REAL PROPERTY APPRAISALS

Student Playbook

Making Education Fun, Engaging & Useful

Continuing Education
Student Information Sheet

READ IMMEDIATELY UPON CHECKING IN

Basic CE Requirement (21 NCAC 58A.1702)

The CE requirement to maintain a license on active status is **eight (8) classroom hours per year** (each license period) consisting of the four (4) hour Real Estate Update course (mandatory for all licensees) and a four (4) hour elective. The content of the Update course changes each year.

Important Points to Note

- Newly licensed licensees do NOT need to take any CE prior to their **first license renewal** but must satisfy the CE requirement prior to their **second license renewal**.
- A course may not be taken for CE credit twice in the same license period. Make sure you have not already taken this course during the current license period.
- If your license is **inactive,** you should check with the Commission to ascertain the amount of CE you need to activate your license.

Attendance Requirement

In order to receive CE credit for a course, students must attend the entire scheduled class session. Sponsors and instructors may, on an individual basis, excuse a student for good reason for up to 10% of the scheduled class session (20 minutes for a 4-hour class session); however, a student must attend a minimum of 90% of the scheduled class session in order to receive a course completion certificate and CE credit. No exceptions to the 90% attendance requirement are permitted for any reason.

Student Participation Requirement

To help assure that the mandatory continuing education program will be one of high quality, the Commission requires that students comply with the following student participation standards:

> A student shall direct his active attention to the instruction being provided and refrain from engaging in activities unrelated to the instruction which are distracting to other students or the instructor, or which otherwise disrupt the orderly conduct of a class. **Examples of Prohibited Conduct**: Sleeping; reading a newspaper or book; performing office work; carrying on a conversation with another student; making or receiving a phone call on a cellular phone; receiving a page on a pager that makes a noise; loudly rattling or shifting papers; or repeatedly interrupting and/or challenging the instructor in a manner that disrupts the teaching of the course.

Sponsors and instructors are required to enforce the student participation standards. Sponsors have been directed to NOT issue a course completion certificate to a licensee who violates the standards and sponsors must report inappropriate behavior to the Commission.

Course Completion Reporting

Sponsors are responsible for reporting course completion information to the Commission via the Internet within **7 days of course completion.** Licensees are responsible for assuring that the real estate license number that they provide to the course sponsor is correct.

Licensees may address comments/complaints about courses, instructors, and/or sponsors to:

Continuing Education Officer
North Carolina Real Estate Commission
P.O. Box 17100
Raleigh, North Carolina 27619-7100

Certificates of Course Completion

Course sponsors will provide each licensee who satisfactorily completes an approved CE course a Certificate of Completion on a form prescribed by the Commission within 15 calendar days following a course. The certificate should be retained as the licensee's personal record of course completion. **It should not be submitted to the Commission unless the Commission specifically requests it.**

Check the Label of Your Newsletter

The number of continuing education credit hours credited by the Commission to your licensee record for the current license period as of a stated date will appear on the mailing label of each edition of the Commission's newsletter. You may also check your **current year's** CE credits online at the Commission's website: www.ncrec.state.nc.us. You will need to log in under Licensee Login using your license number and pin number. If you are unsure of your pin number, please follow the instructions on our website.

Please avoid calling the Commission office to verify the crediting of continuing education credit hours to your license record unless you believe that an error has been made. Please use our website to verify that your credit hours have been reported. Your cooperation in this regard will be especially needed during the May 15 - June30 period each year.

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Real Property Appraisals

Course Description

Whenever buyers need a mortgage to buy a home, they've probably been told that they need an appraisal. This is an inevitable part of buying a home for anyone who needs a mortgage and, like it or not, it can make or break the transaction.

Course Description, Continued

Because appraisals are a crucial part of the transaction, real estate agents should understand the appraisal process. Even though you may prepare a competitive market analysis (CMA) for your clients, CMAs are not as detailed, nor do they serve the same purpose as an appraisal. A home appraisal is an unbiased determination of the fair market value of the home by a professionally trained third party.

Course Description, Continued

This course provides a review of the sales comparison, cost, and income approaches in appraising real estate.

This course provides continuing education hours for licensed real estate licensees. It is intended to enhance the knowledge and effectiveness of licensees and is approved for 4 hours of continuing education.

Course Learning Objectives

- After completing this course, you should be able to do all of the following:
  - Differentiate between CMAs and appraisals
  - Describe the elements, forces, and principles that create and influence value
  - Name the steps involved in the appraisal process
  - Describe how appraisers reconcile the estimates from the three approaches to arrive at a final value
  - Differentiate between the types and styles of appraisal reports
  - Describe the purpose and use of the sales comparison approach.

