

17 Appraisal and Valuation

Property valuation may be considered the heart of all real estate activity. Only a practical understanding of real estate values will enable real estate brokers and salespersons to carry out their functions in a useful and dependable manner in serving their clients and in meeting their obligations to the general public.

Brokers and salespersons should have a good understanding of: the theoretical concepts of value; the forces which influence value; and the methods by which such value may be estimated most accurately.

Probably the question most frequently asked brokers by clients is, “How much do you think the property is worth?” It is a daily occurrence for the real estate broker to have clients ask about the fair price, fair rental, fair basis for trade, or a proper insurance coverage for property. A broker needs to know how to answer such questions correctly.

To be successful in business, an agent must determine whether time can profitably be spent in trying to sell property at a listing price set by the owner. The agent must keep in mind that in accepting a listing the agent is obligated to put forth best efforts to find a buyer for the property at that price. A seller’s unrealistic asking price is a roadblock that can be remedied by a knowledgeable salesperson capable of making a market analysis and using the three approaches to value. Such ability assists the seller to set the most appropriate listing price.

The real estate professional is cautioned, however, not to claim greater appraisal ability or expertise than is actually possessed. Great harm can come to the client and to the professional if significant appraisal mistakes are made. When unable to competently perform an appraisal request, the advice of a professional real estate appraiser should be sought. Licensed or certified appraisers are governed in their competency by the Competency Provision of the Code of Ethics of the Uniform Standards of Professional Appraisal Practice (USPAP), promulgated by the Appraisal Foundation.

THEORETICAL CONCEPTS OF VALUE AND DEFINITIONS

Definition of Appraisal

To appraise means the act or process of developing an opinion of value; an opinion of value. (USPAP, 2000 ed., pg. 10) It may be said that value is the present worth of all rights to future benefits, arising out of property ownership, to typical users or investors. An appraisal report is usually a written statement of the appraiser’s opinion of value of an adequately described parcel of property as of a specified date. It is a conclusion which results from the process of research and analysis of factual and relevant data.

Real estate appraising methods are being standardized by virtue of the experience and practice of qualified people in all parts of the country who encounter the same types of valuation problems, and who by various methods and processes succeed in solving them in an equitable manner. It is natural, however, that differences of opinion may exist as to the value of specific parcels of real estate and the means of estimating their value.

Property rights are measurable. Real estate as a tangible thing can be measured. It includes both land and improvements and exists independent of any desire for its

possession. To distinguish between its physical aspects and rights in and to real property, the latter are called *property interests* in real estate.

These interests - ownership in fee simple and other lesser interests - have been discussed in preceding chapters.

Property rights in real estate are normally appraised at Market Value. There are many definitions of Market Value, but a good working definition is the most probable price the property would bring if freely offered on the open market with both a willing buyer and a willing seller.

Rights in real property are referred to as “Bundle of Rights,” which infers: right to occupy and use; to sell in whole or in part; to bequeath (give away); and, to transfer by contract for a specific period of time (lease). It also implies the right not to take any of these actions.

These rights are limited by: the government’s power of taxation; eminent domain; police power (for safety, health and general welfare of the public, such as zoning, building codes); and, right of property to escheat (revert) to the state in the event the owner dies and leaves no heirs.

The rights in a property must be known by the appraiser before making a proper valuation, and the appraiser must also be able to distinguish between personal and real property. Market value is the object of most appraisal assignments, and appraisals mainly are concerned with fee simple estate valuation as opposed to partial interest value.

The widespread need for appraisals is apparent. Everyone uses real estate in one way or another and must pay for its use, which involves a decision about value. Practical decisions concerning value must be based upon some kind of an appraisal or evaluation of real property collateral.

The term evaluation has a special meaning and use for institutional lenders since passage of the Federal Institutions Reform, Recovery, and Enforcement Act (FIRREA). In reality, it is an appraisal, an estimate of value.

Although an appraisal may be transmitted orally, it is usually a written statement of an estimate of value and is referred to as an *appraisal report*.

Traditional Approaches to Value

Basically, there are three approaches to property valuation used by appraisers. Each gives a separate indication of value, yet the approaches are all interrelated and all use market comparison techniques. All three approaches are considered in each complete assignment. However, all three are not always employed, depending upon the property type and the process and report type agreed to by the client and the appraiser.

The approaches to value are: Sales Comparison (or Market Data) Approach; Cost Approach; and Income Capitalization Approach.

The Appraiser’s Role in the Real Estate Profession

The appraiser, by reason of professional training, experience, and ethics is responsible for furnishing clients with an objective third party opinion of value, arrived at without pressures or prejudices from the parties involved with the property, such as an owner or lender.

The appraiser has a heavy personal and professional responsibility to be correct and accurate in opinions of value. Otherwise, the appraiser's clients may easily suffer loss and the appraiser's professional reputation may also suffer.

There has been considerable controversy in recent years concerning the appraiser's potential for influencing declining neighborhoods and discrimination in housing. The main thrust of the controversy charges that appraisers have tended to view declining neighborhoods as reducing in value without regard for individual home upgrading and homogeneous neighborhoods as being more stable in value than mixed neighborhoods. It has been claimed that loan appraisals in these declining or mixed areas have been unduly pessimistic and conservative because of these purported appraiser attitudes. This supposed conservatism, it has been declared, leads to further decline because favorable loans are not made.

Appraisers respond that the professional appraiser will only consider the factors actually affecting value, and lenders' policies for granting loans are beyond the appraiser's control. Lenders reply that the appraiser's opinion of value is the main basis for the loan and prudent lending practices must be followed.

In the making of thousands of daily appraisal decisions, there is probably some truth on all sides.

A proper appraisal does not contribute to either problem mentioned above. An accurate appraisal, resulting from the competency of a skilled appraiser, will reflect only the forces affecting value.

True forces affecting value. It is necessary that appraisers be exceptionally sensitive to their roles in accurately assessing the true forces affecting value. In accomplishing this, the appraiser cannot allow the general neighborhood composite of ethnic, religious, or minority populations or the general condition of neighborhood improvement to detract from a clear and objective evaluation of the property appraised on its own merits.

It is also the appraiser's responsibility to keep the appraisals timely in a changing market.

It is no longer prudent to rely solely on past sales of comparable property. The appraiser must use all pertinent data and appraisal methods to insure the appraised value is, in fact, the closest estimate of the price the property would bring if freely offered on the open market.

World events of the late 70's resulted in interest rate and property appreciation spirals to historic highs, dramatic decline in construction, creative financing approaches to generate sales, and extraordinary levels of foreclosure and bankruptcy. Such times required exceptional appraiser sensitivity to the true market forces.

Occasionally appraisers have contributed to individual property problems by failing to understand or recognize contrary market trends.

The professional appraisal associations have responded with increased emphasis on education in current appraisal and financial techniques. The dynamics of such a volatile market require the appraiser to keep abreast of new techniques and market forces. Recognizing this, California statutes enforced by the Office Of Real Estate Appraisers (OREA) require continuing education for licensed and certified appraisers. Those requirements are set forth in the OREA portion at the end of this chapter.

Appraisal Report

An appraisal report sets forth the data, analysis and conclusions of the writer. When put in writing, it protects both appraiser and client. Reports vary in scope and length. The following information should be included and is more specifically outlined in Standards 1 and 2 of the USPAP:

- A **final value conclusion** is expressed in terms of dollars for the property which is being appraised.
- The **value conclusion** can be made for any date in the past, and, with some care, for any date in the future. The time of inspection of the physical improvements is generally taken as the date of value unless otherwise informed by either the property owner, owner's attorney, or a court of law. The date of the final writing and delivery of the report is the date of the appraisal, not to be confused with the date of value.
- **Adequate description of the property.** The street address, including city and state, as well as a complete legal description as set forth by the deed in the County Recorder's Office, should be shown, and the physical structures should be clearly described. The length of this description will depend upon the length and extent of the report.
- The **latitude of the reasonings** in determining the *value conclusion* will depend upon the type of report and the complexity of the appraisal problem.
- **Market data, and other factual data.** This includes information on the city and neighborhood which affects the *value conclusion*; information gathered on the site, improvements and the environment of the neighborhood which should be processed by means of one or more of the approaches to value; and, the preliminary estimate of value should be reconciled by means of logic and reasoning in order to arrive at one *value conclusion* for the property. Lengthy details are usually omitted in letter form reports, but appraiser retains the information as backup.
- **Signature and certification.** Appraisal reports must be signed by the writer and in most instances are preceded by a statement to the effect that the writer has no present or contemplated interest in the property. Requisites of an appraisal are set forth in the USPAP, which was adopted in 1989 by the major appraisal organizations.

Laymen's Terms for Appraisal Reports (USPAP Terminology)

Letter form report. This type of report is generally used when the client is familiar with the area, and supporting data are not necessary. It consists of a brief description of the property, the type of value sought, the purpose served by the appraisal, the date of value, the value conclusion and the signature of the appraiser. This is known as a Restricted Use Report and is governed by Section 2.2(c) of the USPAP. Specific language is required to put readers on notice that this report type is for a single user for his/her single purpose.

Short form report. This type of report is normally used by lending institutions, such as banks, insurance companies, saving and loan associations, and governmental agencies. Generally, it consists of simple check sheets or spaces to be filled in by the appraiser. The report varies from two to eight pages in length and includes the pertinent data about the property, with photos, maps, plats and sketches. Today these types of reports are classified as Summary Reports and are governed by Section 2.2(b) of USPAP. This

category of report can also be a narrative format, but the data presented will be generally in a summary format with more information than a restricted report.

Narrative report. This type of report can be a complete document including all pertinent information about the area and the subject property as well as the reasons and computations for the *value conclusion*. It includes: maps, photographs, charts and plot plans. It is written for court cases and out-of-town clients who need all of the factual data. It gives the comprehensive reasoning of the *appraiser* as well as the *value conclusions*. These reports are classified as Self-Contained Reports. They are governed by Section 2.2(a) of USPAP.

Any of these report types could be done on a form or in a narrative format. The contents and the depth of discussion, not the format, define the report type in USPAP terms.

Purposes and Uses of Appraisals

The basic purpose of an appraisal is to estimate a particular value, i.e., market value, check for support of sales price, loan value, investment value, etc. Some of the uses for requiring the estimate of value are:

Transfer of ownership of property.

- An appraisal assists buyers and sellers in arriving at a fair and equitable sales price. An appraisal of physical property may also include an opinion of its age, remaining life, quality or authenticity.
- The listing agent needs an estimate of value of the property before accepting a listing from the owner. If the agent can show by means of an appraisal the appraised fair market value of the property, and obtain a listing at that figure, a sale more likely will result. The real estate practitioner should be prepared to demonstrate a knowledge of both comparative and economic values.
- Where a trade is involved, appraisals tend to assist in clarifying the opinions of value formed by both parties to the trade.
- Valuations are necessary for the distribution of estate properties among heirs.

Financing and credit.

- The lender has an appraisal made of the value of the property to be pledged as security for a mortgage loan.
- Measuring economic soundness of real estate projects involves feasibility studies in relation to financing and credit.

Appraisal for taxation purposes.

- Appraisals are needed by governmental bodies to establish the proper relationship between land and improvements for real estate taxes (ad valorem taxation).
- Properties subject to estate taxes must be evaluated for the purpose of levying federal and state taxes.
- Appraisals of income-producing properties are necessary to property owners for the basis of depreciation. Normally, only improvements can be depreciated, not the land. An allocation of the market value between land and improvements is a requisite for accounting and taxation purposes.

Condemnation actions.

- With the right of eminent domain being vested in governmental agencies, it is important that properties under condemnation be evaluated at market value to

properly estimate purchase price, benefits, and damages to the property being affected.

Insurance Purposes.

- Appraisals are based principally upon the cost of replacement. This is important for the purpose of insuring properties for fire insurance.
- Appraisals are useful in setting claims arising from insurance contracts after a property has been destroyed.

Miscellaneous reasons for appraisals.

- Catastrophic damage. Establishing fair market value of property before and immediately after the damage.
- Fair rental value for negotiation of leases.
- Appraisals for inheritance and gift tax purposes.
- Fraud cases.
- Damage cases.
- Division-of-estate cases. A distribution of property under the terms of a will, in divorce proceedings, or between rival claimants, frequently requires that the value of the property involved be determined by appraisal.

PRINCIPLES OF VALUATION

A knowledge of basic assumptions, postulates or premises that underlie appraisal methods is essential to an understanding of the purpose, methods and procedures of valuation. The following principles of value influences are the more important for a general understanding of the appraisal process.

Principle of conformity. Holds that maximum value is realized when land uses are compatible and a reasonable degree of architectural harmony is present. Zoning ordinances help set conformity standards.

Principle of change. Real property is in a constant state of flux and change, affecting individual properties, neighborhoods and cities. The appraiser follows trends and influences and is sensitive to changes in conditions that affect the value of real estate. Economic, environmental, government, and social forces affect all markets, especially real estate.

Principle of substitution. This principle is the basis of the appraisal process. Simply stated, value will tend to be set by the cost of acquiring an equally desirable substitute. The value of a property to its owner cannot ordinarily exceed the value in the market to persons generally, when it can be substituted without undue expense or serious delay. In a free market, the buyer can be expected to pay no more, and a seller can expect to receive no less, than the price of an equivalent substitute.

A property owner states that owner's house is worth \$95,000. Buyers in the market can obtain a substitute property with the same features and utility for only \$90,000. The seller's house, therefore, has a value of approximately \$90,000, not \$95,000.

Principle of supply and demand. Holds that price varies directly, but not necessarily proportionately, with demand, and inversely, but not necessarily proportionately, with supply. Increasing supply or decreasing demand tends to reduce price in the market. The opposite is also true.

Principle of highest and best use. The best use of a parcel of land, known as its highest, best and most profitable use, is that which will most likely produce the greatest net return to the land over a given period of time. This net return is realized in terms of money or other amenities.

The application of this principle is flexible. It reflects the appraiser's opinion of the best use for the property as of the date of his appraisal. At one period of time, the highest and best use of a parcel of land in a downtown business district might be for the development of an office building; at another time, a parking lot may be the highest and best use.

A single-family house on a commercial lot may not be the highest and best use for the site. A four-unit apartment on multiple zoned land suitable for 30 units is probably not the long-term highest and best use of the land.

It is also useful to understand that highest and best use may not be only economic or profit-making in character. Environmental, aesthetic, and historical considerations are increasingly important in governmental views of highest and best use.

The Appraisal Institute, at Page 244 of the 10th Edition of *The Appraisal of Real Estate*, offers this definition for highest and best use:

“The reasonably probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value.”

The first reference in the definition applies to vacant land while the second applies to improved properties. This indicates that there may be two highest and best uses, one with the site vacant and the other as improved. These must be reconciled into a final highest and best use determination for the property being appraised.

Determining highest and best use includes assessing potential buyers' motives, the existing use of the property, potential benefits of ownership, the market's behavior, community or environmental factors, and special conditions or situations which come to bear on appraisal conclusions of value.

Principle of progression. The worth of a lesser-valued object tends to be enhanced by association with many similar objects of greater value (inadequacy or under-improvement).

Principle of regression. The worth of a greater-valued object is reduced by association with many lesser-valued objects of the same type (super adequacy or over-improvement).

Principle of contribution. A component part of a property is valued in proportion to its contribution to the value of the whole property or by how much that part's absence detracts from the value of the whole. Maximum values are achieved when the improvements on a site produce the highest (net) return, commensurate with the investment.

Principle of anticipation. Value is created by anticipated future benefits to be derived from the property. In the Fair Market Value Analysis, appraisers estimate the present worth of future benefits. This is the basis for the income approach to value. Simply stated, the income approach is the analysis of the present worth of projected future net income and anticipated future resale value. Historical data are relevant because they aid in the interpretation of future benefits.

Principle of competition. Competition is created where substantial profits are being made. If there is a profitable demand for residential construction, competition among builders will become very apparent. This could lead to an increase in supply in relation to the demand, resulting in lower selling prices and unprofitable competition, leading to renewed decline in supply.

Principle of balance. Value is created and sustained when contrasting, opposing, or interacting elements are in equilibrium, or balance. Proper mix of varying land uses creates value. Imbalance is created by an *over-improvement* or an *under-improvement*. Balance is created by developing the site to its highest and best use.

Principle of four-stage life cycle. In due course, all material things go through the process of wearing or wasting away and eventually disintegrating. All property is characterized by four distinct stages: *growth, stability, decline, and revitalization*.

Single properties, districts, neighborhoods, etc., tend generally to follow this pattern of growth and decline. It is also evident this process is frequently reversed as neighborhoods and individual properties in older residential areas are renewed and restored.

Revitalization and modernization in inner-city older neighborhoods may result from organized government programs or as a result of changing preferences of individual buyers. Most neighborhoods remain in the mature or stable stage for many years, with decline being hardly noticeable as renewal becomes essentially an ongoing process.

BASIC VALUATION DEFINITIONS

Value Designations

There are many different designations or definitions of value. They may be divided into the following two main classifications:

Utility value, which is value directed toward a particular use. This frequently is termed *subjective* value and includes valuation of amenities which attach to a property or a determination of value for a specified purpose or for a specific person.

Market value, which represents the amount in money (cash or the equivalent) for which a property can be sold or exchanged in prevailing market conditions at a given time or place as a result of market balancing. It may be based on a “willing buyer” and “willing seller” concept. This is frequently termed the *objective* value, since it is not subject to restrictions of a given project.

Appraisers carefully define the value being sought. Types of values are Liquidation Value, Insurable Value, Investment Value and, of course, Assessed Value (for taxation).

The real estate market sometimes places great importance on real estate financing terms. Market Value might be estimated for specific financing arrangements: seller carry-back, balloon payments, renegotiable mortgages or other “creative” financing techniques.

Market Value Defined

In appraisal practice, the term Market Value is defined by agencies that regulate federal financial institutions in the U.S. That definition is the one found in USPAP and is given as:

“The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.”

Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

- buyer and seller are motivated;
- buyer and seller are well informed or well advised and acting in what they consider their best interest;
- a reasonable time is allowed for exposure in the open market;
- payment is made in terms of cash in United States dollars or terms of financial arrangements comparable thereto; and
- the price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

(Source: *Uniform Standards of Professional Appraisal Practice*, Appraisal Foundation, 2000 Edition, page 160.)

