

Real Estate Principles of Georgia

Lesson 14:  
Real Estate  
Appraisal

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Appraisal Basics

Appraisal: Estimate of a property's value by professional appraiser and set forth in written appraisal report.

- Opinion, not a scientific conclusion.



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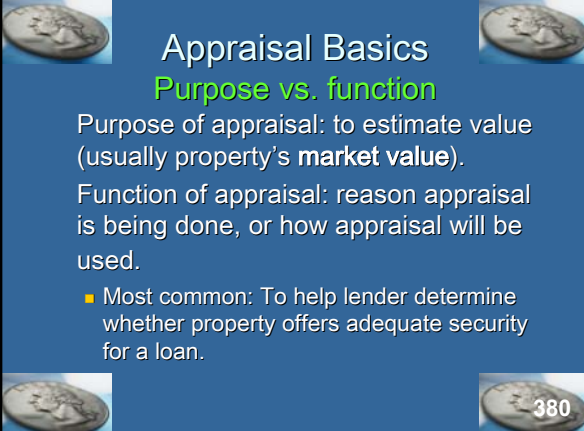
Appraisal Basics

Purpose vs. function

Purpose of appraisal: to estimate value (usually property's market value).

Function of appraisal: reason appraisal is being done, or how appraisal will be used.

- Most common: To help lender determine whether property offers adequate security for a loan.



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## Appraisal Basics

### Functions of appraisals

Other functions of real estate appraisals:

- land development (highest and best use)
- property tax assessments
- establishing rental rates
- property exchanges



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## Appraisal Basics

### Functions of appraisals

- determining needed insurance coverage
- estimating remodeling costs/contribution to value
- condemnation proceedings
- probate of estates
- corporate mergers, acquisitions, and bankruptcies



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## Appraisal Basics

### Appraiser/client relationship

Many appraisers employed by:

- banks or savings and loans
- mortgage companies
- private corporations involved in real estate
- government agencies such as FHA, VA

Fee appraiser: Self-employed appraiser, hired by client to appraise specific property for a fee.

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## Appraisal Basics

### Appraiser/client relationship

Appraiser must disclose any financial interest in property being appraised.

Fee must be tied to difficulty of appraisal and how long it will take.

- Can't be percentage of property's value.



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## Appraisal Basics

### Licensing and certification

Appraisers are licensed and certified under state law.

Appraisals used for federally related loans must be prepared by state-licensed or state-certified appraisers.

- Exemption: loans of \$250,000 or less

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## Appraisal Basics

### Licensing and certification

Appraisals used in federally-related loan transactions also must conform to **Uniform Standards of Professional Appraisal Practice (USPAP)**.

- Failure to abide by USPAP in order to defraud federally insured lender is felony.

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## The Concept of Value

Value: The present worth of the future benefits of property ownership.

- Almost always measured in terms of money.



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## The Concept of Value

### Elements of value

Elements of value:

- Demand
- Utility
- Scarcity
- Transferability



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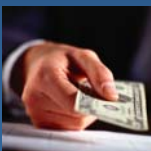
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## Types of Value

### Market value

- Market value: How much property is worth to average person who might buy it.
  - Also called **objective value** – appraiser is objective not subjective.



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## Market Value Definition

USPAP definition of market value:

“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.”

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## Market Value Market price vs. market value

Market price: Price someone paid for property in actual transaction (sales price).

Market value: Price someone should pay for property under ideal conditions.

- “Most probable price property should bring”

**Market value ≠ Market price**

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## Market Value Arm's length transaction

Arm's length transaction: Sale of property made under ideal conditions.

- Competitive and open market.
- Prudent and informed parties.
- No undue stimulus (no unusual pressure to sell or buy immediately).



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## Summary Appraisal Basics

- Appraisal
- State certification
- Value
- Market value
- Market price
- Value in use
- Investment value
- Liquidation value
- Assessed value
- Insurable value
- Loan value
- Going concern value

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## Principles of Value



Value is created and changed by:

- social ideals and standards
- economic trends
- government regulations
- physical and environmental factors

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## Forces that Affect Value Social

Social ideals and standards:

- demographics (population size, growth, density)
- family size and living arrangements
- attitudes about education



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## Forces that Affect Value

### Economic



Economic trends:

- local economic conditions
- national economic trends
- employment trends and wage levels
- cost and availability of financing

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## Forces that Affect Value

### Governmental

Government regulations:

- zoning ordinances
- building codes
- environmental regulations
- fire regulations
- taxation policies




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## Forces that Affect Value

### Physical

Physical and environmental factors:

- climate
- topography
- soil characteristics
- flood control

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## Principles of Value

### Principle of highest and best use

Highest and best use: Property use that would bring owner the greatest net return.

- Important in appraisal of income-producing property.