Course Learning Objectives

- After completing this course, you should be able to do all of the following:
  - Determine characteristics of the subject property.
  - Explain steps 1 through 3 in the sales comparison approach.
  - Explain steps 4 through 6 in the sales comparison approach.
  - Describe the purpose and use of the cost approach.
  - Explain depreciation as used in the cost approach.
  - Describe the purpose and use of the income approach.

Chapter 1
Review of Value & Appraisal Fundamentals

Chapter Learning Objectives

- After completing this course, you should be able to do all of the following:
  - Differentiate between CMAs and appraisals
  - Describe the elements, forces, and principles that create and influence value
  - Name the steps involved in the appraisal process
  - Describe how appraisers reconcile the estimates from the three approaches to arrive at a final value
  - Differentiate between the types and styles of appraisal reports

Overview

- An appraisal informs the buyer, seller, and lender about the market value of a home
- Appraisers must be licensed and follow the standards, rules, and guidelines of the Uniform Standards of Professional Appraisal Practice (USPAP) when developing and reporting appraisals
- All appraisals performed for transactions that involve federally insured financial institutions must adhere to USPAP

CMAs and Appraisals

- Appraisers develop an opinion of market value
- Real estate licensees deal with listing prices and actual or estimated sales prices
- The **listing price** is a price established by the seller
- The **actual sales price** of a property is an historic fact
- An **estimated sales price** is an opinion about the negotiated price that a hypothetical buyer and the seller would reach under specific conditions

CMAs and Appraisals

- A **comparative market analysis** (CMA) is a comparison analysis of the price of recently sold, active, and expired listings that are similar (comparable) to a specific home
- Properties that have recently sold give a picture of the comparable and competitive properties within the subject's neighborhood
- Comparable properties currently on the market refer to current listings and properties under contract that are awaiting the completion of contingencies

CMAs and Listings

- When working with prospective sellers, you typically present the CMA during a listing presentation
- The CMA lays the foundation for setting a realistic listing price for the property
- CMAs help prospective buyers determine an offering price for a specific property
- The CMA shows recent closed sales of similar properties and their length of time on the market

Appraisers

- An **appraiser** performs valuation services competently and in a manner that is independent, impartial, and objective
- An appraiser gives an opinion of value in a written statement called an **appraisal report**, which is the conclusion of the appraiser's research and analysis of all relevant data regarding the subject property

USPAP

- Standards for the appraisal profession are set forth in the Uniform Standards of Professional Appraisal Practice (**USPAP**) developed by the Appraisal Standards Board of The Appraisal Foundation
- USPAP specifies the valuation procedures to be followed in developing and communicating an appraisal and the ethical rules for appraisal practice
- The **valuation process** is a systematic procedure the appraiser follows to answer a client's question about real property value

Purposes of Appraisals

- Mortgage lending purposes
- Tax assessments and appeals of assessments
- Negotiation between buyers and sellers
- Government acquisition of private property for public use
- Business mergers or dissolutions
- Lease negotiations

Pricing vs. Appraising

- Only licensed or certified appraisers can refer to a real estate valuation they have made as an appraisal
- Real estate licensees must not mislead sellers to believe that they can use the listing price of their property for any other purpose than marketing the property
- Appraisers must validate the opinion reached by using additional valuation methods

Pricing vs. Appraising

- Appraisals use three approaches to value, while CMAs rely on a limited version of the sales comparison approach
- Appraisals are concerned with prices actually paid in the marketplace, while CMAs use properties currently on the market
- Appraisal reports provide a specific market value in dollars, while CMAs provide a range of values
- Appraisals are used for all types of real estate, while CMAs are most effective for 1-4 residential properties

Appraiser Independence

- Appraisers are trained to deflect attempts to influence the appraisal or value opinion, remaining independent, impartial, and objective
  - The appraiser is responsible for the analyses, opinions, and conclusions contained in the appraisal
- Appraiser independence is critical to enhance the public trust that appraisals contain credible opinions of value
  - Federal and State law require appraiser independence
  - Without public trust, mortgage investors could withdraw funds from the market resulting in a shortage of funds for residential lending

Economic Principles of Value and Valuation

- **Value** is the monetary, material, or assessed worth of an asset, good, or service
- An item is deemed valuable because people perceive it has worth
- Value is a concept always rendered as an opinion

Elements That Create Value (DUST)