Legal Definition

The legal definition of Fair Market Value under California law is found in the Code of Civil Procedure, Section 1263.320, as follows:

“The fair market value of the property is the highest price on the date of valuation that would be agreed to by a seller, being willing to sell but under no particular or urgent necessity for so doing, nor obliged to sell, and a buyer, being ready, willing, and able to buy but under no particular necessity for so doing, each dealing with the other with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available.”

Value vs. Price

When reference is made to the value of a property, generally fair market value is meant. Market price is what one might get from the sale of the property in terms of money. Sometimes value and price are the same, most particularly when there is no compulsion to buy or sell. Under other circumstances, there might be a wide difference between the market value of a property and the actual sale price. The appraiser must be careful to consider normal buyers and sellers attitudes for the type of property appraised. The appraiser is estimating actual market value not theoretical value.

The immobility of real estate makes it unique. Theoretically, there are no two parcels exactly alike and therefore no means of making a total comparison between properties. Circumstances of one buyer and one seller affect the sale price of a specific property, whereas the actions of many buyers and sellers of similar type properties determine the going rate for the sale or exchange of property on the open market.

Among the various types of value that have been designated from time to time are book value, tax value, market value, cash value, capital value, speculative value, par value, true value, exchange value, reproduction value, physical value, replacement value, insurance value, investment value, rental value, face value, depreciated value, leasehold value, sound value, sales value and cost value.

The real estate broker should be concerned mostly with the concept of Fair Market Value, or simply market value, for this is the basis upon which most property is generally bought and sold.

Value vs. Cost

Value can be distinguished from “cost” as well as from “price,” for neither is necessarily synonymous with value. The principal differences may be explained as follows:

Value has to do with the combined factors of present and future anticipated enjoyment or profit. The value sought in the appraisal of property may be said to be the discounted present worth of all desirable things (benefits) which may accrue from a skillful use of it. A conclusion in regard to these things will clearly be a matter of opinion: an intelligent estimate based on a thorough analysis of all available influencing factors and on reasonable and more or less warranted assumptions.

Cost represents a measure of past (or prospective) expenditures in money, labor, material or sacrifices of some nature in acquiring or producing the commodity. While cost may be, and frequently is, a factor upon which value is partially based, it need not be, as it does not control present and future value. An example of this fact is the value of an apartment property as compared with an oil well (assuming that the building and drilling costs were the same). The oil well may prove to be a big producer and of great value, or it may prove to be a dry hole and of no value. An apartment building might be costly to build but have little value because of its bad location and high vacancy factor.

Price is what one pays for a commodity, regardless of pressure motives or intelligence of the seller or buyer. Usually it is considered to be the amount of money involved in a transaction. Whether we receive in value more or less than what we pay for will depend on the soundness of judgment in the analysis or appraisal of value. Under an efficient market structure, price will usually tend to equal value, varying only as buyers and sellers have unequal knowledge, negotiating skills, or economic strength. Some factors influencing market price (as distinguished from value) are favorable financing, distress sale, forced purchase, uninformed purchaser or seller, misrepresentation of facts by the seller and high pressure sales practices.

Appraisers carefully distinguish between market value, cost and price in refining their appraisal conclusions.

Purposes and Characteristics of Value

The purpose of a valuation or an appraisal is usually indicated in the value concept employed, for example: market value, assessed value, condemnation value, liquidation value, cash value, mortgage loan value, fire insurance value, etc. The purpose of an appraisal frequently dictates the valuation method employed and influences the resulting estimate of value.

Intended use. The intended use of the report has become distinct from the purpose of the appraisal. This relates to how the process has been separated from the writing of the report (Standard 1 vs. Standard 2 in USPAP). The purpose of the appraisal may be, for instance, to help in settling an estate. The intended use of the report may be to communicate the value findings to heirs only, or may include attorneys and/or taxing authorities. The purpose helps to define how the appraisal process will be laid out. The intended use will help to determine which report type is most appropriate for communicating the results of the process.

Four elements of value. There are only four elements of value, all of which are essential. These are utility, scarcity, demand (together with financial ability to purchase), and transferability. None alone will create value.

For example, a thing may be scarce but, if it has no utility, there is no demand for it. Other things, like air, may have utility and may be in great demand, but are so abundant as to have no commercial value. *Utility* is the capacity of a commodity to satisfy a need or desire. To have utility value, real estate should have the ability to provide shelter, income, amenities or whatever use is being sought. Functional utility is an important test for determining value. Likewise, the commodity must be transferable as to use or title to be marketable.

Generally speaking, a commodity will have commercial or marketable value in proportion to its utility and relative scarcity. Scarcity is the present or anticipated supply of a product in relation to the demand for it. Utility creates demand, but demand, to be effective, must be implemented by purchasing power. Otherwise, a person desiring a product cannot acquire it.

Fundamental to the concept of value is the “highest and best use” principle, discussed earlier in this chapter. Location is a most important factor in determining highest and best use. Any analysis to reach a decision as to the “highest and best use” must include consideration as to the future supply and demand for such use within the area and a possible oversupply or undersupply with attendant effect on market demand and value.

FORCES INFLUENCING VALUE

The value of real estate is created, maintained, modified and destroyed by the interplay of the following four great forces:

Environmental and physical characteristics. Examples of physical characteristics include: quality of conveniences; availability of schools, shopping, public transportation, churches; similarity of land used; and types of physical hazards. Environmental considerations include climate, soil and topography, barriers to future development (oceans, mountains, etc.), transportation systems, and access to other areas/regions.

Social ideals and standards. Examples of social forces include: population growth and decline; age, marriage, birth, divorce and death rates; and attitudes toward education, recreation, and other instincts and yearnings of mankind.

Economic influences. Examples of economic forces are: natural resources; industrial and commercial trends; employment trends; wage levels; availability of money and credit; interest rates; price levels; tax loads; regional and community present economic base; new development trends; and rental and price patterns.

Political or government regulations. Examples of political forces include: building codes; zoning laws; public health measures; fire regulations; rent controls; environmental legislation controlling types of new development; fiscal policies; monetary policies; government guaranteed loans; government housing; and credit controls.

Each and every one of these many physical, social, economic and political factors affect cost, price, and value to some degree. The four forces interweave and each one is in a constant state of change.

Factors Influencing Value

Directional growth. In any estimate of value, attention should be given to “the city directional growth” as well as to “Urban Renewal Plans.” The city directional growth refers to the manner and direction in which the city tends to expand.

Properties in the direction of growth or renewal in different sections of the city tend to increase in value, especially if the growth or renewal is steady and rapid.

Location. Location is an exceptionally important value factor because location influences demand for the property. Location must not be described too generally, and is an effective value factor only when it is specifically related to highest and best use. Brokers often claim, “The three most important characteristics for any property are location, location and location.”

Utility. Utility includes the capacity to produce. This important factor involves judgment as to the best use to which a given property may be put. Building restrictions and zoning ordinances affect utility.

Size. The width and depth of a parcel of land will often determine the possibilities and character of its use.

Corner influence. Corner sites sometimes have higher unit value than a site fronting on one street only. Disadvantages include loss of privacy, higher cost as off-site improvements cost more and lot maintenance is more expensive, and setbacks may require a smaller size house. Commercial properties benefit from corner sites because of easy access and added exposure.

Shape. Parcels of land of irregular shape generally cannot be developed as advantageously as rectangular lots.

Thoroughfare conditions. The width of streets, traffic congestion, and condition of pavement have an effect on the value of frontage properties and to a lesser degree on other properties in the neighborhood.

Exposure. The south and west sides of business streets are usually preferred by merchants because pedestrians seek the shady side of the street on warm afternoons and merchandise displayed in the windows is not damaged by the sun. This traditional view in older commercial districts is somewhat offset by new architectural concepts (e.g., shopping malls), parking and convenience.

Character of business climate. Larger cities develop residential, shopping, financial, wholesale, and industrial districts.

Plottage or assemblage. An added increment of value when several parcels of land are combined under one ownership to produce greater utility than when the parcels are under separate ownership.

In highly urbanized multiple residential and commercial areas plottage, or assemblage, makes it possible to gain that higher utility. An example of this would be a density bonus for the combining of residential lots. This principle may also apply to light industrial areas.

Topography and character of soil. The bearing qualities of the soil may affect construction costs. Extensive foundations are usually necessary in soft earth. The type

and condition of the topsoil affect the growth of grass, plants, shrubs and trees. Value may also be influenced by land contour and grades, drainage and view points.

Obsolescence. Caused by external or economic changes which decrease the functional utility of a property, or by physical deterioration of the property.

Changes in types and methods of construction, style of architecture, or interior arrangements for specific purposes may render a particular building out of date. Changes in the uses of neighboring property may also contribute to the obsolescence of a building. Careful appraisal will include the potential for remodeling, refurbishing or other method to restore value.

Building restrictions and zones. These sometimes operate to depress values and at other times to increase values.

For example, there may be a vacant lot on a residential street which will sell for only \$150 a front foot for single family residential use but would sell for \$600 per front foot as an apartment site. Or a vacant lot in a zoned area may sell for more per front foot as a business site because of the supply of business sites being restricted by zoning.

Additional Factors Important for Residential Property

When appraising residential property, it is customary to make a direct comparison between the property being appraised (subject property) and comparable properties in the area which have sold recently. This is the market data or “sales comparison approach” method based upon the economic principle of substitution (i.e., the value of a particular property will not generally exceed the cost to purchase a similar, or substitute property which is equally desirable and available).

Gross rent multiplier. An appraiser may also use a technique known as Gross Rent Multiplier (GRM) by comparing actual rentals and sales prices of properties comparable to the subject to get another indication of value by multiplying the monthly rent by an appropriate GRM. If a comparable property rents for \$700 a month and sells for \$84,000, which is 120 times the gross monthly rental ($\$84,000 \div \$700 = 120$), the indicated GRM applicable to the subject property is 120.

GRM applies only to *rental* income. When part of a property’s income comes from *non-rental sources*, an appraiser will use a similar gross income multiplier (GIM).

Square foot method. In making a preliminary estimate of the value of residential property, it is usual to evaluate the lot and the present value of the building. In California, an estimate of the cost of replacing a building is usually made by the square foot method. The square foot method requires measuring the building and dividing it into rectangles. Multiplying the length by the width of each rectangle will produce the square footage of that segment. The total square footage of the residence is obtained by adding together the square footage of all rectangular segments. The sum obtained thereby is multiplied by an appropriate construction cost per square foot, depending upon the type of construction involved. The result is known as the replacement cost of the residence. Depreciation is then taken from the replacement cost to give the present value of the improvements. The present value added to the land value represents an indication of the value of the subject property. In analyzing depreciation, special attention should be paid to the condition of the building, the exterior finish and roof, the interior fixtures, plans and workmanship, interior decoration, plumbing, heating, and electric fixtures, etc. Particular attention should be given to the inspection of the

foundation and the underpinnings of the house in connection with possible termite infestation and soil problems such as subsidence or expansion.

Multi-family dwellings. Trends and standards for residential dwellings vary in the markets, especially for multi-family structures. Appraisers must consider: the layout; adequacy of size; conveniences; safety features and comfort; adaptability for intended use; and cost and ease of maintenance.

Additional Factors Important for Commercial Property

Commercial property is real property acquired for investment. Commercial structures are of many types, sheltering such businesses as shopping centers, banks, service establishments, restaurants, parking lots, retail stores and office buildings. A downtown, regional, or community commercial district is usually clearly defined and located on major streets. Store rentals and business leases are generally based on square footage of rentable area. In many localities the tenant pays, in addition to rent, all property expenses/charges such as taxes, insurance, maintenance, and assessments. Such a lease is a “net” (or, in some communities, a “net, net, net”) lease.

Front footage valuations are still applicable in many downtown areas or location. In appraising such property, care must be used to properly evaluate such things as floor plans, utility, relationship of site area to improvements, obsolescence, parking accommodations, ratios of net rentable areas to gross area. Efficiency, safety, structural and design features are also very important, as are energy standards and efficiencies.

Additional Factors Important for Industrial Property

Industrial lands are usually valued in terms of gross buildable area, either by square foot or by acre (e.g., 30 cents a square foot; \$13,000 an acre). One of the reasons for valuing industrial land in terms of area is that the parcel is generally all usable. Indeed, optimum efficiency of site, buildings and equipment are vital to the successful operation of industrial properties.

Industrial buildings are generally constructed of concrete or steel, including prefabrications, or tilt-ups. Industrial parks (groups of industrial buildings having similar uses) have grown in importance. These require plenty of parking space, storage facilities, excellent operating layouts, management services, and even room to expand. These properties are frequently designed and equipped to meet needs of specific occupants.

Topography. The topography of undeveloped land is of importance, and consideration should be given to the cost of grading, if required.

Subsoil. The character of the subsoil is frequently overlooked, and yet may be vital. Quicksand, rock, or other detriments may make a certain site unsuitable for a given industry. Drainage may also be an important factor.

Plottage value. There is an added increment of value known as plottage which is gained from combining land parcels in an urban area into a reasonably sized industrial site.

Tract layouts. In the study and valuation of unimproved but potentially valuable industrial lands, it is often necessary to have the assistance of a competent engineer who is familiar with plant and tract layouts.

Additional Factors Important for Agricultural or Farm Lands

Present trends show larger and fewer farms, fewer farm buildings per acre, and fewer family-style operations. The type of buildings an appraiser usually finds on agricultural lands include residences, machine sheds, poultry sheds, multifunctional barns, silos, and various animal shelters. According to some experts in the field, farm buildings contribute less than 20% of the total property value.

One important factor in estimating the value of agricultural land is the nature and long-term trend of costs and prices for the crop grown or intended to be grown. For example, if the property is to be used as a dairy farm the appraiser must consider: whether the soil is suitable for hay and grain; water supply for the cattle and crops; proximity to markets; climatic conditions; labor conditions, etc.

Farm land valuation is highly specialized and often requires the assistance of soil and crop experts and appraisal specialists to evaluate irrigation systems and other equipment and machinery.

ECONOMIC TRENDS AFFECTING REAL ESTATE VALUE

Regional, National and Global Economics

Property values increase, decrease, or remain stable based on the interaction of the four forces influencing value. Appraisers must examine and evaluate these forces.

Economic trends and forces at higher levels (regional, national and international) affect property values at the local level. The real estate appraiser must recognize that the general pattern of statistical analysis that guides in interpreting value influences on a national level should be used in the general analysis of state and regional forces which in turn influence local property values.

An appraiser should follow national and regional economic trends, changes in national income levels, international developments and government financing policies because the greater the severity and duration of any economic swing, the wider and deeper is its influence. Conditions to be observed include: gross national product; balance of payments to other countries; national income levels; employment; price level indexes; interest rates; fiscal and monetary policies; building starts; and credit availability.

Factors Influencing City Growth and Development

An appraiser is constantly concerned with the conditions and prospects of the local economy because the value of local real estate is largely determined by the health of the community, as measured by household purchasing power, population changes, employment diversification and stability, wage and price levels, and area growth potential, including environmental conditions.

Cities are classified generally by the functions that stimulate and determine their potential and growth. These classifications are:

Commercial. Primary source of revenue stems from commercial enterprises. These are usually farming cities, cities located at railroad terminals or on ocean ports.

Industrial. Primary source of revenue is derived from manufacturing and processing of commodities.

Extractive industry. Primary source of revenue comes from natural resources, e.g., mining, fishing and lumber.

Political. Primary source of revenue is government employment.

Recreation and health. Primary source of revenue comes from tourist trade, vacation and health resorts.

Education. The anchor point of these cities is a college or university.

Population Trends

Because of the direct relationship existing between the value of real property and population growth, the appraiser should be concerned with population trends and other demographic factors affecting local population, such as: opportunities for employment; quality of local government; civic and social conditions; demand for goods and services; transportation and living conditions; and, opportunities for education and personal improvement.

Neighborhood Analysis

A neighborhood may be defined as a group of similar land uses which are similarly affected by the operation of the four forces influencing value: utility, scarcity, demand(desire) and effective purchasing power. A common definition for a neighborhood is a grouping together of individuals within the community for similar purposes and interests, whether the reasons be commercial, industrial, residential, cultural or civic. The life cycle of a neighborhood includes growth in desirability, peak desirability, stability for a time, then deterioration. The cycle then tends to turn again as the neighborhood becomes more desirable due to change in use or renewal.

Neighborhood analysis is important because the neighborhood is the setting for the property to be appraised and the property has value, to a large extent, as it contributes to or detracts from the neighborhood.

A neighborhood tends to be a somewhat self-contained community, frequently defined by physical boundaries such as hills, freeways, or major streets and usually with some sense of community. In urban areas, the neighborhood tends to become somewhat blurred due to modern transportation and area-wide cultural, educational, recreational, and commercial services. In analyzing the “neighborhood” of the parcel to be appraised, a good starting point is to ascertain the community identity and boundaries.

After defining, even in vague terms, this community identity, an appraiser will look to common services and features, such as local shopping, street patterns, zoning boundaries, and cultural, religious, educational and recreational services. In short, an appraiser searches the local area by observation and through government and public utility investigation to find the factors most affecting use and value patterns in the area.

Neighborhood analysis also tends to define the best search area for comparable market data. As the appraisal progresses, the appraiser may extend or contract this search area.

Some sources of neighborhood data:

- U.S. Census tract maps and data (local library or vendors).
- City and county population demographics (planning departments).
- City, county, and state street and highway systems (city, county and state road/engineering/highway departments).
- Local zoning and general planning, including community plans (planning departments).

- School locations, capacities, policies (local school districts).
- Public utility services: water, sewer, natural gas, electric power, telephone (local public utility companies and government agencies).
- City and county economic statistics (local chambers of commerce).
- Local tax information (county tax assessor).
- If pertinent, private wells and septic laws (local health departments); national forest/park laws (local forestry and park dept.), etc.

SITE ANALYSIS AND VALUATION

Although the location of the neighborhood and city must be weighed in analysis and valuation of a particular site, the location of the site itself, in relation to the neighborhood, is a very important factor.

