. The Uniform Residential Appraisal Report (see Figure 16.2)

III. Value is monetary worth based on desirability

A. Characteristics of value (DUST)

1. Demand is the need or desire for possession or ownership backed by the financial means to satisfy that need
2. Utility is the usefulness of an item for its intended purpose
3. Scarcity refers to a finite or limited supply

4. Transferability indicates 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
    d. Not simply the average or highest price

2. Essential to determine market value

    a. The buyer and seller must be unrelated and acting without undue pressure.
    b. Both the buyer and the seller must be well informed of the property's use and potential, including its advantages and defects.
    c. A reasonable length of time must be allowed for the property to be exposed in the open market.
    d. Consideration is paid in cash or its equivalent.
    e. Price must represent a normal consideration, unaffected by special financing.

C. Market value versus market price

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

D. Market value versus cost

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

E. Basic principles of value are 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 that is

    a. Physically possible,
    b. Legally permitted,
    c. Economically or financially feasible, and
    d. Most profitable (maximally productive).

7. Increasing and diminishing returns—improvements to land and structures reach a point at which they no longer increase property value.

    a. Law of increasing returns applies when money spent on improvements produces an increase in income or value.
    b. Law of diminishing returns applies when additional improvements do not increase income or value.

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—the principle that value depends on:

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

IV. The Three Approaches to Value

A. The sales comparison approach (see Figure 16.3)

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 sale prices of the comparable properties are made include:

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

3. A dollar value is assigned to each adjustment (difference) between the subject property and a comparable property.

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 Figure 16.4)

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 buildings and improvements.
    c. Estimate the amount of accrued depreciation resulting from physical deterioration, external depreciation, and functional 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. Depreciation—loss in value of an improvement for any reason.

    a. Physical deterioration is normal wear and tear.

        (1) Curable—repairs that are economically feasible.
        (2) Incurable—repairs that are not economically feasible.

    b. Functional obsolescence results from outmoded items and poor design.

        (1) Curable if outdated physical or design features could be replaced or redesigned economically.
        (2) Incurable if outdated physical or design features could not be replaced or redesigned economically or physically.

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

2. 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.

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

C. The income approach is based on the present value of the rights to future income (see Figure 16.5)

1. Steps in the income approach to value:

    a. Estimate the annual potential gross income, which is 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

        i. Debt service (principal and interest payments)
        ii. Capital expenditures/capital improvements

d. Estimate the price an investor would pay for the income produced by this particular type and class of property.

i. Compare the annual net operating incomes of recently sold similar properties to the sales price of those properties.
ii. 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. Formula and its corollaries are:

income ÷ rate = value
income ÷ value = rate
value x rate = income

2. Gross rent multipliers and gross income multipliers are informal substitutes for income capitalization. (see Figure 16.6)

a. Gross rent multiplier (GRM)

i. Used for property with one-to-four residential units.
ii. Based on the gross monthly rent of recently sold similar properties.
iii. The sales price divided by the gross monthly rent results in the gross rent multiplier.

b. Gross income multiplier (GIM)

i. Used for residential properties of five or more units and commercial properties.
ii. Based on the gross annual income (from all sources) of recently sold similar properties.
iii. The sales price divided by the gross annual income results in the gross income multiplier.

D. Reconciliation—obtaining the final opinion of value 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 approaches used should be considered 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.