- There are four elements of value
  - Demand
  - Utility
  - Scarcity
  - Transferability
- Each element by itself cannot create value

Physical and Economic Factors

- **Natural factors** include location, topography and soil, climate, and natural resources
- **Manmade factors** include such things as the size and shape of the land parcels and infrastructure within a community or neighborhood
- **Economic factors** include employment expansion or layoffs, opening or closing of a major employer, availability or absence of mortgage money, and the discovery or depletion of natural resources

Political and Social Factors

- **Governmental controls** include zoning, building codes, health codes, and other restrictions or conditions affect land use
- Population characteristics and **social factors (demographics)** include population trends, family characteristics, and attitudes of the people

Market Value Defined

- The term "market value" has many similar definitions
  - Real estate agents consider it to be the price a property brings on the open market
  - Mortgage loan originators follow the definition in the Fannie Mae Selling Guide
- Implicit in the Fannie Mae definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer

Market Value Defined

- USPAP defines market value as "a type of value, stated as an opinion that presumes the transfer of a property, as of a certain date, under specific conditions set forth in the value definition of the term that is identified by the appraiser as applicable in an appraisal
- The appraiser's value conclusion is specified in an appraisal report and is likely to be the most common type of value used in typical real estate transactions

Market Value, Price, and Cost

- Market value is an opinion
- Market price (or price) is a fact
- Cost represents expenses in money, labor, material, or sacrifices in acquiring or producing something
  - USPAP defines cost as the actual or estimated amount required to create, reproduce, produce, replace, or obtain a property

Supply and Demand

- **Supply and demand** is recognized as being the first step in how market prices are determined
- **Supply** refers to the total amount of a given type of property for sale or lease, at various prices, at any given point in time
- **Demand** refers to the desire and ability to acquire goods and services through purchase or lease
- A **market** is a place suitable for selling and buying

Supply and Demand

- More supply than demand creates a buyer's market
- Reducing supply or increasing demand will raise the price in the market
  - This creates a seller's market because there is more demand than supply
  - The less there is of something, the higher the cost; the more there is, the lower the cost
- If the demand for real estate increases, the price of the real estate will also increase

Highest and Best Use

- Legally permissible
- Physically possible
- Financially feasible
- Maximally productive

Changes in Socioeconomic Patterns

- Four-Phase Life Cycle
  - **Growth.** A period during which the area gains in public favor or acceptance.
  - **Stability.** A period of equilibrium without significant gains or losses.
  - **Decline.** A period of diminishing demand and acceptance.
  - **Renewal.** A period of rejuvenation and rebirth of market demand.

Conformity, Substitution, & Anticipation

- The **principle of conformity states** that the more that structures are in harmony with one another, the more valuable each of those structures
- The **principle of substitution** refers to value that is set by the cost of getting an equally desirable substitute
- The **principle of anticipation** expresses that value is created by the expectation of future benefits

Contribution & Balance

- The **principle of contribution** is the worth of an improvement as well as what it adds to the entire property's market value, regardless of the actual cost of the improvement
- The **principle of balance** states that real estate value is created and sustained when contrasting, opposing, or interacting elements are in a state of equilibrium

Progression and Regression

- The **principle of progression** states that the value of an inferior property will be worth more because of the presence of greater-valued properties nearby
- The **principle of regression** states that the value of a superior property (over improvement) will be worth less because of the presence of lower-valued properties nearby

The Appraisal Process

- Define the appraisal problem
- Determine the scope of work necessary to solve the appraisal problem
- Collect and analyze data (general and site specific)
- Apply the appraisal approaches to value
- Reconcile value indications and determine a final opinion of value
- Report the defined value

Define the Appraisal Problem

- The client and any intended users of the property that the client identifies
- The intended use of the appraisal
- The purpose of the assignment (type of value)
- The effective date of the value opinion, which establishes the context for the opinion of value
- Any relevant property characteristics, e.g., location, type of property, interest to be appraised
- The assignment conditions (extraordinary assumptions or hypothetical conditions)

Determine the Scope of Work

- The appraiser identifies the amount and type of information researched, evaluates the assignment, makes the scope of work decisions, and discloses that scope of work in the report
- Decisions made here must lead to credible assignment results

Collect and Analyze Data

- To determine the property's value, appraisers obtain data from government publications, the MLS, subscription services, the Internet, and personal observation
  - **General data** is information about the area where the property is located that affects the value of the property
  - **Site-specific data** is information that has to do with the details about the property being appraised (the subject property) and comparable properties that have been sold or leased in the local market