Since sites in a neighborhood are not usually uniform in size, shape and other physical and economic characteristics, some are superior to others. It is important that the site be analyzed separately and evaluated in conformity with the principle of highest and best use.

Other reasons to separate the land from the value of an entire property, along with important factors contributing to site value, are discussed on the following pages.

Legal Data of Site Analysis

Legal description.

- An appraiser must determine the legal property description as set forth by a deed or official record.
- The proper legal description to locates the property physically within the neighborhood.

Taxes.

- A comparison is made between the subject and similar properties to ascertain if the property being appraised has been fairly assessed (assessed value, tax rate and tax total). This comparison of properties is not as useful since the adoption of Proposition 13.
- The extent of the tax burden will have a bearing upon the desirability of the property, particularly when taxes are out of proportion to income.

Zoning and General Plan.

- Copies of the latest zoning ordinances and general plan should be studied to inform the appraiser as to the present usages to which the land may be developed. Sometimes the highest and best use of land is limited by zoning restrictions.
- Proposed or contemplated changes in the existing ordinances should be determined, since this could have a bearing upon the valuation of the property. However, zoning by itself does not create value unless there is a demand for the land so zoned.

Restrictions and easements.

- Public and private restrictions and easements affecting the land must be discovered.
- The restrictions and the types of easements on the property have a direct bearing upon the use and value of the site being appraised.

Determination of existence of other interests in property.

- Life estates.
- Leases.
- These partial interests divide property values among the parties involved. This does not mean a mathematical division, but rather a division of the bundle of rights.

Physical Factors Involving the Site

The physical features of the site should be compared with typical lots in the neighborhood.

Lot values will generally tend to cluster around a “site value,”... the price generally accorded a single, usable, typically-sized parcel of land in the area. Lots larger or smaller will tend to increase or decrease when compared to this usual “site value.” A good view will also tend to increase lot value. The effect of topography (drainage, low spots, rock, etc.) can frequently be measured by the cost to cure the problem to make the site usable.

Shape of a lot.

- The utility of the lot is the governing factor in irregular or odd-shaped lots.
- The total area of the lot is not the most important factor. A 50' x 150' lot containing 7,500 square feet is more valuable than a 25' x 300' lot (also 7,500 sq. ft.) because of utility.
- Irregular-shaped lots are frequently valued in terms of total site value expressed in dollars rather than in terms of unit values of price per square foot or frontage foot.

Topography and soil conditions.

- The topography and the type of soil can have an adverse effect upon the site value if it makes building costs higher.

Corner influence.

- In today's market, it has generally been found that corner single-family lots are not valued appreciably more than inside lots.
- Corner lots provide better light and more convenient access.
- On the other hand, corner lots result in more traffic noise and trespassing and, if applicable, greater special assessments for streets and lighting.

Relation of site to surroundings.

- The site must be studied in its relationship to streets, alleys, transportation, and stores.
- Does the homesite abut commercial or multi-residential uses?
- Is it a key lot looking upon other back yards?
- If a corner lot, does a bus line stop at the corner?

Availability of public utilities.**Title encumbrances and encroachments.****Landscaping and underground utilities.**

Methods of Site Valuation

A. Sales or market data comparison.

1. Sales and listings (data) of vacant sites are obtained and compared with the property being valued.
2. The data should be of comparable properties, including the same zoning and in the same or similar neighborhood. Since people make value, the data gathered should be from areas where the purchasing power or income levels are the same as the subject property.
3. The sales prices should be investigated to determine whether the price paid was the result of a true open market transaction reflecting fair market value. Listings may also be considered.
4. Some sources of comparable market data are:
 - a. Title insurance company records.
 - b. Tax assessor's records.
 - c. Recorder's office.
 - d. Multiple listing files.
 - e. Financial news.
 - f. Appraiser's personal files.
5. The verified market transactions should be compared with the subject parcel as to:
 - a. Time.
 - (1) Determine if prices have gone up, down, or remained stable from the time of each sale to the date of value.
 - (2) A percentage factor or a dollar amount may be applied to the comparable sales in order to arrive at an adjusted price due to the time factor.
 - b. Location.
 - (1) Determine if the location of each comparable property is superior, equal or inferior to that of the subject property.
 - (2) A percentage factor or dollar amount may be applied to the data in order to adjust for the difference in location.
 - c. Characteristics of the lots.
 - (1) The size, depth, and topography of the other properties are compared with the property being valued.
 - (2) A percentage factor or dollar amount is determined for these characteristics and applied to the comparable properties to adjust their prices towards the property being appraised.
 - d. The adjusted prices of the comparable properties are then compared and analyzed in order to arrive at an estimate of value for the property under study.

Example. Using only 3 lot sales (the minimum) as a demonstration.

<i>Sale No.</i>	<i>Price</i>	<i>Date</i>	<i>Size (feet)</i>	<i>Square Feet</i>
1	\$5,000	October, 1995	50 x 120	6,000
2	\$4,750	March, 1996	40 x 130	5,200
3	\$5,500	June, 1996	50 x 120	6,000
Subject			50 x 150	7,500

Through investigation, it was found that prices have been increasing approximately 1% a month during the past year.

Sale No. 1 is believed to be located in an area inferior to the subject. This lot would sell for about \$500 more if located in the subject's block. Sale No. 2 is located in an area believed to be about \$250 better than the subject. Sale No. 3 is also in a superior location, by the same \$250 adjustment.

The shape and topography of Sales No. 1 and No. 2 are better than the subject by an amount estimated to be \$500 and \$100 respectively. Sale No. 3's topography and utility appear about the same as the subject.

Adjustments.

<i>Sale No.</i>	<i>Time</i>	<i>Location</i>	<i>Characteristics</i>	<i>Adjusted \$</i>	<i>Adj. \$/sq. ft.</i>
1	+\$500	+\$500	-\$500	\$5,500	\$.92
2	+\$240	-\$250	-\$100	\$4,640	\$.89
3	+\$110	-\$250	0	\$5,360	\$.89

The average adjusted price per square foot of the comparable sales is \$.90. Therefore, the subject property has an indicated value as follows:

7,500 square feet x \$.90 per square foot = \$6,750

In actual practice, the use of more sales data is advisable in order to arrive at a well-supported adjusted price per square foot.

- e. If all pertinent factors are considered, the adjusted prices will probably be in a fairly close range. If there is still a wide discrepancy, the appraiser will:
- (1) re-analyze work to find undisclosed pertinent factors;
 - (2) reexamine data as being true examples of fair market transactions;
 - (3) recompute adjustments to insure accuracy; and
 - (4) finally, discard the data or explain the apparent contradictions.

B. Abstraction.

1. The abstraction method is used to obtain land value where there are no vacant land sales.
 - a. Sales of houses in the same neighborhood on lots with similar characteristics are obtained.
 - b. An estimate of the cost new of the improvements is made.
 - c. An amount is deducted from cost new for depreciation.
 - d. The depreciated cost of the improvements is deducted from the selling price of the property.
 - e. The difference represents an approximation of land value.

Example: Appraised lot size is 65' X 100' = 6,500 sq.ft. Sale property is 6,000 sq. ft. lot with a single family residence and sold for \$83,000. The sale building has an estimated cost new of \$61,000 and an accrued depreciation estimated at \$20,000. Land value by abstraction:

Price of sale property	\$83,000
Less depreciated value of improvements:	
Cost new	\$61,000
Less accrued depreciation	<u>\$20,000</u>
Depreciated value	<u>\$41,000</u>
Indicated land value	\$42,000
Divide by lot size	÷ 6000 sq.ft.
Indicated lot value/sq.ft.	\$7.00/sq.ft.
Multiply by subject lot size:	
65' x 100' = 6,500 sq.ft.	<u>x 6,500</u>
Indicated value of lot	\$45,500

- C. **Plot Plan.** For better appraisal reporting, a plot plan can be prepared, with lot dimensions and improvements drawn to scale. It should show walks, driveways and other lot improvements and roof plans of the various structures on the site. The plot, together with pictures of the site, neighboring street and lot improvements are vital for an effective site analysis.

ARCHITECTURAL STYLES AND FUNCTIONAL UTILITY

It is essential for an appraiser to have a working knowledge of building design and construction. Good basic design of both interior and exterior has a decided effect on the marketability of real estate. There is no substitute for appropriate materials and proper proportions and scale. The appraiser should be aware of imitations and new plastic replacements.

To achieve maximum value, architectural style and design should be related to the site. A typical stable neighborhood should be improved with homes of approximately the same size, age and style. A house that has an architectural style extremely foreign to its surroundings tends to encounter difficulty when offered for sale.

Or a home meets resistance in the market because of its style, which places it within a definite age group. Thus, if a certain style of architecture has lost its appeal because public taste has changed, this trend will have an adverse effect on value. Both real estate brokers and appraisers must be familiar with home styles and know the effect on value of misplaced styles. The appraiser must also be alert to resurgence of older properties in public acceptance.

This section: contains brief descriptions of various architectural styles in single family homes; explains how to determine quality of construction; and defines functional utility and its effect on marketability.

Architectural Styles

Colonial. Cape Cod and Cape Ann styles are: generally quite small in size - minimum with good taste; symmetrical-windows balanced on both sides of front door; either one or one and one-half stories with little head room upstairs; fairly steep gable or gambrel roof covered with wood shingles; and exterior of wood siding.

New England Colonial. A square or rectangular, box-like structure having: maximum usable space; symmetrical windows balanced on both sides of front door; either two or two and one-half stories; gable roof covered with wood shingles; exterior of wood generally painted white; and impressive front entrance usually with transom fan of glass above the door.

Dutch Colonial. A moderate-sized home generally not more than 50 feet wide, with a symmetrical front having: an entrance at the center, balanced by the windows; low-sweeping gambrel roof; exterior generally of stone; and either one and one-half story with dormer windows or two and one-half stories with dormer windows.

Georgian and Southern Colonial. These styles have elaborate front entrances with plain or fluted columns; are generally of brick or wood; have prominent gabled roofs, often hipped; are very symmetrical; require large plots of land; large scale, not suitable for a small house; and either two, two and one-half or three stories.

English Elizabethan. This style has gothic refined lines with molded stone around windows and doors; generally of brick, stucco, or stone; steep pitched roof, covered with slate or shingle; usually leaded metal casement windows; and requires a large building site.

English Half-Timber. This style has protruding timber faces with stucco between the faces; lower story of heavy masonry; steep pitched roof; generally two stories; and requires a large lot area.

Regency. A generally symmetrical style with front entrance in center; exterior of brick or stone; shutters on each side of windows; low hipped roof; two stories in height; and octagonal window on second floor over front door.

French Provincial. Usually a large house on a sizable plot, masonry exterior walls with very high roofs; large high windows with long shutters; and one and one-half or two and one-half stories.

French Normandy. Generally has turrets at entry; walls of brick or stone; unsymmetrical; and steep pitched shingle roof.

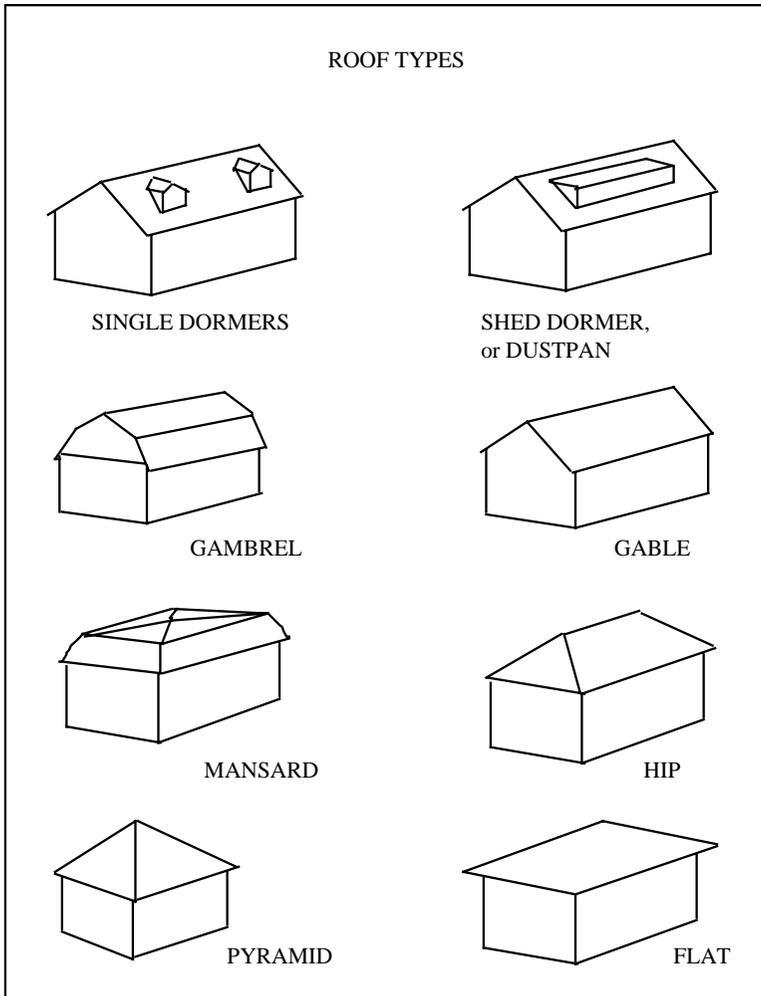
True Spanish. Enclosed patios; red mission tiled roof; wrought iron decorations; and stucco walls (usually white).

Small California Spanish. Stucco exterior; flat composition roof with mission tile trim in the front; suitable for small lots; no patio; and one story only.

Monterey Spanish. Two stories; stucco (generally white); red mission tiled roof; second story balconies; and decorative iron railings.

Modern and Contemporary. Generally one story; usually flat or low pitched roof; often on concrete slab; large amount of glass; and indoor/outdoor living.

California Bungalow or Ranch House. One story; stucco with wood trim; often on concrete slab; shingle or shake roof; low and rambling; generally attached garage; and indoor/outdoor living.



Building Quality

One of the most important reasons for inspecting a property is to determine its quality of construction and condition. The appraiser must be knowledgeable as to structural details of buildings. All exposed portions of a building should be closely inspected to ascertain the materials used, the present condition, and the type and quality of construction, which may be classified as follows:

A. Low quality.

1. Competitive low cost house which does not exceed the minimum building codes.

B. Fair quality.

1. Plain and inexpensive finishes on both interior and exterior.
2. Cheap quality finish hardware, lighting fixtures, and heating.
3. Generally erected in areas of low purchasing power.
4. Typically, stucco exterior, concrete slab floor, composition roof.

C. Average quality.

1. Meets VA and FHA standards.
2. Usually purchased by persons of moderate income.
3. Medium standard of construction with some low cost refinements.
4. Usually of stucco exterior, hardwood flooring, composition roof or shingle.
5. Finish hardware, lighting fixtures and heating of average quality.
6. House found in large tract developments.

D. Good quality.

1. Good architectural design, workmanship and materials.
2. Stucco walls with wood and masonry trim, hardwood floors, shingle roofs.
3. Usually contains two bathrooms, forced air furnace or equal heating, good quality lighting fixtures and finish hardware.
4. Usually has extra built-in equipment in kitchen.

E. Very good quality.

1. Generally, custom designed by architect.
2. Home contains many extra features.
3. Stucco walls with extensive wood or masonry trim, hardwood flooring, shake roofs.
4. Two or more bathrooms, forced air heating, very good quality finish hardware and lighting fixtures.
5. Custom fireplaces.

F. Excellent quality.

1. Custom designed by architect.
2. Extra features are of the highest quality and design.

3. Stucco walls with redwoods or cedars or other fine woods, stone trim, hardwood, marble and custom carpet floorings, clay tile, slate roofs, copper gutters and so on.
4. A bath with each bedroom, walk-in closets, zoned heating, special wood finishes such as teak, cherry, walnut, etc., designer lighting including recessed art lighting.
5. Custom fireplaces, custom wood libraries, bars, butler's pantries, granite or marble counters in baths and kitchen, gourmet appliances.

Functional Utility

Good architecture is concerned with room layout and functional utility as well as exterior style. A functional analysis of a property measures the conveniences and economy in the use of the property. The combined factors of usefulness and desirability have an effect on a property's marketability. The degree of its functional utility is important in any consideration of its marketability. Thus, marketability is the ultimate test of functional utility.

Functional Utility Checklist

A. Building.

1. Living room.
 - a. Adequacy of floor and wall space for proper placement of furniture.
 - b. Circulation - should not have to pass through long living room to reach other parts of the house.
 - c. Fireplace should be away from the traffic flow.
 - d. Wall spaces - adequate for furniture arrangements.
2. Dining room or area.
 - a. Ease of access to kitchen.
 - b. Size of room or area governed by overall size of house.
 - c. Best if room is nearly square.
3. Bedrooms.
 - a. Master bedroom should be of adequate size (minimum 10' x 12').
 - b. Other bedrooms (minimum 9' x 10').
 - c. Cross ventilation should be provided.
 - d. Located away from family areas and kitchen for privacy.
 - e. Should not have to go through one bedroom to enter another.
 - f. Closet space should be adequate (minimum depth 2 feet; minimum area 6 square feet).
 - g. Proximate to full bath facilities.
4. Kitchen.
 - a. Workspace should be ample and efficient in plan.
 - b. Equipment should be centrally located to eliminate unnecessary foot travel.
 - c. Walls, ceilings and floors should be of easily maintained materials.
 - d. Adequate provision should be made for proper lighting and ventilation.

- e. Kitchen should be conveniently located in relation to dining areas and family room.
 - f. Kitchen should have an exterior entrance.
 - g. Laundry facilities should be adjacent to kitchen.
5. Bathrooms.
- a. Proper location with respect to other rooms.
 - b. If only one bathroom exists, it should be located off the central hall.
 - c. Bathroom should not open directly into kitchen or living room.
 - d. Adequate ventilation - exterior window or automatic exhaust fan is necessary.
 - e. Floors, walls, and ceilings easily cleaned and maintained.
6. Closets and storage.
- a. At least one clothes closet per bedroom.
 - b. Adequate linen closet space.
 - c. Storage closets should be centrally located.
 - d. A storage area should be provided near the laundry equipment.
 - e. Exterior storage necessary if there is only a carport.

