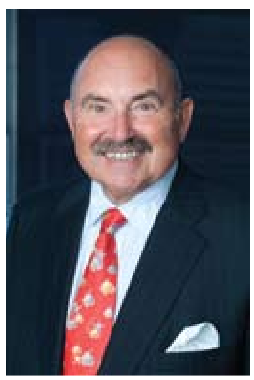
Michael Rikon

Basic Appraisal Concepts For Dummies

Your client is considering a purchase of property and asks you to review an appraisal on "Black Acre." Now What? In order to provide appropriate advice, one should understand the fundamentals of valuation of real estate.



Real property value is very dependent on the factual circumstances presented. It is also dependent on the reason for the need to value the property. Michael Rikon, *What's It Worth — Who Wants to Know?: The Valuation of Real Property Litigation* 16 Prob.& Prop. 20 (Jan./Feb. 2002).

Real property rarely presents itself in a perfect model of circumstance for valuation. This does not mean that one occasionally does not get lucky. There can be a very recent sale of a condominium unit in the same building, in the same line, and only one floor away. This rarity aside, real property is usually unique in a number of factors including its location. It generally lasts forever and is of limited supply. Its value may be very dependent on its use, which could be unique to its present owner. What real property is worth may not correspond to what it cost. Nor does fair market value necessarily mean assessed value. Real property value will often vary depending on subjective factors, legal issues, and the very nature of the inquiry.

How Real Property Is Valued

Appraisers estimate property value by utilizing three approaches to analyze real estate data. The

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three classic methods of valuing real property are: the market data or comparable sales approach; the income capitalization approach; and the cost approach. Let's examine each method separately.

Cost Approach

In the cost approach, an appraiser values the property premised on the value of the land and then adds what it would cost to build a new structure. The value is based on reproduction costs less observed depreciation. All increment costs are also considered and added to the value. The cost approach is rarely used for real estate. Real property must constitute a "specialty" for the cost approach to be employed. A "specialty" has been defined as a building designed for a unique purpose. For a building to be a "specialty," it must be truly unique so that only the owner would have use for it and the sole way to replace it would be by its reproduction.

Thus, an appraiser will rarely use the cost approach in the appraisal report. When it is used it is only to value a special purpose property that is not frequently sold in the market. It may be used in valuing new or proposed construction when there is reliable construction cost data available. Indeed, most real estate appraisers are not qualified to provide evidence of cost. It is much more prudent to adopt instead the value found by an architect, cost estimator, or builder. An appraiser who attempts to present a cost value by simply using a reference book is looking for trouble.

Market Data Approach

This approach, also known as the comparable sales approach, is used when the subject property is similar to other properties that have been sold, or perhaps are currently for sale in the subject property neighborhood. This method works well for residential properties and is always used for vacant land. The appraiser will analyze the sales by making a grid to show the appraiser's adjustments for location, size, time, zoning, marketing factors, view, and other factors that a buyer would consider, all with the idea that the comparable sales, as adjusted, will indicate a value of the subject.

It is a rare appraisal that does not include the sales comparison approach to value a property. The appraiser will research the market for information on properties that are similar to the subject property and have recently sold. The objective is to find sales that have similar characteristics such as topography, condition, size, location, zoning, date of transaction, etc. Appraisers then must "adjust" the comparable sales for the various factors, usually in a grid comparing the comparables to the subject property. All of the comparables as adjusted are then studied by the appraiser, often with several adjusted sales being given more weight than others to indicate a value of the subject.

Several points must be made regarding adjustments to the "comps." Generally, the comparable sales used should be verified. The sales should have taken place as close to the valuation date as possible or they may be deemed remote as to time. The sales should be adjusted for market conditions to reflect a rising or falling market. The comparable sales must have the same highest and best use. In reviewing an appraiser's adjustment factors, one must be alert for any large adjustment since the greater the adjustment, the less reliable the sale.

The Capitalization Of Income Approach

This approach analyzes a property's income-producing capability and then capitalizes the future income to indicate present value. Case law has indicated that if the property is indeed income-producing, the capitalization approach must be used.

If there are leases on the property, they must be evaluated and considered. But in condemnation, the property is valued as if it is free and clear of all liens, encumbrances, and leases. The appraiser makes an extensive market study and estimates the economic rent of the property. Actual rents provide a good indicator of fair market rental, especially if there is no indication that the actual rent is too high or too low.

Just as was the case when adjustments were made to comparable sales by using a grid, each of the comparable rentals will also be adjusted by a grid to consider such factors as market conditions, location, or physical characteristics of the comparable lease. In any event, there must be a grid or other detailed explanation to show how the gross rental of the subject property was determined.

The appraiser then estimates the expenses of the property. The net income is then applied a capitalization rate which, itself, is determined by a study of various economic factors including the returns on other investments, taking into account mortgage, equity components, and risk. The rate of capitalization should be a reflection of the market, i.e., what an investor would require from an investment in a property of similar age, kind, and condition.

The capitalization rate is the most critical part of the equation. The lower the "cap" rate, the higher the value of the property. Conversely, the higher the "cap" rate, the lower the value. A capitalization rate must be determined based on an objective study of various factors including a band of investment which allocates between mortgage and equity. The resulting mortgage and equity rates are weighted or blended to produce an overall capitalization rate.

The resulting "cap" rate is then divided into the net income to indicate a value for the property, care must be taken not to capitalize a speculative or hypothetical income stream from a non-existent structure. But a property with an existing lease and in development may certainly be valued on a capitalization approach, for that is exactly what a buyer would do when purchasing the property.

Reconciliation

The appraiser will then reconcile the values found by the market data approach with the value determined by the capitalization of income approach. Most appraisers will rely more on the income approach if the property is income producing.

USPAP Requirements

The Appraisal Foundation publishes the Uniform Standards of Professional Appraisal Practice (USPAP) on a yearly basis. The Standards are developed by the Appraisal Standards Board. The Foundation has been authorized by Congress as the source of appraisal standards and appraiser qualifications. There are many standards that must be considered by an appraiser.

A few of the most important are the requirement that the appraiser consider the effect and use of existing land use regulations and the reasonable probability of a re-zoning (Rule 1-3); the consideration of an anticipated public or private improvement located on or off the site to the extent they are reflected in market actions (Rule 1-4 (F)); and the requirement that an appraiser analyze all agreements of sale, options, and listings of the subject property current as of the effective date of the appraisal (Rule 1-5 (a)). There are more rules and they should be reviewed as should the mandatory ethics rules.

Conclusion

Having a basic understanding of appraisal concepts and principles will assist the review of an appraisal report so as to determine whether it indicates the market value of the specified property. While following the correct concepts is important, so is the application of common sense.