Collect and Analyze Data

- **Regional data** is information about the region's economic health and amenities
- **Community data** is information about the town or city where the property is located
- **Neighborhood data** concerns the neighborhood's condition and amenities

Collect and Analyze Data

- In highest and best use analysis, the appraiser considers the use of the land as though it were vacant and the use of the property as it is improved
- The goal is to determine whether or not the property is being used for its most profitable permitted use
- The highest and best use is selected from various alternative uses

Apply Appraisal Approaches to Value

- The sales comparison approach is most relied upon when there is recent sales data in the subject property's area
- The cost approach is most relied upon for properties with new or almost new improvements, or for unique properties
- The income approach is most relied upon in appraising investment properties when income data for comparable properties is available

Reconciliation and Reporting

- Reconciliation is the adjustment process of weighing results of all three appraisal methods to arrive at a final supportable value opinion, called the final value estimate
- The **final value estimate** is an appraiser's opinion of the defined value of the subject property, arrived at by reconciling the estimates of value
- The nature of the reconciliation depends upon the appraisal problem, the approaches used, and the reliability of the value indications derived

Reconciliation & Final Value Estimate

- The chance of arriving at the same value conclusion from two or three different approaches is so remote that, if it did occur, it is a red flag
- All three approaches should be used on every assignment, but sometimes an approach is inapplicable, unwanted by the client, or lacks enough supportable data to apply

Sales Comparison Approach

- Things to verify when using the Sales Comparison Approach
  - Comparables are significantly comparable to the subject property
  - An adequate amount of sales data
  - Sales data is both accurate and reliable
  - Adjustments made to the comps are logical and in good order
  - Adjustments are mathematically correct
  - Value conclusion drawn from the adjusted comparables is legitimate

Cost Approach

- Things to verify when using the Cost Approach
  - Sites used to develop an opinion of the subject's site value are comparable to the subject
  - Adjustments made to comparable sites are logical and accurate
  - Reproduction or replacement cost is identified correctly
  - Unit chosen for the comparative-unit method is appropriate
  - Data obtained for the unit-in-place or quantity survey method is current and accurate
  - Accrued depreciation is deducted properly, without under-depreciating or double-depreciating certain items
  - External influences researched include all possible ones

Income Approach

- Things to verify when using the Income Approach
  - Market rents are mathematically accurate
  - Reconstructed operating statement is accurate
  - Gross income estimate is mathematically accurate
  - Net income estimate is mathematically accurate
  - Capitalization rate (GRM or direct Cap rate) is mathematically accurate
  - Comparable sales are sufficiently comparable to the subject property
  - An adequate amount of rental data available from the subject market

Elements of Credible Appraisals

- Clear, accurate description of the property
- Recent and comparable sales
- An opinion of value based on researched data

What Reconciliation is Not

- Reconciliation is not a mathematical process
- Reconciling is not a way to fit the conclusion into a preconceived value
- Reconciliation is not the narrowing of the range of value estimates

Appraisal Reports

- The term "**report**" refers to written or oral communication transmitted to the client upon completion of an assignment
- Appraisal standards set minimum requirements for the content and level of information in each type of report
- Reporting options recognized by USPAP
  - Appraisal Report
  - Restricted Appraisal Report

Appraisal Report

- An **Appraisal Report** must be used when the intended users include parties other than the client
- The Uniform Residential Appraisal Report (URAR) is an example of an Appraisal Report
  - It contains many fields of information in organized categories and allows for proper summarizing statements and even an addendum to support and clarify concepts when necessary
  - Most residential appraisals are completed on this standardized form and are considered Appraisal Reports

Restricted-Appraisal Report

- The **Restricted Appraisal Report** is the briefest presentation of an appraisal and contains the least detail
- For the Restricted Appraisal Report, the client is the only **intended user**

Report Styles

- **Form style report** means that an appraiser is presenting the report using preprinted forms
- A **narrative style report** contains a high level of detail, is presented in descriptive paragraphs rather than in a form or letter and may be 10 to 100 pages or more in length
- **Oral reports** are reserved for litigation purposes but may be used at any time if requested by the client

Key Terms

- Appraisal
- Appraisal Management Company
- Appraisal Report
- Arm's Length Transaction
- Comparables
- Comparative market analysis (CMA)
- Cost
- Cost approach
- Credible appraisal
- Demand

Key Terms

- Economic life
- Economic obsolescence
- Effective age
- Effective demand
- Final value estimate
- Form style report
- Functional obsolescence
- Functional utility
- Income approach
- Intended user