B. Site.

1. Construction should be related to the size of the building site.
2. The house should be so located on the land that it relates to the building site or "belongs."
3. Adequate front, rear and side yards are necessary for light and privacy. Yards may be clustered in planned unit developments.
4. A private service yard for drying clothes and storage of refuse should be convenient to the kitchen.
5. Entrance to the garage should be convenient and readily accessible.
6. Proper landscaping.
7. Recreational and garden facilities.
8. Adequate yard improvements.

Broker's Guidelines for Considering Physical Characteristics of Real Property for FHA Insurance Purposes

- A. **Visual appeal of property.** How well will the property as a whole retain its market appeal?
1. Exterior design of structures.
 - a. Visual appeal based upon the probability of continuing market acceptance.
 - b. Certain architectural styles are short-lived in their acceptance and become obsolete.
 2. Setting.
 - a. Measures the property's appeal in the market because of terrain, accessory buildings, walks, landscaping.

- b. The dwelling and surroundings should present a pleasing and unified composition.
 3. Interior design of dwelling.
 - a. The interior design should exhibit simplicity of treatment, harmony in proportions and refinement in design.
 - b. Interior permanent features should be up-to-date and of adequate construction.
- B. **Livability of property.** The degree of usefulness, convenience and comfort which the property affords is determined by:
 1. Site utilization.
 - a. Considers all aspects of the site and its arrangements as these affect the livability of the entire property.
 - b. The lot characteristics including size, shape, topography, orientation and natural advantages are considered.
 2. Dwelling space utilization. Consideration is given to the size and efficient distribution of space within the structure.
 3. Room characteristics. Consideration is given to the size and proportion of the rooms in relationship to the overall area of the dwelling. The following factors are considered:
 - a. Room orientation.
 - b. Circulation.
 - c. Privacy.
 - d. Closet and storage space.
 - e. Kitchen efficiency.
 - f. Service facilities.
 - g. Insulation.
- C. **Natural light and ventilation.** The effect of natural light and natural ventilation on the desirability, livability and healthfulness is considered.
 1. The proper amount or ratio of natural light to room area should be maintained.
 2. Ventilation of all rooms is studied to measure its effect on desirability of the dwelling.
 3. Cross ventilation desirable in all bedrooms.
- D. **Structural quality.** The quality of structural design, materials, and workmanship is determined for the dwelling. The component elements to be considered are as follows:
 1. Foundations.
 2. Wall construction.
 3. Partitions.
 4. Floor construction.
 5. Ceiling construction.
 6. Roof construction.

- E. **Resistance to elements and usage.** A determination is made as to the resistance of the dwelling to the effects of weather, decay, corrosion, fire, and deterioration. Consideration is given to three categories:
1. Lot improvements.
 - a. How is the soil protected from erosion?
 - b. Is the land properly graded so that the structure is not damaged by water?
 - c. The yard improvements such as walks and walls should be of adequate materials.
 2. The building exterior. Analysis is made with reference to the resistance of the exterior of the building to the effects of the elements.
 3. Building interior. Consideration is given to the resistance of interior surfaces and materials to determine wear and tear and deterioration.
- F. **Suitability of mechanical equipment.** Measures the extent that the equipment contributes to the desirability and appeal of the dwelling through convenience, economy, and comfort. Consideration is given to:
1. Plumbing system.
 2. Heating system.
 3. Electric system.
 4. Supplementary equipment.

THE APPRAISAL PROCESS AND METHODS

Over time, well defined ground rules have been developed by professional appraisers to arrive at an estimate of value. This orderly, systematic procedure is known as the appraisal process. Not every step is used every time or necessarily in the same order. However, this comprehensive check list for the appraisal process should serve to give a better understanding of the importance of properly evaluating the various elements that influence market value and market price.

Overview of the Appraisal Process

As governed by Standard 1 of USPAP, the orderly steps and considerations of the appraisal process are designed to answer two questions:

What is highest and best use? and

What is this use worth?

To reach a legitimate conclusion:

- A. Define the problem.
1. Identification of the property to be evaluated.
 - a. Complete mailing address (including city and state).
 - b. Complete legal description (by lot, block and tract number, including county where recorded; by metes and bounds descriptions; or by the government survey system).
 2. Description of use of property to be appraised.
 - a. Vacant lot.
 - b. Single-family residential.

- c. Multi-family residential.
 - d. Special purpose (commercial, etc.)
 3. Interests to be appraised.
 - a. Which of the bundle of rights are to be evaluated? Rights affect value because they set the limits within which the property may be used.
 - b. An appraisal estimates the value of the rights of ownership, not merely the physical land and its improvements.
 - c. The extent of the research and the valuation opinion will vary depending upon which of the following rights are involved:
 - (1) Fee Simple (complete ownership).
 - (2) Easement across property.
 - (3) Lessor's or lessee's interest.
 - (4) Mineral Rights.
 - (5) Miscellaneous interests.
 4. Purpose and intended use of the valuation determine the types of information to be gathered and processed, such as:
 - a. Fair value for sale of a home.
 - b. Value for mortgage loan purposes.
 - c. Value for insurance purposes.
 - d. Value for condemnation proceedings.
 - e. Miscellaneous purposes and functions.
 5. Date of value is generally the date of the last inspection of the property, although it may be any time in the past. Prospective values may be rendered, such as for proposed developments where "future sales" are projected and discounted to present value.
- B. Make a preliminary survey of neighborhood, site and data required for appraisal.
1. Make a preliminary estimate of the highest and best use of the subject property.
 - a. Analysis of the site and improvements. Is it a proper improvement? Does the improvement meet the test? Take inventory of important site utilities and building construction features.
 - b. Analysis of the neighborhood. What are the boundaries and what services are available?
 2. The type of property determines the variety of specific data needed.
 - a. For a single-family home, emphasis will be placed on data concerning similar lots and improvements.
 - b. For a four-plex, emphasis will be placed on data concerning small multi-family units.
 3. A definite plan facilitates the gathering of necessary data as indicated from the preliminary survey.

- C. Collect other general and specific data. The value of a property is affected by demand and by purchasing power available. Data should be obtained on population trends, income levels, and employment opportunities. A number of sources should be investigated.
1. General data are obtained from government publications, newspapers and magazines.
 2. Regional data (metropolitan area) are obtained from monthly bank summaries, regional planning commissions, and government agencies.
 3. Community data (city) are obtained from the Chamber of Commerce, planning commission, city government, banks and savings and loan associations, and real estate boards.
 4. Neighborhood data, obtained from personal inspection, real estate practitioners and builders active in the area, include:
 - a. Age and appearance of the neighborhood.
 - b. Hazards and adverse influences.
 - c. Percentage build-out.
 - d. Contemplated development.
 - e. Proximity to schools, business, recreation, etc.
 5. Obtain comparable market data, such as sales and listing prices, from:
 - a. Assessor's records and county recorder's office.
 - b. Title insurance and trust companies.
 - c. Real estate boards and local real estate offices.
 - d. Property owners in the neighborhood.
 - e. Appraiser's/other appraisers' data bases.
 6. Collect and analyze data regarding the subject property's improvements from:
 - a. Assessor's office for age and other nonconfidential information.
 - b. City building department.
 - c. Contractors in area.
 - d. Personal inspection of improvements.
- D. Analyze the data to conclude what is the highest and best use and the estimated worth of this use. As discussed later in this chapter, the following are the three approaches to value which will be used:
1. Sales Comparison Approach, formerly known as the Market Data Approach. Study of value as indicated by the prices of recent sales and reliable listings of properties similar to the appraised property.
 2. Cost Approach. Study of value by adding the value of the land, if vacant, to the cost new, less accrued depreciation, of improvements
 3. Income Approach. Study of value of the property as an income stream as it would be sold in the open market.
- E. Make final estimate of defined value and write the report. The form and extent of the report will depend upon the purpose, type of property, and request of the client.

The Departure Provision

The Departure Provision sets forth the portions of the USPAP Standards that can be left out or departed from in the appraisal process. Care must always be given in departing from the full appraisal process, since the analysis not undertaken may have a material impact on the final value conclusion. In addition to Standard 1 and the Departure Provision, there is Statement 7 and Advisory Opinions 11, 12, 13 and 15 which provide additional valuable guidance in developing a proper appraisal process. These can all be found in the current edition of USPAP.

METHODS OF APPRAISING PROPERTIES

There are three approaches to consider in making a market value estimate. These approaches are:

Sales comparison approach. Recent sales and listings of similar type properties in the area are analyzed to form an opinion of value.

Cost approach. This approach considers the value of the land, assumed vacant, added to the depreciated cost new of the improvements. This is considered a substitute or alternative to buying an existing house.

Income approach. The estimated potential net income of real property is capitalized into value by this approach.

Not only does each parcel of real estate differ in some respects from all other properties, but there are many different purposes for which an appraisal may be made. Each variation of purpose could result in a considerable, yet logical, variation of estimated value. For example the nature of the property, whether noninvestment, investment or service; the purpose of the purchase, whether for use, investment or speculation; and the purpose of the appraisal, such as for sale, loan, taxation, insurance and the like, all constitute matters which will influence the proper methods of appraisal approach and the final result reached by the appraisal.

Consequently, the first step in any appraisal procedure is to have a clear understanding of the purposes for making the appraisal and the value to be sought. The adequacy and reliability of available data also are determining factors in the selection of the approaches to be employed. A lack of certain pertinent or up-to-date information may well eliminate an otherwise possible approach. When this is the case, it is not considered a departure from USPAP, since the approach was considered but not workable.

In other instances, proper procedures may only call for an appropriate discounting of conclusions drawn from such data. Thus, based on its adaptability to the specific problem, one method is subsequently the focus of the analysis and the other approach methods may not be employed. This is considered a limited appraisal and a departure from USPAP Standard 1.

In most appraisals, all three approach methods will ordinarily have something to contribute. Each approach method is used independently to reach an estimated value. Then, as a final step, by applying to each separate value a weight proportionate to its merits in that particular instance, conclusions are reached as to one appropriate value. This procedure is known as reconciliation.

THE SALES COMPARISON APPROACH

This approach, formerly known as the market data comparison approach, is most generally adaptable for use by real estate brokers and salespersons. It lends itself well to the appraisal of land, residences and other types of improvements which exhibit a high degree of similarity, and for which a ready market exists. The principle of substitution is the basis of this approach. The buyer should not pay more for a property than the cost of acquiring a comparable substitute property. An analysis of market data is necessary in all three approaches to value.

The mechanics of the market comparison approach involve the use of sales and market data of all kinds in order to compare closely the property being appraised with other similar properties which have recently been sold or are offered for sale as to time of the sales, location of the sales and physical characteristics of the improvements. The sources used for determining value include actual sales prices, listings, offers, rents and leases, as well as an analysis of economic factors affecting marketability.

Sources of Data

Sales or market data are obtained from many sources including:

Appraiser's own files. Information gathered on previous assignments might provide information for the present appraisal.

Public records. The county assessor's office keeps a record of all sales transactions recorded within the county. This information is kept confidential for the assessor's own use, but an owner can obtain needed information about owner's property from the assessor's office. The date of recording of any deed may be obtained from the recorder's office. The exact legal description as well as legal seller and buyer can be obtained from an inspection of the deed (or facsimile). The documentary transfer tax applies on all transfers of real property located in the county. Notice of payment is entered on the face of the deed or on a separate paper filed with the deed. Tax is computed at the rate of 55 cents for each \$500 of consideration or fraction thereof. If a portion of the total price paid for the property is exempt because a lien or encumbrance remains on the property, this fact must be stated on the deed or on a separate paper filed with the deed.

Multiple listing offices, fellow appraisers or brokers. Information on listings, offerings, and sales may frequently be obtained from real estate multiple listing facilities, real estate offices or by appraisers familiar with the area.

Legal property owner, sellers or buyers. When viewing comparable sales and other pertinent data in an area, additional information is solicited by interviewing property owners living in the neighborhood. The appraiser should try to confirm the sales price and circumstances of the sale with buyer, seller and/or broker. If informed of the appraiser's purpose, parties will usually verify and explain the sale.

Classified ads and listings. Ads are a source of information on properties currently being offered for sale. If possible, the appraiser's name should be on the mailing list of banks, savings and loan, and other institutions selling properties.

Listing prices may often indicate the probable top market value of a specific property while bid prices may normally indicate the lowest probable value. Both are subject to variation based on motivation, but a reasonable number of properties falling into this category will provide a bracket within which a current fair value may be found. Offers

are likely to approach market value more closely than are listings. However, an offer to purchase is not usually a matter of common knowledge.

The Procedure

The procedure used in the sales comparison approach method is to systematically assemble data concerning comparable properties which are as “like-kind” to the subject as possible in regard to: neighborhood location; size (a comparable number of bedrooms and baths); age; architectural style; financing terms and general price range. The greater the number of good comparable data used, the better the result, provided a proper analysis is made. The approach is based on the assumption that property is worth what it will sell for in the absence of undue stress, and if reasonable time is given to find a buyer. For this reason, the appraiser should look behind sales and transfers to ascertain what influences may have affected sales prices, particularly if only a few comparisons are available.

Proper comparisons between like properties are ideally based on an actual inspection. Inspections should determine: the condition of improvements at time of sale, not as of date of inspection; room arrangement and room count so that the utility of the data may be compared to the subject property; yard improvements and their influence upon the sales price; the sales price (from buyer, seller or broker), to determine if the sale was an arm’s length or open market transaction; size and topography of the lot. For nearly comparable properties, negative (downward) adjustments should be imposed for the subject’s poor repair, freakish design, existing nuisances, etc. Conversely, positive adjustments should be made for the subject’s superior design, view, special features, better condition, higher quality of materials, landscaping, and the like.

Unless the sales being compared are of recent date, consideration must also be given to adjusting values in keeping with the economic trend of the district and the worth of the dollar. Financing terms receive value adjustment considerations, e.g., for favorable existing assumable financing, or perhaps seller-assisted financing.

Units and elements of comparison. The common units of comparison used by appraisers in the sales comparison approach are property components that can readily be used for comparison purposes: square footage; number of rooms; and number of units. Elements of comparison are characteristics in either the property or the transaction itself that cause prices to vary. These principal elements of comparison are financing terms, time (the market conditions at the time of the sale), sale conditions (no pressures/arm’s length), location, physical characteristics, and income (if any) from the property.

Using the appropriate units and elements of comparison for the subject and each comparable, the appraiser assigns an estimated adjusted amount (dollar or percentage) for each difference found in the items of comparison (number of bathrooms, view, square footage, financing, forced sale). An adjusted price is thus established for each comparable property that should realistically reflect what the subject would sell for in the current market. The less comparable properties are then eliminated from consideration and greatest weight is given to the comparable sales most similar to the property being appraised. Through this judgment or reconciliation process, the appraiser arrives at the final estimate of value for the subject property.

Advantages. Some advantages of using the sales comparison approach are:

- It is the most easily understood method of valuation and in most common practice among real estate brokers and salespersons.

- It is particularly applicable for appraisal purposes involving the sale of single family residences and loan arrangements therewith. These make up the great bulk of real estate transactions.

Disadvantages. Some disadvantages of the comparison approach method are:

- Locating enough “nearly alike” properties which have recently sold or been listed.
- Adjusting amenities to make them comparable to the subject property. The greater the amount of adjustment or number of adjustments, the less reliable the comparable becomes.
- Older sales become less reliable in a changing market.
- Occasional difficulty confirming transaction details.
- Limitations in rapidly changing economic conditions and periods of high inflation and interest rates, when property appreciation rates may cause hazardous value conclusions.

Application of the Procedure - Residential Sales

Like properties are always compared. The more current the data the better. The suggested order for making unit and element comparisons is in this sequence:

- finance terms
- time (market conditions)
- sale conditions
- location
- physical characteristics
- other (e.g., special considerations for income property)

The steps.

- Research the market for *bona fide* “like-kind” recent market data. Select data. Verify.
- Select the appropriate units and elements of comparison. Adjust the sales price of each comparable (or eliminate it from consideration). The adjustment is always made to the comparable, not to the subject property.
- Each comparable will have its own value indication. Eliminate the less comparable properties. Set out comparison results in chart or grid form. Using judgment and experience, reconcile or correlate the adjusted sales prices of the comparables and, by giving greatest weight to the sale that is most compatible to the subject property, assign an estimated value to the subject. Do not average the adjusted sales prices of the comparables. Reconciliation is a judgment process. It is not mechanical.

Example. Assume that the house to be appraised is a 2,400 square foot, 5-year old, single-family tract home located two blocks from the beach, with a fair view, stucco, 10 rooms, 4 bedrooms, 3 baths, 3 car garage. It is in good condition.

Prices have been increasing at 1% a month. The appraiser has selected from the neighborhood comparables which are equal in most of their financing and physical characteristics, except as shown on the rating chart. The value or sales price for the subject property is determined as shown on the chart below.

Adjust sales prices to indicate the appraised parcel value by subtracting the adjustment if the appraised parcel (subject) is inferior to the comparable and by adding the adjustment if the subject is superior to the comparable.

**SALES COMPARISON DATA APPRAISAL RATING GRID –
SINGLE-FAMILY RESIDENCE TRACT HOME**

Elements/Units	Comparables			Subject
	Data 1	Data 2	Data 3	
Sales Price	\$164,000	\$176,000	\$178,000	?
Adjustments				
Financing Terms	Normal	Normal	Normal	Normal
Conditions of Sale ..	Normal	Normal	Normal	Normal
Time (Sale Date)	June, 1995	Nov., 1995	April, 1996	Aug., 1996
Adjustment 1%/mo	+\$22,960	+\$15,840	+\$7,120	
Distance to Beach ...	1 Block	3 Blocks	4 Blocks	2 Blocks
Adjustment.....	*(inferior) -\$6,000	*(superior) +\$2,000	*(superior) +\$4,000	
Garage.....	Equal	Equal	Equal	Equal
Age	Equal	Equal	Equal	Equal
Rooms	Equal	Equal	Equal	Equal
Bathrooms.....	Equal	Equal	Equal	Equal
View.....	None	Some	Fine	Fair
Adjustment	*(superior) +\$4,000	*(superior) +\$1,000	*(inferior) -\$6,000	
Square footage.....	2,400	2,430	2,390	2,400
Adjustment	<u>0</u>	<u>0</u>	<u>0</u>	
Net Adjustments ...	\$20,960	\$18,840	\$5,120	
Adjusted Sale Price.	\$184,960	\$194,840	\$183,120	
Indicated Value				\$185,000

* Inferior means the subject property is inferior to the comparable in this regard. Superior means the opposite. Subtract the adjustment if the subject property is inferior to the comparable property. Add the adjustment if the subject property is superior to the comparable property.