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## Principles of Value

- Highest and best use
- Anticipation
- Substitution
- Competition
- Contribution
- Change
- Supply and demand
- Conformity
- Increasing/Decreasing Returns

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## Principles of Value

### Principle of change



Principle of change: Property's value will increase or decrease over time.

- Changes in value occur:
  - in response to external forces, and
  - as the property improves or deteriorates.

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## Principles of Value

### Principle of change

Property's four-phase life cycle:

- Development / integration
- Equilibrium / stability
- disintegration
- rejuvenation



Property's value depends on where it is in its life cycle.

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## Principles of Value

### Principle of change

Property has:

- physical life cycle, and
- economic life cycle.

Economic life usually ends before physical life.

- Improvements become obsolete before they actually fall apart.



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## Principles of Value

### Principle of anticipation

Principle of anticipation: Anticipated future benefits of owning property add to its value.

- If property's value is expected to increase in future, that anticipation increases its current value.
- If property's value is expected to decrease in future, that anticipation decreases its current value.



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## Principles of Value

### Principle of supply and demand

Principle of supply and demand:

- If demand for product exceeds available supply, its value will increase.
- If supply of product exceeds demand, its value will decrease.

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## Principles of Value

### Principle of substitution

Principle of substitution:  
Value of product is limited by cost of obtaining equally desirable substitute, if substitute can be obtained without undue delay.



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## Principles of Value


### Principle of substitution

If two equally desirable properties are available, the one that costs less will be purchased first.

- Principle of substitution is the theoretical basis for all three methods of appraisal.



\$200,000



\$150,000

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## Principles of Value

### Principle of conformity

Principle of conformity: In residential neighborhood, some conformity among properties has a positive effect on values.

- Great disparity within neighborhood (in terms of quality and condition of homes) may decrease values.



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## Principles of Value

### Progression/regression

Property value is affected by value of surrounding properties.

Principle of progression: Inexpensive home is more valuable when surrounded by expensive homes.

Principle of regression: Expensive home is less valuable when surrounded by smaller or rundown homes.

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## Principles of Value

### Principle of competition

Principle of competition: Value of property, especially income-producing property, is affected by competing properties.

- Example: Income from and value of gas station is reduced if second gas station is built across the street.



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## Principles of Value

### Principle of contribution

Principle of contribution: An improvement may contribute more or less to property's value than improvement cost to make.



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## Summary

### Principles of Value

- Highest and best use
- Change
- Anticipation
- Supply and demand
- Substitution
- Conformity
- Contribution
- Competition

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## The Appraisal Process

### 7 Steps

1. Define problem.
2. Determine data needed and where to find it.
3. Gather and verify general data.
4. Gather and verify specific data.
5. Select and apply appraisal methods.
6. Reconcile value indicators for final value estimate.
7. Issue appraisal report.

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## The Appraisal Process

### Step 1: Define the problem

To define the problem, appraiser must:

- identify subject property
- determine function of appraisal



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## The Appraisal Process

### Step 2: Determine data needed

**General data:** Information pertinent to subject property's value that does not concern property itself.

**Specific data:** Data concerning subject property itself.

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## The Appraisal Process

### Step 3: Gather and verify general data

Includes information about:

- economic situation in community
- condition of neighborhood



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### The Appraisal Process

#### Step 4: Gather and verify specific data

To collect specific data, appraiser performs:

- building analysis
- site analysis



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### The Appraisal Process

#### Step 5: Apply appraisal methods

Appraiser must choose appropriate appraisal method(s), given type of property being appraised.

- May choose only one method, use two methods, or use all three.



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### The Appraisal Process

#### Step 6: Reconciliation

After appraiser applies appraisal method, resulting estimate of what property is worth is called a **value indicator**.

- Each method applied results in different value indicator.
- Value indicators must be **reconciled** to arrive at final value estimate.



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## The Appraisal Process

### Step 7: Issue appraisal report

Final step in process is to prepare appraisal report and present it to client.



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## Gathering General Data

### Economic conditions

Economic forces include:

- Population growth shifts
- Employment and wage levels
  - Basic Employment & Service Employment
- Price levels
- Building cycles
- Personal tax and property tax rates
- Building costs
- Interest rates



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## Gathering General Data

### Neighborhood analysis

Indicators of stable property values:

- high percentages of home ownership
- high occupancy rates
- many families with children
- presence of public services
- mass transit
- restrictive zoning and private restrictions

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## Gathering Specific Data

### Site analysis

Objective of site analysis: to determine property's highest and best use.

Appraiser examines site's physical characteristics:

- lot size
- lot shape
- topography



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## Site Analysis

### Frontage

Frontage: Length of lot boundary abutting a street, a body of water, or some other amenity.