Reconciliation: Data 2 is close to the subject property in size, location, and view although not as good as the subject. Data 3 is the latest sale, but has the greatest difference in view and location. Data 1 is the oldest sale but is most useful for confirming the indication of value. Indicated value: \$185,000.

COST APPROACH

The Cost Approach views value as the combination of:

the value of the land as if vacant; and

the cost to reconstruct the appraised building as new on the date of value, less the accrued depreciation the building suffers in comparison with a new building.

The principle of substitution applies: i.e., value tends to be set by the price of an equivalent substitute. In the Cost Approach, the substitute is the cost of reconstructing the present building on a vacant site.

The total cost of the land as if vacant, plus the reconstruction cost new of the building with all direct and indirect expenses and profit, and before deduction of depreciation, will tend to set the upper limit of value. In this view, the cost new can be used as a benchmark for measuring the other approaches.

The Procedure in Brief

- Estimate the value of the land as though vacant and available for development to its highest and best use.
- Estimate the replacement or reproduction cost of the existing improvements as of the appraisal date.
- Estimate the amount of accrued depreciation to the improvements from all causes (physical deterioration and/or functional or external obsolescence).
- Deduct the amount of the accrued depreciation from the replacement cost new to find the estimate of the depreciated value of the improvements.
- Add the estimated present depreciated value for the improvements to the value of the land. The result is an indication of the value for the subject property.

Cost New Bases

The Cost Approach views the value of the building at its cost of reconstruction as new on date of value. There are three bases of reconstruction cost as new:

- Historic Cost indexed to Cost New;
- Reproduction Cost New; and
- Replacement Cost New.

Each basis has value to a cost-as-new study, but terms should not be confused.

Historic cost indexed to cost new. Historic Cost is the actual cost of the building when originally constructed, yesterday or fifty years ago. By use of price indices from building or engineering cost services, or from the original building contractor, Historic Cost can be “indexed” to Cost New on date of value. Indexed Historic Cost can be very useful if the building is fairly new and/or it is so unique that it is the only reliable value base. The advantage of Indexed Historic Cost is the accuracy of employing actual building costs. The disadvantage is that the older the costs are the less reliably they can be indexed. When considering Indexed Historic Costs, the appraiser should be certain that historic costs were normal costs at time of construction and that historic costs, as indexed, will accurately reflect Cost New on date of value.

Reproduction cost new is the cost, on date of value, of constructing a replica of the appraised building. This is a replica in actual design and materials. In this method, the cost-as-new estimate is made as if looking at plans of an exact duplicate of the present

building. The advantage of Reproduction Cost New is the greater accuracy of duplicating the building in actual design and materials. The disadvantage is that advances in building construction and methods, materials and design make cost estimates of obsolete building construction very difficult and wildly distorted for materials no longer reasonably available or requiring large amounts of hand labor. Reproduction Cost New is most useful for study of refined methods of depreciation, unique construction, and occasional legal requirements for court testimony.

Replacement cost new views the building as if reconstructed with modern methods, design and materials that would most closely replace the use of the appraised building. For example, an older brick warehouse would be constructed today with concrete block or tilt-up cast slab construction. The advantage of Replacement Cost New is the ready availability of accurate current costs, and a better understanding by all parties of modern methods, design and materials. The disadvantage is the subjective decisions of proper current replacement materials and design for older construction. In actual practice, the Replacement Cost New is the most frequently used Cost Approach base.

Steps in the Cost Approach

- A. An estimate is made as to the land's current market value, assumed vacant and available for improvement to its highest and best use. Land value is usually based on a market approach utilizing comparable market data of similar sites in the area.
- B. An estimate is made of the cost new of reconstructing the buildings and other improvements.
 1. The appraiser selects the proper cost new base:
 - a. *Historic Cost* of appraised building indexed to cost new on date of value.
 - b. *Reproduction Cost* of duplicating the replica of the appraised building using original materials and design on date of value.
 - c. *Replacement Cost* of replacing the use and facility of the appraised building using modern materials, methods, and design on date of value.
 2. The appraiser completes property inspection, description, measurement, inventory, and plot plan of appraised building improvements and equipment, with notes regarding type, style, quality, and condition of building materials, workmanship and condition.
 3. The appraiser selects appropriate method of cost new estimating.
 - a. The ***Square-Foot Method*** is the most common method used by appraisers on the West Coast to estimate the cost of construction. The property being appraised is compared with similar structures where costs are known, and which have been reduced to units per square foot of floor area. Standard type buildings whose costs are known are broken down to a cost per square foot of floor area. The building being appraised is compared with the most comparable standard building and its cost per square foot is used for the subject property. Adjustments must be made for size of building, and various exterior and interior features. Though adjustments cannot be made for many variables, this method, in most instances, is accurate enough for the real estate appraiser. The square-foot method can be used and applied faster than any other estimate.
 - b. The ***Cubic-Foot Method*** is similar to the square-foot method, except the cubic contents of buildings are compared instead of the square footage of

the floor area. This method is most popular in the Eastern United States. If used properly, it is more accurate than the square foot method, since the height as well as area of the building is taken into consideration. This method is most often used for industrial or warehouse buildings.

- c. The **Quantity Survey Method** involves a detailed estimate of all labor and materials for each component of the building. Items such as overhead, insurance, and contractor's profit must be added to direct costs. This is a very accurate but time-consuming method to arrive at costs. Because of the detail and time required, this method is seldom used, except by building contractors and professional cost estimators.
 - d. The **Unit-in-Place Cost Method** entails calculation of the cost of units of the building as installed. The total costs of walls in place, heating units, roof, etc. are obtained on a square foot basis, including labor, overhead, and profit. This is a detailed, accurate method generally used for checking on new construction units. It is seldom used by appraisers because specialized knowledge is necessary to gather all elements of unit costs.
4. The appraiser investigates cost sources and estimates cost-as-new of all buildings and improvements. Costs must be measured accurately. They are classified as direct (hard) costs and indirect (soft) costs. Indirect costs are usually associated with the administration of the project while direct costs are expenditures for labor, equipment and materials, overhead and profit.
- a. Cost sources:
 - (1) Costs of comparable buildings under construction.
 - (2) Owners, builders, and/or contractors of comparable buildings.
 - (3) The contractor of original building, if available.
 - (4) Published cost services (usually handbooks providing current comprehensive cost data, by local areas and general construction types).
 - (5) Professional cost estimators.
 - b. The appraiser completes the cost estimate to include all:
 - (1) Direct expenses of construction such as labor, materials and equipment and engineering for the building, site preparation, street and utility work, landscaping, etc.
 - (2) Indirect expenses such as legal, title, appraisal and feasibility study fees, licenses, permits, *ad valorem* taxes during construction, demolition and removal costs, inspections, insurance during construction, financing charges, accounting, etc.
 - (3) Developers' overhead, supervision, and profit; for planning, construction, and sale of the project to "turnkey" condition (that is, completely ready for a new purchaser/occupant) and selling costs.
- C. The appraiser estimates the accrued depreciation and deducts from cost-as-new estimate. This amount must be deducted from the cost-as-new to determine the present value of the improvements. The difficulties of correctly estimating depreciation tend to increase with the age of the improvement. Experience and good judgment are among the necessary qualifications for making a realistic estimate of

proper depreciation. There is no justification in assuming that improvements necessarily depreciate at a rate corresponding to their age.

- D. The appraiser adds the land value to depreciated value of improvements for indicated value by Cost Approach.

DEPRECIATION

In connection with the appraisal of real property, depreciation is defined as “loss in value from any cause.” It is customarily measured by estimating the difference between the current replacement or reproduction cost new and the estimated value of the property as of the date the property was appraised.

Contrasting with depreciation is *appreciation* of value from inflation or special supply and demand forces relating to the specific property. Appreciation may reduce or offset entirely a normally anticipated decrease of value due to depreciation.

Depreciation includes all of the influences that reduce the value of a property below its cost new. The principal influences are often grouped under three general headings and subdivided as follows:

1. Physical deterioration resulting from:
 - a. Wear and tear from use;
 - b. Negligent care (sometimes termed “deferred maintenance”);
 - c. Damage by dry rot, termites, etc.; or
 - d. Severe changes in temperature.
2. Functional obsolescence resulting from:
 - a. Poor architectural design and style;
 - b. Lack of modern facilities;
 - c. Out-of-date equipment;
 - d. Changes in styles of construction;
 - e. Construction methods and materials obsolete by current standards; or
 - f. Changes in utility demand such as desire for master bath or more garage space.
3. External obsolescence resulting from adverse environmental and economic influences outside the property itself, such as:
 - a. Misplacement of improvement (not typical for neighborhood);
 - b. Zoning and/or legislative restrictions;
 - c. Detrimental influence of supply and demand; or
 - d. Change of locational demand.

The first two categories of accrued depreciation are considered to be inherent within the property and may be curable or incurable. The third category is caused by factors external to the property and is almost always incurable.

Appraisal and Income Tax Views - “Book” vs. Actual Depreciation

It is important to understand that “depreciation” is a word with two meanings: one for the appraiser and another for the owner concerned with tax position.

Book depreciation. Depreciation, for the owner’s income tax position, is “book” depreciation, a mathematical calculation of steady depreciation from owner’s original purchase price or cost basis. This “book” depreciation allows the owner to recover the

cost of the investment over the “useful life” of the improvement. It accrues annually and is an income tax deduction. In this sense, the owner’s accountant sees depreciation as a deduction from gross income.

Frequently, “book” depreciation results in negative gross income, at least on paper. The building seems to be losing value faster than the income replaces it. This gives the owner a “paper loss” that can be offset against other income. This “paper loss” or “tax shelter” is a motivating factor for purchase or exchange of many income properties.

“Book” depreciation is:

- an allowable deduction from cost for accounting or income tax purposes;
- determined by owner’s policy and to meet IRS requirements; and
- deducted from owner’s original (historic) cost.

“Book value” is the current value for accounting purposes of an asset expressed as original cost plus capital additions minus accumulated depreciation, based on the method used for the computation of depreciation over the useful life of the asset for income tax purposes. Depreciation is allowed on improvements only, not land.

The book value of the property may be ascertained at any given time by adding the depreciated value of the improvement to the allocated value of the land.

Actual depreciation. The “book” depreciation from owner’s original cost is not the depreciation normally considered by the appraiser. The appraiser looks not to owner’s original cost, but cost new on date of value. From this current cost new, the appraiser deducts the estimate of accrued “actual” (not book) depreciation. Depreciation (loss in value) is estimated only for improvements.

“Actual” depreciation used by appraisers is:

- loss in value;
- determined by market data, observed condition, etc.; and
- deducted from current reconstruction cost new.

Because accountants and appraisers select rates of depreciation for different purposes, accruals for book and actual depreciation vary considerably. While both estimators may use the same period as to the remaining economic life of the property and may also use the same method, additional considerations may affect the resultant rate. Whereas the accountant may be restricted because of accounting conventions, the appraiser is under no such restrictions.

The real estate agent who is determining values should understand the necessity for following proper appraisal procedures and should not rely on book values either to estimate accrued depreciation or for future depreciation accruals.

Methods of Calculating Accrued Depreciation

Accrued depreciation is depreciation which has already occurred up to the date of value. Remainder depreciation is depreciation which will occur in the future. Accrued depreciation may be classified either as curable or incurable. The measure between curable and incurable is economic feasibility. It is possible to physically restore or cure most depreciation such as by expensive restoration of old homes. However, in most circumstances, cure of deficiencies is measured by the economic gain (increased rents) compared with the cost of the cure. Three methods of estimating accrued depreciation are discussed next.

Straight line or age-life method is depreciation which occurs annually, proportional to the improvement's total estimated life.

For example, an improvement with an estimated total life of 50 years would be said to depreciate at an equal rate of 2 percent per year. (2 percent x 50 years equals 100 percent depreciation.)

The effective age of the building is generally used instead of the actual age. Effective age is the age of a similar and typical improvement of equal usefulness, condition and future life expectancy. For example, if a building is actually 25 years of age but is as well maintained and would sell for as much as adjoining 20-year-old properties, it would be said to have an effective age of 20 years.

The straight line method is: easy to calculate; used by the Internal Revenue Service; and easily understood by the lay person.

However, in actuality, buildings do not depreciate in a straight line at a stated percentage each year, but will vary according to maintenance and demand for the type of structure.

The **cost-to-cure** or observed condition method (breakdown method) involves:

- Observing deficiencies within and without the structure and calculating their costs to cure. The cost to cure is the amount of accrued depreciation which has taken place.
- Computing an amount for physical deterioration or deferred maintenance for needed repairs and replacements.
- Determining and assigning a dollar value to functional obsolescence due to outmoded plumbing fixtures, lighting fixtures, kitchen equipment, etc.
- Measuring functional obsolescence which cannot economically be cured (e.g., poor room arrangements and outdated construction materials) and calculating the loss in rental value due to this condition.
- Calculating external obsolescence (i.e., caused by conditions outside the property) and determining the loss of rental value of the property as compared with a similar property in an economically stable neighborhood. The capitalized rental loss is distributed between the land and the building.

This is the most refined method of examining complex causes and cures of depreciation. However, it can be difficult to calculate minor or obscure depreciation accurately. Also, measurement by rental loss is sometimes difficult to substantiate.

A **combination** of the straight line and cost-to-cure methods may be used to:

- determine the normal depreciation as if the property is not suffering from undue depreciation; and,
- add any excess deterioration and obsolescence.

For example: a house is 20 years old and has a remaining life estimated at 40 years for a total life of 60 years, thus depreciating at a rate of 1.67 percent a year. Effective age due to condition estimated at 15 years.

Cost New \$105,000

1. Normal deterioration:	
1.67 percent x 15 years = 25 percent	
25 percent x \$105,000 =	\$26,250
2. Excessive physical deterioration:	
New roof, exterior painting	\$5,000
3. Functional obsolescence, curable:	
Modernize bathroom	\$3,900
4. Functional obsolescence, incurable:	
Poor room arrangement results in rental loss of \$40 per month when compared to normal house.	
Monthly gross multiplier 100.	
100 x \$40 a month =	\$4,000
5. External obsolescence:	
Estimated monthly rent of subject if located in ideal neighborhood (after curing physical and functional deficiencies)	\$1,000
Estimated rental loss due to external causes	\$50
Yearly rental loss is 12 x \$50 = \$600	
Capitalization rate applicable to properties in ideal neighborhood (ratio of annual rent to value) = 10.5 percent	
Capitalized rental loss:	
\$600 ÷ 10.5 percent = \$5,700	
Ratio of land to building value: in ideal neighborhood, land 30 percent, building 70 percent.	
Economic obsolescence:	
70 percent x \$5,700	\$3,990
TOTAL ESTIMATED DEPRECIATION	<u>\$43,140</u>
DEPRECIATED VALUE OF HOUSE	\$61,860

Reproduction or replacement cost method. The subject property is improved with a duplex, two detached garages, a covered porch for each unit and common driveway and walk.

Measurements and current cost replacement figures for the improvements are as follows:

Each unit of duplex is 25' x 35' @ \$55.00 per sq. ft.

Each detached garage is 21' x 25' @ \$20.00 per sq. ft.

Each covered porch is 6' x 10' @ \$14.00 per sq. ft.

Driveway is 20' x 100' @ \$2.40 per sq. ft.

Walk is 3' x 40' @ \$2.40 per sq. ft.

The improvements are now 12 years old and it is determined that such improvements have a remaining economic life of 38 years. The current lot value, by comparison, is \$45,000.00. Depreciation computations are based on the use of the straight line method.

What is the replacement cost new and, using the cost approach method, what is the present value of this property?

Each duplex unit (25' x 35' x \$55.00) x 2	\$96,250.00
Each detached garage (21' x 25' x \$20.00) x 2	21,000.00
Each covered porch (6' x 10' x \$14.00) x 2	1,680.00
Driveway (20' x 100' x \$2.40)	4,800.00
Walk 3' x 40' x \$2.40	<u>288.00</u>
Improvements – Total Replacement Cost New.....	124,018.00

Depreciation:

12 yrs. + 38 yrs. = 50 yrs. life of improvements when new

100 ÷ 50 = 2 percent annual depreciation rate, or recapture rate.

12 yrs. x 2 percent = 24 percent total depreciation to date.

124,018 x 24 percent = Total depreciation in value to date..... 29,764.00

Total value of improvements less depreciation

	\$94,254.00
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Plus lot value. 45,000.00

Total Current Value by Replacement Cost Approach \$139,254.00

Market data method. A comparative method is frequently used in residential appraisals where the property being appraised can be compared with market data of buildings of similar type and condition.

1. From the sales price of a comparable residential property, deduct an estimate of land value.
2. From the resulting total comparable improvement value, deduct the estimated contributory value of secondary improvements and landscaping.
3. The result is the value of the comparable main residence at its total depreciated value in place.
4. Divide this main residence value by the residence square footage. This yields depreciated unit value.
5. By multiplying the appraised building square footage by the unit value of the comparable residence, the total indicated depreciated value is found for the appraised residence.

Sales price of comparable property	\$180,000
Less estimated land value	<u>- 55,000</u>
Improvement Value	125,000
Less estimated value of secondary improvements and landscaping	<u>- 23,000</u>
Value of comparable residence	102,000
Divide by area of comparable residence	<u>÷ 2,900 sq.ft.</u>

Depreciated unit value of comparable residence	\$35.17/sq.ft.
Multiply by size of appraised residence	x <u>2,850 sq.ft.</u>
Indicated depreciated value in place of appraised residence	\$100,234

Advantage of the Market Data Method: This method is the most accurate measure of depreciation from the market.

Disadvantage of the method: It is sometimes difficult to obtain truly comparable market data and occasionally difficult to accurately estimate land value and secondary improvement value for deductions for main residence value indication.

Age-life method using effective age. House has an actual physical age of 25 years with a remaining life of 25 years, thus depreciating at the rate of 2 percent a year. It is the opinion of the appraiser that the subject house is of the same condition and utility as similar houses that are only 20 years of age. Therefore, the house has been assigned an effective age of 20 years.

The accrued depreciation would thus be 20 years times 2 percent or 40 percent.

Calculated cost new	\$120,000
Accrued depreciation (40 percent x \$120,000)	<u>48,000</u>
Depreciated value of improvement.	72,000
Plus land value	<u>50,000</u>
Indicated value by cost approach.....	\$122,000

Measuring physical deterioration. A store building has a remaining useful life of 30 years and an effective age of 20 years. Present reproduction cost for the structure is \$230,000. The roof is 75% deteriorated. A new roof will cost \$10,000. The air conditioning and heating systems are 40% depreciated. Their installed cost new is \$8,000. What is the total amount of physical deterioration?

The building, under the straight-line or age-life method, is 40% depreciated (100% ÷ 50 = 2% x 20 years effective age = 40%). This 40% depreciation to the building is to be applied to the amount of the building’s reproduction cost less the depreciation already taken on the other components.

Depreciation to roof (.75 x \$10,000)	\$7,500
Depreciation to air conditioning and heater (.40 x \$8,000).....	\$3200
Depreciation to rest of building (.40 x \$212,000)	<u>\$84,800</u>
Total physical deterioration	\$95,500

Income approach - future depreciation. Future depreciation is loss in value which has not yet occurred but will come in the future and is of significance in the capitalization of income method, which will be discussed next. In the income approach to valuation, depreciation is based on the remaining economic or useful life, during which time provision is made for the recapture of the value of improvements. It is the return “of” the investment, as differentiated from the return (interest and profits) “on” the invested capital. Under the income approach, this depreciation is usually measured by one of two methods: straight-line or sinking fund.

In straight-line depreciation, a definite sum is deducted from the income each year during the total estimated economic life of a building to replace the capital investment. If the appraiser estimates that a building will have a remaining life of 25 years, this

method provides that 1/25 or 4 percent of the building's value be returned annually as a deduction from net income.

The sinking fund method also includes a fixed annual depreciation deduction from income, but with yearly reserves from such funds deposited into a sinking fund which, with compound interest, will offset the depreciated value of the structure and be collectible at the end of the building's useful life. Accruals for future depreciation to replace the capital investment are in addition to and essentially different from both maintenance charges and reserves for periodic replacement of curable depreciation.

Should there be any estimated salvage value to the improvement at the end of its economic life, this amount need not be returned through the annual depreciation charge under either the straight-line or the sinking-fund method.

INCOME (CAPITALIZATION) APPROACH

The income approach is concerned with the present worth of future benefits (the income stream) which may be derived from a property. This method is important in the valuation of income-producing property, although it can rarely be relied on as the only approach. An important consideration in this approach is the *net* income which a fully informed person using good management can expect to receive during the remaining useful life of the improvement. An alternative, using *gross* income and the Gross Rent Multiplier (GRM) is explained later in this chapter.

The process of calculating the present worth of a property on the basis of its capacity to continue to produce an income stream is called *capitalization*. The capitalization approach is based primarily on the appraisal concepts of comparison, substitution and anticipation.

Appraiser's and Owner's Viewpoints

A real estate professional will understand that there are several differences in the owner's and appraiser's viewpoints on income property.

An owner purchases income property as an investment, based on personal desires and tax position. The owner frequently views the investment as equity in a financed property. "Equity" is the owner's down payment or the difference between the loan amount and the value or price of the property. The owner calculates the payments on the loan as an expense of owning the property, and deducts from income tax the interest paid on the loan and the "book" depreciation from the purchase price or cost basis. The owner can deduct only actual expenses, not reserves for future expenses, and can compute gross income only from income actually collected (or owed), not just projected. The owner looks for a profitable resale or exchange at a higher price or favorable tax position. In most cases, the appraiser will ignore these personal considerations.

The appraiser reconstructs expense and income into amounts the well-informed investor would anticipate, without specific regard for personal equity, spendable income, or tax consequences. Using methods outlined below, an appraiser analyzes an income property to ascertain its value to the market *generally*, i.e., the Fair Market Value.

Capitalization

Capitalization is the mathematical process of estimating the present value of income property based on the amount of anticipated annual net income it will produce. Capitalization converts the future income stream into an indication of present worth of

property. There are several methods of capitalizing net income. Our discussion will deal with the *direct* method.

There are four types of capitalization (cap) rates used in the appraisal process:

- The *interest rate* is the rate of return *on* invested capital. It is the same as the yield rate or risk rate. It does not include any provision for the return *of* investment capital.
- The *recapture rate* is the rate at which invested funds are being returned to the owner.
- The *capitalization rate* is derived from the interest rate and the recapture rate.
- The *overall rate* is derived from the relationship between net income and value for the total property and theoretically provides in one rate for both return *on*, and recapture of, the capital investment. The overall cap rate is an income rate. *Any* interest in income producing property can be valued using this rate but appraisers apply it most commonly to fee simple estates.

Capitalization rates may be estimated by several methods:

- market or sales data;
- band of investment (uses a weighted average rate by combining a rate for mortgage loan money and a rate for investor's equity); or
- summation (has very limited use - involves building up a "safe" interest rate based on various risk/investment factors).

Of course, the market or sales data method involves an appraiser's systematic comparison of recent sales of similar properties. The appraiser analyzes each comparison property's sales price, rents, expenses, net income and cap rate, makes needed adjustments and selects an appropriate indicated overall cap rate for the property being appraised. This rate represents both the return *on* and the return *of* the investment. To ensure reliability of the selected rate, the appraiser uses judgment and experience to make certain the comparables and the subject property have similar age, physical, location, income, expense and risk characteristics.

Capitalization rate formula. The capitalization rate is a combination of the interest rate (return on the investment) and the recapture rate (return on the investment in improvements). If only the land produces income, the cap rate and interest rate are the same. However, when improvements contribute to the income production, a provision must be made for recapture of the value of the improvements before the end of their economic life. Land has no limited economic life; it will never wear out and thus will always be able to produce income. The building is a wasting asset and cannot be used indefinitely.

The most common method of providing for recapture of the investment in the improvements is the "straight line" method, with the building value recaptured in equal annual installments. The recapture rate is computed by dividing the remaining economic life of the improvements into 100%. Thus, the annual recapture rate for a building with an estimated remaining economic life of 40 years is 2.5% ($100\% \div 40$). If the remaining economic life is 25 years, the recapture rate is 4%.

To find the indicated value of income property, divide the net annual income by the capitalization rate:

$$\text{Net Annual Income} \div \text{Capitalization Rate} = \text{Property Value}$$

or

$$I \div R = V$$

If any two factors in this formula are known, the third can be obtained.

$$I = R \times V$$

and

$$R = I \div V$$

INCOME APPROACH PROCESS

The main steps to calculate value by capitalizing income are:

- Determine the net annual income;
- Select the appropriate cap rate by market comparisons; and
- Capitalize the income (divide the net annual income by the cap rate).

Determining Net Annual Income

The procedures for determining net annual income are:

- Estimate potential gross income the property is capable of producing.
- Deduct from potential gross income an annual allowance for vacancy factor and rent collection loss. The remainder is called “effective” gross income or adjusted gross income.
- Deduct from adjusted gross income the estimated probable future annual expenses of operation (fixed expenses, variable expenses, reserves for replacements for building components or short-lived items) to obtain the net income of the investment property.

Income and expenses. The potential gross income used is the expected future income. In many cases, the immediate past or current income may be an indicator of future income. However, reliance solely upon past or current income is incorrect. The income to use is the one which the purchaser and seller anticipate over the remaining productive life of the improvement, as adjusted for foreseeable economic changes.

Income estimates. The gross income estimate for an income property is the potential or anticipated gross income from all sources (market rents, services, parking space fees and rentals, and coin-operated equipment, etc.). Gross income is estimated as of the date of the appraisal. Contract rent is the actual, or contracted, rent received from the property. Market rent is the rent the property should bring in the open market at the date of appraisal. Rents and vacancy factors and collection losses are based on current market rent data. The appraiser uses his/her judgment of the area in arriving at an allowance for vacancy and collection losses.

Rent data is obtained from the subject property’s rent schedule and the appraiser’s review of rents from similar recent sales in the area. Individual apartments or units of the comparables are compared with the subject property, using square footage, number

of bedrooms, or similar items of comparison. It is assumed management for all properties is adequate. Cost of deferred maintenance or repairs is an adjustment item.

Market rent schedules and expenses are usually maintained on a monthly basis. Both must be converted to an annual basis.

Expenses must be realistic. The operating expenses (all expenditures necessary to produce income) are to be deducted from the effective gross income to find the net operating income expected from the property. The appraiser must use caution in extracting expense information from owner's operating statement as some items included on the operating statement, such as principal and interest payments on mortgages and depreciation allowance for income tax purposes, must be disregarded by the appraiser as not being allowable expense items.

These non-allowables may include entertainment expenses and other items of personal expense, and capital improvement expenditures. Since most operating statements are prepared by accountants for tax and accounting purposes, appraisers usually must reconstruct them to properly forecast annual expenses.

Expenses are generally classified as being one of the following:

- **Fixed expenses.** These are incurred annually with relatively little change from year to year. They are to be paid whether the property is fully occupied or not. These items include taxes, insurance, licenses and permits.
- **Variable expenses.** These expenses are incurred continually in order to maintain and give service to the property. They are variable depending upon the extent of occupancy and include items such as utilities, management fees, security, costs of administration, maintenance and repairs for structures, grounds and parking area maintenance, contracted services (e.g., rubbish removal) and payroll.
- **Reserves for replacements.** This is an annual allowance for replacing worn out equipment and building components, such as stoves, carpets, draperies, roof covering.

Selecting the Cap Rate

The appraiser selects an appropriate overall capitalization rate ("present worth" factor) after market analysis of similar properties. This rate provides for return of invested capital plus a return on the investment).

The rate is dependent upon the return which investors will actually demand before they will be attracted by such an investment. The greater the risk of losing the investment, the higher will be the accompanying rate as determined in the market for such properties. By analyzing market prices, the rate can be approximated at any given time.

A variation of only 1 percent may make a substantial difference in the capitalized value of the income.

For example, based on an annual net income of \$30,000, and a capitalization rate of 6 percent, the capitalized property valuation would be \$500,000 ($\text{income} \div \text{rate}$). Capitalizing this same income at a rate of 7 percent would result in a value of only \$428,500 (rounded).

Capitalizing Net Annual Operating Income

The final step after having determined the net annual income and the capitalization rate is to capitalize the income. This may be merely the mathematical calculation of dividing the income by the rate if the income is considered to be in perpetuity.

For example, the valuation of property which has an assumed perpetual annual net income of \$30,000 and a capitalization rate of 5 percent is \$600,000. The lower the rate, the greater the valuation, and the greater the assumed security of the investment. So-called annuity tables are used in capitalizing incomes for fixed periods of varying duration.

As stated earlier, an important element in all capitalization rates is provision for a return of the investment on the improvements to the property during their remaining economic life. This may be called an amortization of such investments. It may be provided for by straight-line depreciation, which recovers a definite sum every year for the period of years estimated to be the economic life of the improvement, at the end of which time the cost of improvement will be accrued. It may also be provided for by other methods, such as establishing "sinking funds" or a declining balance depreciation. These are more technical procedures which are used by professional appraisers.

INCOME APPROACH APPLIED

Using procedures just discussed, here are two examples for finding estimated value using the income approach.

- How much should an investor pay for a 10 unit apartment house, 24 years old, estimated fair market rent per unit being \$500 per month. Indicated vacancy factor is 7%. Acceptable cap rate is 8 percent. Fixed expenses are: taxes of \$3,200 and insurance of \$860. Operating expenses are: management - \$3,960; utilities - \$1,200; waste removal - \$600; reserves for replacement - \$1,700.

Gross Scheduled Income (Annual)		\$60,000
(10 x \$500 x 12 = \$60,000)		
Less Income Loss Due to Vacancy Factor.....		<u>4,200</u>
(.07 x \$60,000 = \$4,200)		
Effective Gross Income		55,800
Less Expenses		
Fixed		
Taxes	\$3,200	
Insurance	<u>860</u>	
Total		\$4,060
Operating		
Management	3,960	
Utilities	1,200	
Waste Removal	<u>600</u>	
Total		5,760
Reserves for Replacement		
Roof	800	
Painting	500	
Carpeting	<u>400</u>	
Total		1,700

SUBTRACT TOTAL OF EXPENSES	<u>-11,520</u>
NET OPERATING INCOME (NOI)	\$44,280
Capitalization Rate Furnished By Owner is 8%.	
Using formula $I \div R = V$	
$\$44,280 \div .08 = \$553,500$	
Indicated Value (rounded)	\$555,000

2. A small commercial building has rental income of \$27,650 annually and suffers vacancy/collection losses of 5%. Expenses include: taxes-\$3,780; utilities-\$850; roof reserve-\$1,500; insurance-\$1,100; maintenance-\$2,000; repainting and fixture reserve-\$500; and management-\$2,000. The appraiser finds similar properties have cap rates ranging from 8.75% to 9.37%. Based on this market data the appraiser selects an indicated overall capitalization rate for the subject property of 9%. Using the Income Approach, what is the indicated value of the property?

Gross scheduled Income (Annual)	\$27,650
Less Vacancy and Collection Loss (5%)	<u>1,383</u>
Effective Gross Income	26,267
Less Expenses	
Fixed	
Taxes	\$3,780
Insurance	1,100
Operating	
Maintenance	2,000
Utilities	850
Management	2,000
Reserve for Replacements	
(Roof, Repainting and Fixtures)	2,000
Subtract Total Expenses	<u>-11,730</u>
Net Operating Income (NOI)	14,537
Indicated Overall Capitalization Rate 9%	
$\$14,537 \div .09 = \$161,522$	
Indicated Total Value by Income Approach	\$161,522
Round Value to	\$161,500

RESIDUAL TECHNIQUES

Suppose vacant land returns net income of \$6000 a year and the applicable interest rate for this type of real property is 7 percent. Using the income method, the property has a value of \$85,715 ($\$6,000 \div .07$).

However, income from improved property is the result of the contribution of both land and buildings. The buildings have limited economic life and their value must be recaptured over their remaining economic life. Income attributable to land is deemed perpetual.

There are three methods to capitalize income from improved property. They are each a "residual technique" because capitalization is applied to the residual (leftover or

unknown) net income attributable to the property as a whole, to the building, or to the land. The appropriate technique would be selected based on market data. The same net income figure applies in all three methods.

Property Residual Technique

This is the simplest method of capitalizing the net income from improved property because the property is valued as a single unit (used when the value of neither land nor improvements can be estimated independently). The property’s total net income is capitalized directly at an overall rate developed from the market data, comparing similar income producing properties which are also similar in the way net income is estimated.

Example. The net income generated from real property is \$32,000 annually and the overall cap rate selected from the market data approach is 9%. What is the value of the property?

$$\text{Income} \div \text{Rate} = \text{Value}$$

$$\$32,000 \div .09 = \text{Value}$$

$$\text{Value} = \$355,556$$

Building Residual Technique

If the value of the land is known and the value of the building is unknown, the property’s value may be determined by the building residual technique. This technique allocates the net income of the property to both land and building. The procedure is:

1. Multiply the known land value by the applicable interest (i.e., return) rate on the land to determine the income attributable to land only.
2. Deduct income to the land from total net income to determine the balance (“residue”) of the net income which represents the portion of the income attributable to/earned by the building
3. Capitalize the building’s income at the overall cap rate (interest rate plus recapture rate) to derive the value of the building.
4. Add the capitalized value of the building to the land value to arrive at the value of the whole property.

Example. An appraiser estimates that a 60 unit apartment building has an estimated remaining economic life of 25 years. The annual net income of the property is forecast at \$216,000. On the basis of several comparables, an appraiser estimates that the land value is \$60,000 and the applicable rate of interest for this type of investment property is 8%. What is the indicated value of the property by the income approach?

Annual net income of property		\$216,000
Less interest on \$60,000 land value at 8%		<u>4,800</u>
Net income attributable to building		\$211,200
Interest rate	8%	
Recapture rate	<u>4%</u>	
Cap rate	12%	
Indicated building value (\$211,200 ÷ .12)		\$1,760,000
Land value (by comparison)		<u>60,000</u>
Indicated property value		\$1,820,000

Land Residual Technique

If the building value is known and the land value is unknown and cannot be determined separately, the value of the property as a whole may be estimated by using the land residual technique. The land residual technique is similar to the building residual technique except that the appraiser must first find the income attributable to the improvements and the residue (balance) of the income is then attributable to the land. The procedure is:

1. Multiply the known improvement value by the applicable building capitalization rate (interest rate plus recapture rate) to determine the income attributable to the building only.
2. Deduct income to the building from the total net income to determine the residue (balance) of the net income attributable to/earned by the land.
3. Capitalize the land's income at the interest rate only (since it is not necessary to recapture the permanent land value) to derive the value of the land.
4. Add the capitalized value of the land to the building value to arrive at the value of the whole property by the land residual technique.

Example. Same facts as the building residual technique example above.

Annual net income of property	\$216,000
Less income attributable to building (\$1,760,000 x .12)	<u>211,200</u>
Net income attributable to land	4,800
Indicated land value (\$4,800 ÷ .08)	60,000
Building value	<u>1,760,000</u>
Property value indicated by land residual technique	\$1,820,000

Finding the Overall Cap Rate - Example

A property sells for \$250,000. Building value is \$190,000. Remaining economic life is 25 years. Annual net income from building is \$28,000. What is the interest rate for the building? What is the overall cap rate?

Recapture rate is 4% ($100\% \div 25$).