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## Site Analysis

- Assemblage: Process of combining smaller lots into a single larger lot.
- Plottage: Increase in value that occurs when two properties are combined into one.



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## Summary The Appraisal Process

- Steps in appraisal process
- General data
- Specific data
- Value indicators
- Reconciliation
- Neighborhood analysis
- Site analysis
- Building analysis

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## Methods of Appraisal

Three methods of appraisal:

- sales comparison approach
- cost approach
- income approach

For some types of property, only one or two methods are appropriate.

If multiple methods used, more weight given to most relevant method in reconciliation.



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## Sales Comparison Approach

Sales comparison approach: Uses recent transactions in local market as basis for estimating subject property's value (also called market data approach).

- Best method for appraising:
  - single-family homes
  - vacant land



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## Sales Comparison Approach

### Comparable sales

Requires locating at least 3 comparable properties.

**Comparable property:** A property similar to subject property that has recently sold.

- Also called a “comp.”
- Sales price of each comp adjusted to reflect differences between it and subject.

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## Choosing Comparables

### Primary elements of comparison

Primary elements of comparison:

- date of sale
- location
- physical characteristics
- terms of sale
- whether sale was arm's length transaction



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## Sales Comparison Approach

### Making adjustments

Always adjust **comparable's** price, not the subject's.

If subject property has feature that comparable lacks, **add** value of feature to comparable's sales price.

If subject property lacks feature that comparable has, **subtract** value of feature from comparable's sales price.

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## Sales Comparison Approach

### Estimating subject property's value

Appraiser estimates subject property's value based on adjusted prices of at least three comparables.

- Appraiser never simply averages adjusted prices.
- More weight given to comparables to which fewer adjustments were made.



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## Summary

### Sales Comparison Approach

- Sales comparison approach
- Comparable
- Arm's length transaction
- Adjustments

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## Cost Approach to Value

Cost approach: Bases estimate of subject property's value on how much it would cost to build a replacement of improvements.

- Cost approach provides ceiling for subject property's value.
- Buyers won't pay more for used property of equal desirability than for new property (principle of substitution).



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## Cost Approach to Value

### 3 Steps

Steps in cost approach:

1. Estimate cost of replacing improvements.
2. Subtract any depreciation.
3. Add value of lot.



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## Cost Approach to Value

### Step 1: Estimating replacement cost

**Replacement cost:** Cost to build improvements with same utility, using modern materials and construction methods.

**Reproduction cost:** Cost to build exact replica of improvements, using identical materials and methods.

- Replacement cost is a much better indicator of property's market value.

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## Estimating Replacement Cost

### 3 Methods

1. Square-foot method
  - Easiest and most widely used.
  - Square footage × construction cost per sq. foot.
2. Unit-in-place method
  - Estimate cost of replacing building components (roof, floors, plumbing, etc.).
3. Quantity survey method
  - Detailed, time-consuming estimate of materials and labor.

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## Cost Approach to Value

### Step 2: Subtract depreciation

Depreciation: Loss in value due to any cause.

Three categories:

- physical deterioration
- functional obsolescence
- external obsolescence



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## Categories of Depreciation

### Deferred maintenance

Physical Deterioration: Loss in value resulting from need for repairs (also called deferred maintenance).

- May be caused by:
  - damage
  - construction defects
  - wear and tear
- Easiest kind of depreciation to identify and measure.



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## Categories of Depreciation

### Functional obsolescence

Functional obsolescence: Loss in value because of poor design or lack of utility.

- May be caused by:
  - design defects
  - outdated fixtures
  - an inadequate floor plan



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## Depreciation

### Curable or incurable

Depreciation is **curable** if cost of correcting item can be recovered in sales price.

Depreciation is **incurable** if:

- problem can't be corrected, or
- cost of correcting it would be too high.

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## Depreciation

### Curable or incurable

Deferred maintenance: Usually curable, unless particularly severe.

Functional obsolescence: May be curable, depending on cost of modifications.

External obsolescence: Never curable, because it's out of property owner's control.

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## Categories of Depreciation

### External obsolescence

- External obsolescence: Loss in value caused by factors outside of property lines, (also called economic obsolescence).

■ Examples:

- adverse zoning changes
- undesirable neighborhood
- traffic congestion
- proximity to a nuisance



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## Estimating Depreciation

### Direct methods

Straight-line method is concerned with property's **effective age** (not actual chronological age).



Effective age: Reflects how much longer structure is likely to remain effective in its current use.

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## Cost Approach to Value

### Adding land value

Last step is to add value of land to depreciated value of improvements.

- Land value is usually estimated using sales comparison approach.