Building's net income	\$28,000
Recapture of building (.04 x \$190,000)	<u>\$7,600</u>
Net income after recapture	\$20,400

Interest rate = $\$20,400 \div \$190,000 = .1074$ or 10.74%

The overall cap rate is the sum of the interest rate and recapture rate:

Interest Rate = 10.74%

Recapture Rate = 4%

Therefore, the Overall Cap Rate = 14.74%

YIELD CAPITALIZATION ANALYSIS

Now preferred over the residual techniques discussed above, yield capitalization analysis is a method of converting economic benefits of ownership into present value by discounting each anticipated benefit at an appropriate yield rate, or by developing an overall capitalization rate that explicitly reflects the required yield rate and anticipated changes in income and/or value, if any. The *yield rate* is a rate of return on capital. This

method simulates typical investor assumptions by using formulas that calculate the present value of future economic benefits based on specified rate of return requirements.

The future economic benefits that are typically considered in this analysis are periodic cash flows and reversion. The procedure used to convert these future economic benefits into present value is called *discounting*, and the required rate of return (or yield rate) is referred to as the *discount rate*. The discounting procedure is based on the assumption that the investor will receive an adequate rate of return *on* the investment, plus return *of* the capital invested. Unlike direct capitalization using market-extracted rates, the method and timing of the returns on and of capital are explicit in yield capitalization analysis. This valuation method can be used to value the fee simple interest in a property, or any property interest for which all future economic benefits can be estimated.

The most common form of yield capitalization analysis is called *discounted cash flow analysis*. In this valuation technique, each anticipated future economic benefit of ownership of the property or property interest being valued must be estimated. Next, each benefit is discounted to present value using a discount rate that reflects the risk associated with the characteristics of the investment. This rate cannot be extracted directly from sales (as can an overall capitalization rate), but must be based on market attitudes and expectations for rates of return for similar assets. Yield rates inherently include a safe, risk-free rate, along with premiums to compensate the investor for the added risk, illiquidity, and burden of management associated with the specific investment. The safe rate included in the yield rate includes an inflationary expectation for the anticipated term of the investment. The discounting process can be performed using formulas and factors obtained from financial tables, or by using financial calculators or personal computers.

The following discounted cash flow analysis example summarizes the application of yield capitalization analysis to a simple real estate problem. The property to be appraised is expected to produce a first-year net operating income of \$100,000, which is expected to increase at 3 percent per year over a seven-year holding period. At the end of the holding period, it is anticipated that the property can be sold for \$1,000,000 net of sales expenses. The appropriate yield rate for this investment is concluded to be 13 percent. The following table shows the anticipated cash flows, along with the present value factors and the calculated present value of each year's cash flow.

Discounted Cash Flow Analysis

	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>	<i>Year 5</i>	<i>Year 6</i>	<i>Year 7</i>
Net oper income	\$100,000	\$103,000	\$106,090	\$109,273	\$112,551	\$115,927	\$119,405
Reversion							<u>\$1,000,000</u>
Total inc	\$100,000	\$103,000	\$106,090	\$109,273	\$112,551	\$115,927	\$1,119,405
Present val factor	<u>x 0.8850</u>	<u>x 0.7831</u>	<u>x 0.6931</u>	<u>x 0.6133</u>	<u>x 0.5428</u>	<u>x 0.4803</u>	<u>x 0.4521</u>
Present value	\$88,500	\$80,659	\$73,531	\$67,017	\$61,093	\$55,680	\$475,859

TOTAL PRESENT VALUE: \$902,339; rounded to \$900,000.

(The present value factors in this analysis were calculated using a financial calculator, but could have been obtained from a set of financial tables.)

GROSS RENT MULTIPLIER

Value is the present worth of all rights to future benefits. The rights being obtained through the payment of rents are the use of the physical structure as well as the intangibles (amenities or satisfactions). Income properties such as large apartments and commercial stores are purchased for the income stream they produce, whereas single-family homes are purchased for shelter plus the satisfaction (amenities of home ownership).

Standard capitalization techniques used for income producing properties do not measure intangibles such as pride of ownership and other amenities found in home ownership.

This indirect method of capitalization, the gross rental multiplier, will measure the market value of the combination of intangibles and tangibles found in single family and small income properties.

The gross rent multiplier is found by dividing the sales price of a house or other small income property by its monthly rent. For example: a \$90,000 sales price divided by a monthly rent of \$600 results in a gross rent multiplier of 150. If homes in the area were selling at prices equivalent to 150 times the monthly rental, then the 150 multiplier would apply to other comparable homes in the area.

Method of Approach In Using the Gross Rent Multiplier

1. Determine the fair or economic rent of the property being appraised by comparison with similar rental properties.
2. The gross rent multipliers of the sales one investigates are calculated by dividing the sales prices by the monthly rents.
3. The rent multipliers may then be tabulated showing how these properties varied from the subject property: i.e., better or poorer.
4. The gross rent multipliers are *not* averaged to arrive at one final multiplier. Rather,
 - a. each property and its multiplier is compared to the subject property as to fair rent obtainable, location, size, condition, utility, and amenities; and
 - b. after proper analysis, a judgment is made as to the appropriate gross rent multiplier.
5. The appraiser multiplies the selected gross rent multiplier by the fair rental of the subject property. The product is the value estimate.
6. Discounted Cash Flow Analysis (DCF) is a technique of income analysis which has grown to be a prominent method in recent years. It is defined as: "The procedure in which a discount rate is applied to a set of projected income streams and a reversion. The analyst specifies the quantity, variability, timing, and duration of the income streams as well as the quantity and timing of the reversion and discounts each to its present value at a specified yield rate. DCF analysis can be applied with any yield capitalization technique and may be performed on either a lease-by-lease or aggregate basis." (*Dictionary of Real Estate Appraisal*, 3rd edition, by the Appraisal Institute) For further study of this method, the reader is advised to seek additional education, as this is a rather technical process subject to misuse and abuse if not properly taught.

SUMMARY

It may be said that all three appraisal approaches to value (Cost, Sales Comparison, and Income Capitalization) should be considered and used when appropriate to the property type. The results are reconciled into one final estimate of value. As independent approaches, the sales comparison method is the most widely used. Investment property is frequently appraised by the income capitalization method, while the replacement cost method best lends itself to special purpose properties or newer properties.

The purpose of the appraisal will have a definite bearing in determining the method of valuation. For example, if the purpose is sale, purchase, exchange or condemnation, the value concept sought is current market value.

Reconciliation of the three indications of value derived through the market data, cost and income approaches leads to the final estimate of value or final value conclusion, which is the final step in the appraisal process. Reconciliation is a method of interpreting the data which have been gathered throughout the entire appraisal process into one final value conclusion. The primary facts which are analyzed and brought together are the estimates of value arrived at by reason of the three approaches to value.

Each approach to value results in only a preliminary estimate or an indicated value of the property. The indications resulting from each of the approaches give a range within which the final value conclusion lies. The result obtained by each of the methods of valuation will not be the same due to the many variables which are encountered, but they generally are within range of each other.

A thorough review of each of the approaches is made in order to narrow the range of preliminary answers. If the results from one particular approach appear to be at a great divergence from the other two, each phase of this approach should be reconsidered to account for the difference.

Greater weight, however, is generally given to one of the approaches over the other two, based on the quality of data in each.

The final conclusion of value is not an average of the three approaches to value. After giving full consideration to each approach, the appraiser uses judgment and reasoning to arrive at one conclusion. The greatest confidence is placed in the approach which seems to produce the most reliable solution to the specific appraisal problem, realizing that it must be reasonable and capable of being supported convincingly.

The final value conclusion should not be reported in odd dollars and cents. If the final answer approximates \$1,000, the answer could be rounded to the nearest \$100; if \$10,000, to the nearest \$500; if \$50,000, to the nearest \$1,000 or more.

APPRAISAL OF MANUFACTURED HOMES (MOBILEHOMES)

The appraisal of mobilehomes attached to foundations on individual lots relies on the approaches outlined for other residential properties. The appraiser needs a technical understanding of mobilehome construction for differences in cost studies. The market data approach works best in this appraisal effort.

Mobilehome coaches in parks are on rental spaces or fee-owned spaces in a mobilehome park subdivision. Again, the general principles of real property appraisal apply, except the appraiser needs the technical background in coach construction to best evaluate quality and features.

In many respects, the appraisal of a mobilehome on a fee-owned space is similar to residential condominium appraisal. This includes consideration of homeowners association services and fees as well as CC&Rs covering operation of the park and space improvement requirements.

Mobilehome appraisal is becoming another specialized opportunity in the appraisal profession. This is particularly true in the expanded market for mobilehomes as low and moderate income housing.

EVALUATING THE SINGLE FAMILY RESIDENCE AND SMALL SINGLE MULTI-FAMILY DWELLINGS

This section outlines basic premises which must be considered in making an appraisal of a single family residence and emphasizes some important factors to be weighed. It points out the differences that will be encountered between appraising new and used homes, and shows appraisal differences between a small multi-family dwelling and a single family home.

New Residence

Neighborhood analysis.

- A. Factors which make up the neighborhood must be determined and analyzed.
 1. Type of occupants.
 - a. Income level.
 - b. Representative age groups and family sizes.
 2. Type of improvement.
 - a. Is there a mixture of uses (e.g., single family, apartments, etc.)?
 - b. What is the age bracket of the improvements?
 - c. What is the price range of typical houses in the area?
 3. Neighborhood trend.
 - a. Are there detrimental factors present which might tend to depress the market?
 - b. Is the trend away from single family houses to multi-family, commercial or industrial uses?
 - c. Is the neighborhood in a transitional stage from owner occupied homes to tenant occupancy?
 - d. Are there advantageous factors which indicate an increasing market demand or price level?
 4. Changes in land use.
 - a. Zoning and restrictions.
 - b. Street and highway pattern.
 - c. Transportation.
 - d. Any encroachments?
 - e. Is utility increased? Decreased?
 5. Community services.
 - a. Commercial.
 - b. Recreational.
 - c. Educational.
 - d. Cultural.
 - e. Governmental.

Inspection of property.

- A. Relationship of the improvements to site.
 - 1. The house, including outbuildings, should have a harmonious appearance on the site.
 - a. Is the house too large for the site?
 - b. Is the house properly oriented on the lot to take advantage of climatic conditions?
 - c. Overbuilt? Underbuilt?
- B. Exterior of house.
 - 1. Determine the quality of construction. Inspect:
 - a. Foundation.
 - b. Walls.
 - c. Roof.
 - 2. Determine the resistance to wear and tear and the action of the elements.
 - a. Are there adequate gutters and drainspouts to take the water away from buildings?
 - b. Are there satisfactory roof overhangs to protect the windows and walls?
 - 3. Measure the exterior dimensions of the buildings in order to obtain their areas.
 - 4. Examine and describe yard improvements for purposes of estimating their value.
- C. Interior of house.
 - 1. Determine the quality of the building.
 - a. Durability of building.
 - b. Arrangement of floor plan and layout of space.
 - c. Attractiveness of design.
 - d. Grade and quality of materials used.
 - e. Adequacy of heating, cooking, electrical, and plumbing equipment.
 - 2. Measure or take note of room sizes and placement of windows for adequate light and ventilation.
 - 3. Determine if the traffic pattern is functionally proper.
 - 4. Does the home have all the modern conveniences necessary for a new house in its price class?

Verification through public records.

- A. Public records should be checked to verify the following about the property being appraised:
 - 1. Proper legal description.
 - 2. Correct street address.
 - 3. Size/dimensions of the lot.
 - 4. Location of the lot with respect to the nearest cross street.
 - 5. Any easements, restrictions or other reservations or interests affecting the property.
 - 6. The assessed value and taxes of the property.
 - 7. Any changes in zoning or street pattern.

- B. Transfer of title of similar properties.
 - 1. Sales of single family vacant lots should be obtained and verified.
 - 2. Sales of improved single family residences within the same neighborhood should be recorded.

Inspection of comparable sales.

- A. Vacant lots or improved similar properties should be inspected.
- B. Similar or dissimilar features as compared to the subject property are recorded and the selling price, terms and reasons for sale or purchase must be verified by the seller or buyer.

Application of approaches to value.

- A. Cost approach to value.
 - 1. From the information gathered in the inspection and the size, quality and cost classification, an estimate of cost is made of all improvements on the land.
 - 2. The land value is estimated from information gathered in the record search of vacant parcels.
 - 3. In the majority of instances, if the improvements are new and the highest and best use of the land, the estimate of value by means of the cost approach is equal to land value plus the new improvement costs.
- B. Sales Comparison or market approach to value.
 - 1. The sales of similar type houses are compared to the subject as to time, location and physical characteristics.
 - 2. Necessary adjustment must be made between the sales and the subject.
 - 3. A preliminary estimate of value by means of the comparative approach is obtained.
- C. Income approach to value.
 - 1. The economic rent of the subject is estimated by means of experience and comparison.
 - 2. Gross monthly multipliers of similar type properties are gathered and analyzed in order to arrive at one multiplier to apply to the subject.
 - 3. DCF may be applied for such properties as new condominium projects, subdivisions or any property with a variable type income over the holding period of the investment.
 - 4. A preliminary estimate of value by means of the income approach is obtained.
- D. Reconciliation of the approaches.
 - 1. Each approach is weighed and compared.
 - 2. With a new property it will generally be found that the cost approach will carry the greatest weight in the correlation.
 - 3. If the new subject property were located within a tract of similar type houses, market comparison would be given the most weight in the reconciliation.
 - 4. After weighing all of the factors involved, one final value reconciliation for the property is set forth.

Older Residence

Neighborhood analysis. In addition to the points covered under new residence, the following should be carefully considered when dealing with an older property in a built-up neighborhood:

- A. Neighborhood trend.
 - 1. A check should be made to determine if proposed zoning changes are being considered by the local government.
 - 2. Contemplated changes might indicate that the best use of the subject is no longer thought to be for single family housing.
- B. Inspection of property. In addition to the items covered under the new residence, consideration should be given to the following:
 - 1. A more careful inspection is made of the premises.
 - a. Note effects of dry rot and termites.
 - b. Look for deferred maintenance.
 - c. Inspect roof and attic for signs of water leaks.
 - d. Check foundation for settling.
 - 2. Room arrangement and functional utility.
 - a. An older home is more likely to have an out-of-date floor plan.
 - b. The livability or utility is often obsolete as compared to a newly designed structure.
 - 3. Wiring and plumbing.
 - a. Is the home underwired for today's electrical appliances? Particular attention should be given to the kitchen.
 - b. Are the plumbing lines being affected by encrustation? Will they have to be replaced shortly?
 - c. Are the plumbing fixtures in the kitchen and bathrooms adequate and in good working condition?
 - 4. Heating plant and/or air conditioning unit.
 - a. Is unit(s) sufficient for size and quality of house?
 - b. What would be entailed to install a new or more efficient unit? Would it be feasible?
- C. Application of approaches. Each approach may be used in valuing an older property. The primary difference between valuing a new and old home is in the determination of depreciation as part of the cost approach.
 - 1. Consideration must be given to the inspection of the home in order to help the appraiser reach an opinion as to the effective age to be assigned.
 - 2. Physical curable deterioration must be calculated with care.
 - 3. Study must be made to determine if a functional item may be treated as curable or incurable.
 - 4. Items of economic depreciation will be more prevalent in an older neighborhood than a newer one.

Definition of small multi-family dwelling.

- A. In most instances, a small multi-family dwelling refers to a property which contains more than one but less than six living units. These units may be one of the following:
 - 1. Double bungalow or duplex.
 - 2. Triple bungalow or triplex.
 - 3. Small courts or numerous houses on a lot.
 - 4. Flats or small apartments.

Reasons for purchasing residential properties.

- A. There are three categories of residential properties.
 - 1. Single family homes.
 - 2. Small multi-family dwellings.
 - 3. Income producing multi-family dwellings.
- B. Single family homes.
 - 1. Primary concern is given to amenities of home ownership.
 - 2. Cost of ownership is of secondary importance.
 - 3. Pride of location and architectural appeal is given consideration before purchasing.
- C. Small multi-family dwellings are purchased for a combination of home ownership and income.
 - 1. Location, architectural attractiveness, and the amenities of ownership are given strong consideration by a purchaser.
 - 2. Income is of secondary importance.
 - 3. Typically, a buyer hopes to be able to reduce the cost of living by obtaining some rental income to decrease expenses.
 - 4. The income received tends to offset real estate taxes, insurance, and maintenance costs.
 - 5. In some instances, rental income will also cover mortgage payments on the property.
 - 6. Usually, the owner of a small multi-family dwelling must do all management work.
- D. Income producing multi-family dwelling.
 - 1. Large multi-family dwellings (above 10 to 15 units) are purchased primarily for the income stream to be produced.
 - 2. The net income or spendable income is the most important item considered by the buyer.
 - 3. Amenities of ownership have little influence in the buying decision.
- E. Other reasons for purchase.
 - 1. Hedge against inflation.
 - 2. Means of forced saving.
 - 3. Chance for appreciation in value due to increasing demand in the area.

Appraisal procedure.

- A. Small multi-family units are appraised approximately the same as single family homes.
- B. Cost factors, depreciation and estimates of land value are calculated in the same manner as with single family homes.
- C. Small units cannot be considered as true income producing units. Therefore, in most instances, monthly gross multipliers are used instead of an income approach to value.
- D. The market comparison approach differs to some extent from the comparative approach as used with homes.
 - 1. Less emphasis is placed on attempting to measure pride of ownership and amenities.

2. The comparison approach can be refined to a greater degree.
 - a. Comparisons may be made on a per unit basis.
 - b. Comparison can be made on a per room basis.
3. The appeal of the units from a renter's standpoint must be considered.
4. The location factor as it relates to transportation and shopping may be given greater consideration than with a single family home.

Amenities of multi-family dwellings.

- A. Factors and amenities considered important by tenants of multi-family dwellings.
 1. Distance from employment centers.
 2. Public transportation.
 3. Distance to good shopping.
 4. Distance to parks and recreation.
 5. Distance from nuisances.
 6. Rent levels.
 7. Pride of ownership.
 8. Adequacy of off-street parking.
- B. Factors considered important by the owner.
 1. Police and fire protection, rubbish collection.
 2. Vacancy rates in the area.
 3. Amount of taxes.

**TYPICAL OUTLINE FOR WRITING THE SINGLE FAMILY RESIDENCE
NARRATIVE APPRAISAL REPORT**

- A. Title Page:
 1. "A market value appraisal of the single family residence known as (Address)."
 2. Name of client.
 3. The name and address of the appraiser
- B. Table of Contents:
 1. Preface.
 2. Body of report.
 3. Addenda section.
- C. Letter of Transmittal:
 1. Date.
 2. Name and address of addressee.
 3. Salutation.
 4. Authorization.
 5. Legal description or reference thereto.
 6. Purpose of appraisal, including type of value estimated.
 7. Date of evaluation.
 8. Reference to following report of _____ pages, including _____ exhibits as well as limiting conditions, factors considered and reasoning employed in arriving at the final conclusion of fair market value.
 9. Estimate of value (written and numbered).
 10. Certification of appraiser.
 11. Signature.

- D. Summary of Salient Facts and Conclusions:
 - 1. Recap of pertinent information such as value estimate, date of value, purpose of appraisal, etc.
- E. Premise Section:
 - 1. Statement of intended use of the appraisal report.
 - 2. Statement of limiting conditions on which the appraisal is based, including full definition of value as estimated in report.
- F. Regional, City and Neighborhood Analysis:
 - 1. Pertinent features.
 - 2. Economic factors.
 - 3. Significant trends.
- G. General Property Information:
 - 1. Record or legal owner.
 - 2. Legal description.
 - 3. Legal address.
 - 4. Location.
- H. Site Analysis:
 - 1. Description of parcel:
 - a. Size and shape.
 - b. Topography and surface drainage.
 - c. Soils including subsoil (foundational).
 - d. Access.
 - e. Landscaping, etc.
 - 2. Street improvements and utilities.
 - 3. Deed restrictions and zoning.
 - 4. Assessed valuation and tax information.
 - 5. Current use and adaptability.
 - 6. Highest and best use.
- I. Improvement Analysis:
 - 1. Basic description:
 - a. Type and date of construction.
 - b. Architectural form.
 - c. Number of rooms.
 - 2. Summary of square foot areas:
 - a. Residence.
 - b. Garage.
 - c. Other structures, walks and drives.
 - 3. Exterior description:
 - a. Foundation and sub-structure.
 - b. Exterior treatment.
 - c. Roof design and cover.
 - d. Porches.
 - 4. Interior description:

- a. Room descriptions (space allotment; floor, walls and ceiling finish; built-ins and fixtures).
5. Mechanical Equipment:
 - a. Heating and air conditioning.
 - b. Electrical.
 - c. Miscellaneous - garbage disposal, etc.
6. Miscellaneous Improvements:
 - a. Outbuildings.
 - b. Patios and walks.
 - c. Landscaping.
- J. Analysis and Valuation:
 1. Statement of problem.
 2. Methods of appraisal.
 3. Investigation.
- K. Estimate of Land Value:
 1. By market data approach.
 2. By sales abstraction.
 3. Economic approaches:
 - a. As percentage of annual income classification.
 - b. As percentage of total property value.
 4. Reconciliation of various approaches.
 5. Final estimate of land value.
- L. The Cost Approach:
 1. Reproduction cost estimate:
 - a. Justification.
 2. Estimate of accrued depreciation:
 - a. Physical deterioration with justification: curable and incurable.
 - b. Functional Obsolescence with justification: curable and incurable.
 3. Economic obsolescence with justification.
 4. Depreciated reproduction cost.
 5. Addition of estimated land value.
 6. Value indicated by cost approach.
- M. The Market Data Approach:
 1. Market data presentation including statement of source and verification:
 - a. Summary of pertinent data (sales and listings).
 2. Analysis of market data:
 - a. Factors of adjustment.
 3. Application of adjusted market data factors:
 - a. Comparison by various common denominators: e.g., ratio of sales price to living area; ratio sales price to number of rooms.
 - b. Direct property comparison.
 4. Reconciliation of indications using reliability coefficients.

5. Value indicated by market data approach.
- N. The Income Approach:
1. Seldom employed in analysis of single family residential property.
 2. Justified gross rent multiplier of neighborhood.
 3. Justified fair rental estimate for subject.
 4. Indicated value by income approach.
- O. Reconciliation and Discussion of Value Estimates:
1. State values estimated by three separate approaches.
 2. Analysis:
 - a. Major, but not exclusive, weight to approach that:
 - Is most closely related to purpose of the appraisal;
 - Is most appropriate for property classification concerned;
 - Has greatest amount of supporting data;
 - Most accurately reflects attitude of typical purchaser; and
 - Is most sensitive to current trends.
 3. State final value conclusions:
 - a. Suggested arbitrary separation:
 - Land; and
 - Improvements.
- P. Addenda Section:
1. Market data.
 2. Market data map.
 3. Plots, maps, pictures, charts, statistical and factual data pertinent to the value estimate and necessary as supporting evidence not included in body of report.
- Q. Appraiser's Qualifications.

CONCLUSION

In concluding this information on concepts, valuation and appraisal techniques, let us wave three warning flags. It is to be noted that there are subtle differences between *valuation* and *appraising*. The first is broader, tends to be economic in origin and emphasizes theory; the latter refers more to practice, methods and techniques. Next, anyone can make an appraisal, even a lay person, but the *worth* of an appraisal report is determined by the experience, knowledge, qualifications, and motives of the person behind it. Finally, let us not be deceived by any broad statement that appraising is an exact science. It is a science as is any of the other social sciences, but people and property cannot be appraised with the exactness and accuracy reached by the mathematical and physical sciences.

ADDITIONAL PRACTICE PROBLEMS

The following are some additional practice problems with suggested solutions.

Applying the Income (Capitalization) Approach

1. A 50 unit apartment building and lot are being appraised. The 30 two-bedroom units rent for \$600 and the 20 one-bedroom units rent for \$475 monthly, which rent

is comparable to market rent in the area. Vacancy and collection losses are estimated to be 5% of potential gross income. The parking structure and laundry facility contribute an additional estimated \$1,200 income per month. What is the property's (land and building) total estimated annual effective gross income?

Solution.

30 x \$600 = \$18,000 x 12 =	\$216,000
20 x \$475 = \$9,500 x 12 =	<u>114,000</u>
Apartment rental income.	\$330,000
Plus other income: \$1200 x 12 =	<u>14,400</u>
Potential Gross Annual Income	\$344,400
Less 5% vacancy/collection loss	<u>-17,220</u>
Total annual effective gross income	\$327,180

2. The owner's operating statement shows the following annual expenses:

FIXED EXPENSES

Real Property Taxes	\$7,200
Insurance	2,200
License	200
Capital Improvements	22,000
Depreciation	<u>10,000</u>
	\$41,600

OPERATING EXPENSES

Water	\$9,000
Gas and Electricity	6,000
Pool Service	4,800
Gardening Maintenance	1,200
Entertainment Expenses	750
Building Maintenance	10,000
Resident Manager Salary	12,000
Refuse Service	<u>1,200</u>
	\$44,950

RESERVES FOR REPLACEMENTS

Appliances, carpets, drapes	\$6,000
Building components	<u>4,000</u>
	\$10,000

TOTAL EXPENSES..... \$96,550

After reconstructing owner's statement (determining proper allowable expense items), what is property's annual estimated net income?

Solution.

Deduct \$32,000 (Capital Improvements and Depreciation) from fixed expenses and \$750 (Entertainment Expense) from operating expense, as being improper deductions.

From problem #1, the effective annual gross income is \$327,180

EXPENSES

FIXED	\$9,600
OPERATING	44,200

REPLACEMENT RESERVES	<u>10,000</u>
TOTAL EXPENSES	<u>- 63,800</u>
ESTIMATED ANNUAL NET INCOME OF PROPERTY	\$263,380

3. The appraiser determined a proper overall capitalization rate for the above property is 9.5%. What is the estimated property value?

Solution.

\$263,380 net income ÷ .095 cap rate = \$2,772,421 estimated property value.

4. Suppose the net income of the property is only \$189,000 and similar properties are valued at \$1,929,000. What is the indicated overall cap rate?

Solution.

\$189,000 (Income) ÷ \$1,925,000 (Value) = 9.8% overall cap rate.

5. Given, based on comparative sales technique:

Sale price of an income property	\$230,000
Building value	\$170,000
Remaining estimated life of building	40 years
Annual net income of property	\$23,500

What is the indicated interest rate for the property?

Solution.

(Improved properties have both an interest rate and a recapture rate included in the capitalization rate. The recapture rate applies only to the improvements, while the interest rate applies to both land and improvements.)

Estimated net income before recapture	\$23,500
Recapture for building:	
100% ÷ 40 yrs. = 2.5% x \$170,000	<u>\$4,250</u>
Net income after building recapture	\$19,250
Interest Rate = \$19,250 ÷ \$230,000 = 8.3%	

6A. Building Residual Technique Problem (Land value known; building value unknown.)

Assume the following:

Annual net income from the whole property	\$14,000
Land value	\$42,000
Recapture rate for building (25 yrs remaining economic life) .	4%
Interest rate	8%

What is (1) the building value and (2) the property value?

Solution.

Net income of property	\$14,000
Income attributable to land: \$42,000 x .08 =	<u>\$3,360</u>
Income attributable to building	\$10,640
Capitalization rate: 12% (8% + 4%)	
Formula: Present Value = Net income ÷ Capitalization Rate	
Therefore, Indicated value of building = \$10,640 ÷ .12 =	\$88,667
Plus land value	<u>\$42,000</u>
Indicated property value by building residual technique	\$130,667
	(\$130,700 rounded)

6B. Land Residual Technique Problem (Building value known; land value unknown.)
 Assume the same figures as above in building residual technique problem, except building value is \$88,700 and land value is unknown.
 What is (1) land value and (2) property value?

Solution.

Net income	\$14,000
Less income attributable to improvements (\$88,700 x .12)	<u>-\$10,644</u>
Income attributable to land	\$3,356
Indicated value of land = \$3,356 ÷ .08 = \$41,950 (rounded) ..	\$42,000
Add improvement value	<u>\$88,700</u>
Indicated property value by land residual technique	\$130,700

7A. Assume that comparisons show comparable single-family houses in a neighborhood rent for about \$380 per month and sell for an average of \$45,600. What is the indicated gross rent multiplier for a subject property in this neighborhood?

Solution.

Formula: sales price ÷ gross monthly rent = gross rent multiplier

Therefore, \$45,600 ÷ \$380 = 120

The gross rent multiplier is 120

7B. Suppose that, when compared to other rentals, the above property lost \$24 per month rental income due to poor kitchen location. What is the estimated depreciation attributable to incurable functional obsolescence?

Solution.

120 x \$24 = \$2,880

THE OFFICE OF REAL ESTATE APPRAISERS

Background

In 1989, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), commonly known as the “Savings and Loan Bailout Bill.” Title XI of FIRREA contains the *Real Estate Appraisal Reform Amendments* which require each state to establish a program to license and certify real estate appraisers who perform appraisals for federally related transactions. Title XI additionally requires states to adhere to real estate appraiser qualifications criteria set by the Appraiser Qualifications Board (AQB) of The Appraisal Foundation.

Office of Real Estate Appraisers

In response to FIRREA, in 1990 the California Legislature enacted the Real Estate Appraisers’ Licensing and Certification Law (Business and Professions Code Section 11300, et seq.) This law created the Office of Real Estate Appraisers (OREA), which was organized in early 1991. OREA regulates real estate appraisers by issuing licenses and investigating complaints of illegal or unethical activity by licensed appraisers.

Real Estate Appraiser Licenses

There are four levels of licensing for real estate appraisers in California. Listed below are the requirements for each of the four levels.

1. **Certified General Real Estate Appraiser** — Certified general appraisers may appraise any type of real property.)

Education — At least 180 hours of appraisal related education covering these specific topics which are required by AQB:

- Influences of Real Estate Value
- Legal Considerations in Appraisal
- Types of Value
- Economic Principles
- Real Estate Markets and Analysis
- Valuation Process
- Property Description
- Highest and Best Use Analysis
- Appraisal Statistical Concepts
- Sales Comparison Approach
- Site Value
- Cost Approach
- Income Approach, including
Estimation of income and expenses
Operating expense ratios
Gross rent multiplier analysis
Direct Capitalization
Cash flow estimates
Measures of cash flow
Discounted cash flow analysis
- Valuation of Partial Interests
- Appraisal Standards and Ethics (USPAP) (15 hours, minimum.)
- Narrative Report Writing

Experience — At least 3,000 hours of acceptable appraisal experience, of which at least 1,500 hours must be in appraising non-residential properties. The experience must have been obtained over a minimum of 30 months. Experience may be obtained in any of the following categories:

- Fee and staff appraisal
- Ad valorem tax appraisal
- Review of an appraisal (400 hours maximum.)
- Appraisal analysis
- Real estate counseling
- Highest and best use analysis
- Feasibility analysis/study
- Setting forth opinions of value of real property for tax purposes
- Assisting in the preparation of appraisals (400 hours maximum.)
- Real estate valuation experience such as that of a real estate lending officer or real estate broker.

Examination — Successful completion of the AQB endorsed Uniform State Certified General Real Property Appraiser Examination.

2. **Certified Residential Real Estate Appraiser** — Certified residential appraisers may appraise *any* one-to-four unit residential property, and non-residential property with transaction value up to \$250,000.

Education — At least 120 hours of appraisal related education covering these specific topics which are required by AQB:

- Influences of Real Estate Value
- Legal Considerations in Appraisal
- Types of Value
- Economic Principles
- Real Estate Markets and Analysis
- Valuation Process
- Property Description
- Highest and Best Use Analysis
- Appraisal Statistical Concepts
- Sales Comparison Approach
- Site Value
- Cost Approach
- Income Approach, including
Estimation of income and expenses
Operating expense ratios
Gross rent multiplier analysis
Direct Capitalization
- Valuation of Partial Interests
- Appraisal Standards and Ethics (USPAP) (15 hours maximum.)
- Narrative Report Writing

Experience — At least 2,500 hours of acceptable appraisal experience. The experience must have been obtained over a minimum of 30 months. Experience may be obtained in any of the following categories:

- Fee and staff appraisal
- Ad valorem tax appraisal
- Review of an appraisal (400 hours maximum.)
- Appraisal analysis
- Real estate counseling
- Highest and best use analysis
- Feasibility analysis/study
- Setting forth opinions of value of real property for tax purposes
- Assisting in the preparation of appraisals (400 hours maximum.)
- Real estate valuation experience such as that of a real estate lending officer or real estate broker.

Examination — Successful completion of AQB endorsed Uniform State Certified Residential Real Property Appraiser Examination.

3. **Residential License** — Residential licensed appraisers may appraise any one-to-four unit residential property with a transaction value up to \$1 million, and non-residential property with a transaction value up to \$250,000.)

Education — At least 90 hours of appraisal related education covering these specific topics which are required by AQB:

- Influences of Real Estate Value
- Legal Considerations in Appraisal
- Types of Value
- Economic Principles
- Real Estate Markets and Analysis
- Valuation Process
- Property Description
- Highest and Best Use Analysis
- Appraisal Statistical Concepts
- Sales Comparison Approach
- Site Value
- Cost Approach
- Income Approach
 - Estimation of income and expenses
 - Operating expense ratios
 - Gross rent multiplier analysis
- Valuation of Partial Interests
- Appraisal Standards and Ethics (USPAP) (15 hours maximum.)

Experience — At least 2,000 hours (1,000 hours for holder of a valid California real estate broker license) of acceptable appraisal experience. Experience may be obtained in any of the following categories:

- Fee and staff appraisal
- Ad valorem tax appraisal
- Review appraisal
- Appraisal analysis (400 hours maximum.)
- Real estate counseling
- Highest and best use analysis
- Feasibility analysis and study
- Setting forth opinions of value of real property for tax purposes
- Assisting in the preparation of appraisals (400 hours maximum.)
- Real estate valuation experience as a real estate lending officer or real estate broker.

Examination — Successful completion of AQB endorsed Uniform State Residential Licensed Real Property Appraiser Examination.

4. **Trainee License** — (Trainee licensed appraisers must work under the technical supervision of a state licensed appraiser. They may assist on any appraisal which falls under the scope authorized for the supervising appraiser.)

Education — 15 hours of instruction related to the Uniform Standards of Professional Appraisal Practice, covering these specific topics which are required by AQB:

- Influences of Real Estate Value
- Legal Considerations in Appraisal
- Types of Value
- Economic Principles
- Real Estate Markets and Analysis
- Valuation Process
- Property Description
- Highest and Best Use Analysis
- Appraisal Statistical Concepts
- Sales Comparison Approach
- Site Value
- Cost Approach
- Income Approach, including
Estimation of income and expenses
Operating expense ratios
Gross rent multiplier analysis
- Valuation of Partial Interests
- Appraisal Standards and Ethics (USPAP) (15 hours maximum.)

Experience — No experience is required for the Trainee License. To accumulate appraisal experience, trainees must work under the technical supervision of a state licensed appraiser.

Examination — Successful completion of AQB endorsed Uniform State Residential Licensed Real Property Appraiser Examination.

Terms of Licenses

Real estate appraiser licenses are valid for two years, however, continuing education requirements are submitted every four years.

Renewal Requirements

All licensed appraisers must meet the following continuing education requirements for license renewal:

Hours. At least 14 hours per year of OREA approved continuing education.

Required topics. Included in the required hours, appraisers must complete at least 7 hours of instruction on the Uniform Standards of Professional Appraisal Practice, and the 4-hour course entitled “Federal and State Laws and Regulations.” In lieu of the four-hour course, a certification indicating that the appraiser has used and understands the material may be submitted.

OREA's Enforcement Division

The Enforcement Division is OREA's investigative and enforcement arm. It promotes professionalism in the industry by providing consumers and businesses with protection against unlawful and fraudulent conduct by appraisers. This is accomplished through the examination of past conduct of applicants for licensure, the investigation of complaints

and, where appropriate, the initiation of proceedings to deny licenses or impose disciplinary sanctions. Subject to various administrative safeguards and the review and approval of the Chief Deputy Director and the Director, the Division may seek to deny, restrict or revoke a license and/or impose a fine of up to \$10,000 for any violation of state law applicable to licensed appraisers.

Additional Information

For additional information, write or phone OREA at:

Office of Real Estate Appraisers
1755 Creekside Oaks Drive, Suite 190
Sacramento, CA 95833-3646
(916) 263-0722

Web site address: www.orea.ca.gov