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## Summary

### Cost Approach

- Cost approach
- Replacement cost
- Reproduction cost
- Depreciation
- Physical Deterioration
- Functional obsolescence
- External obsolescence
- Estimating depreciation

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## Income Approach to Value

**Income approach:** Uses income generated by property to estimate its value to investor.

- Used for income-producing property such as office building or apartment building.
- Also called the capitalization method.



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## Income Approach to Value 5 Steps

1. Calculate property's potential gross income.
2. Deduct bad debt and vacancy factor to estimate effective gross income.
3. Subtract operating expenses to determine net income.
4. Select appropriate capitalization rate.
5. Capitalize property's net income to estimate its value.

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## Income Approach to Value

### 1. Calculating potential gross income

Potential gross income: How much property would rent for in current rental market.

- Also called **economic rent**, in contrast to **contract rent**.
- **Contract rent:** How much property currently rents for under existing lease.

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## Income Approach to Value

### 2. Calculating effective gross income

- **Effective gross income:** Potential gross income (economic rent) minus bad debt and vacancy factor.
- **Bad debt and vacancy factor:** Percentage of potential gross income deducted to allow for unpaid rents and vacancies.

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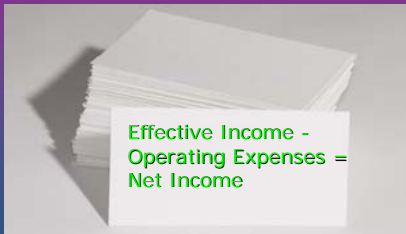
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## Income Approach to Value

### 3. Calculating net income

Net income: Effective gross income minus operating expenses.



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## Calculating Net Income

### Operating expenses

Three types of operating expenses:

- fixed expenses
- maintenance expenses
- reserves for replacement

NOT considered operating expenses:

- mortgage payments (debt service)
- income tax paid on property's earnings

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## Income Approach to Value

### 4. Selecting capitalization rate

Capitalization: Process of converting future net income into estimate of property's present value.

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

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## Selecting the Capitalization Rate

Rate reflects investor's risk

If property is risky investment, the investor:

- requires greater return on investment
- chooses higher capitalization rate

Higher cap rate = lower property value

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## Income Approach to Value

### 5. Capitalizing net income

Final step is to capitalize property's annual net income to arrive at estimate of value.



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## Income Approach to Value

### Gross multiplier method

Gross multiplier method: Simplified version of income approach used to appraise single-family home used as income-producing rental.

Appraiser locates comps and calculates a **gross multiplier** for each.

- Multiplier indicates relationship between comparable's sales price and rental rate.



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## Gross Multiplier Method

### Gross rent vs. gross income

To calculate gross multiplier, appraiser divides comparable's sales price by its rent.

Appraiser may calculate:

- **gross rent**  
(uses monthly rental income), or
- **gross income**  
(uses annual rental income)



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## Gross Multiplier Method

### Rough estimate of value

Gross multiplier method provides only a rough estimate of value.

- Based on gross income.
- Doesn't account for operating expenses or vacancies.
- Commonly used by investors not appraisers for rough estimate of value.



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## Reconciliation and Final Estimate of Value

Final step of appraisal process is reconciliation, aka correlation.

- Appraiser does not simply average value indicators—instead, she gives more weight to most relevant method.



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## Appraisal Report

Appraiser presents conclusions to client in appraisal report.

Three formats for written appraisal reports:

- Narrative reports
- Form reports
- Letter reports



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## Summary

### Income Approach and Reconciliation

■ Income approach	■ Gross multiplier method
■ Potential gross income	■ Reconciliation
■ Effective gross income	■ Narrative report
■ Net income	■ Form report
■ Capitalization	■ Letter report

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## Competitive Market Analysis



Competitive market analysis (CMA): Estimate of value prepared by agent to help seller set a listing price.

- Involves modified form of sales comparison appraisal method.

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## Competitive Market Analysis

### Preparing a CMA

Steps in preparing CMA:

1. Collect and analyze information about seller's property.
2. Choose comparables.
3. Compare seller's property to comps and adjust comps' values.
4. Estimate realistic listing price for seller's property.

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## Preparing a CMA

### Collecting and analyzing information

Agent gathers information about seller's property: neighborhood, site, and improvements.



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## Preparing a CMA

### Choosing comparables

Unlike formal appraisal, CMA may include current and expired listings as comps.



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## Preparing a CMA

### Making adjustments

Adjustments to comps' prices are made based on differences in location, physical characteristics, date of sale, and terms of sale.



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## Preparing a CMA

### Estimating market value

Agent evaluates reliability of each adjusted comparable value—those comparables most like subject property are most reliable.



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## Preparing a CMA

### Completing CMA

When presenting CMA results to seller, agent should use standardized form that lists information in logical sequence.



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## Summary Competitive Market Analysis

- CMA vs. formal appraisal
- Steps in preparing CMA
- CMA form

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