Key Terms

- Licensed and Certified Appraisers
- Market
- Market Value
- Multiple Listing Service
- Narrative style report
- Neighborhood
- Non-Homogeneity
- Oral report
- Price
- Principle of anticipation

Key Terms

- Principle of balance
- Principle of conformity
- Principle of contribution
- Principle of highest and best use
- Principle of progression
- Principle of regression
- Principle of substitution
- Public record data
- Reconciliation
- Replacement cost

Key Terms

- Replacement value (insured value
- Reproduction cost
- Restricted Appraisal Report
- Sales comparison approach
- Supply
- The Appraisal Foundation
- Utility
- Uniform Residential Appraisal Report
- Valuation
- Value

Summary

- An appraisal is an unbiased estimate or opinion of the property value on a given date
- Value or worth is the present and future anticipated enjoyment or profit from the ownership of property
- Value of a parcel usually can be categorized by two basic types of value—market value and value in use

Summary

- The four elements for estimating value are demand, utility, scarcity, and transferability (DUST)
- Other forces include physical, economic, political, and social changes
- Valuation is the process of estimating market value for real property as of a specific time
- Valuation principles include the principle of supply and demand, competition, substitution, conformity, highest and best use, progression, regression, balance, anticipation, and contribution

Summary

- There are 3 main approaches to appraising property to arrive at a market value estimate
  - Sales Comparison Approach
  - Cost Approach
  - Income Approach

Summary

- The final step examination of the different values (reconciling)
- The appraiser decides which of the values is the most appropriate for the property
- The appraiser weighs the relative significance, applicability and defensibility of each approach and relies most heavily on those most appropriate to the intended use of the appraisal
- The final value conclusions are documented in a restricted summary or self-contained appraisal report

Chapter 2
Sales Comparison Approach

Learning Objectives

- After completing this chapter, you should be able to:
  - Describe the purpose and use of the sales comparison approach
  - Determine characteristics of the subject property
  - Explain steps 1 through 3 in the sales comparison approach
  - Explain steps 4 through 6 in the sales comparison approach

Overview

- Select the market sales that are most homogeneous to the subject property
- Develop an opinion of value by analyzing similar comparable properties that have sold and comparing these properties with the subject property
- Adjust for the differences between comparables and the subject

Sales Comparison Approach

- Relies heavily upon the **principle of substitution**
  - A buyer should not pay more for a property than the cost of a substitute property of equal utility and desirability
- The market value of the subject property is estimated by comparing it to other similar properties that have recently been sold, been listed for sale, or for which offers to purchase have been made
- Appraisers can estimate demand by considering the number of potential buyers for a particular property type

Advantages and Disadvantages

- Advantages
  - Easily understood and most commonly used
  - Easily applied for the sale of single-family homes
  - Best for single-family homes, condominiums, and vacant lots
- Disadvantages
  - Finding enough recently sold similar properties to get comparable values
  - Correctly adjusting amenities to make them comparable to the subject property
  - Older sales unreliable with changing economic conditions
  - Difficulty in confirming transaction details

Subject Property Characteristics

- Before appraisers collects market data and search for comparables, they perform onsite quality, condition, and functional utility surveys of the property to determine its relevant characteristics
- An appraiser's inspection of a property is significantly different from one completed by a home inspector
  - Appraisers perform unbiased valuation services for their clients, home inspectors work in the interest of their buyers
  - A home inspector looks for defects and never assigns value
  - Home inspectors perform a more thorough visual inspection and have different standards than appraisers

Inspection of the Subject Property

- An appraiser’s inspection of a residence has two main parts
  - Exterior inspection
  - Interior inspection
- Appraisers rate the condition of the improvements by using the UAD **from C6** (substantial deficiencies and defects) to C1 (new, with no physical depreciation)
- They rate the quality of the home with ratings that range from **Q1** (exceptionally high quality) to **Q6** (lowest quality)

Inspection of the Subject Property

- Appraisers must use a standard set of abbreviations called the **Uniform Appraisal Dataset** (UAD)
  - UAD is a component of the Uniform Mortgage Data Program which is a program used to enhance the accuracy and quality of loan data delivered to Fannie Mae or Freddie Mac

Common Undesirable Factors

- Unappealing mixture of exterior architectural styles
- Misplaced architectural style that does not fit the site or is incompatible with other styles in the neighborhood
- Improper situation of residence on the site
- No central hallway or entryway
- No hall closet or linen closet
- Minimum-sized bedroom closets
- Inadequate closet or cupboard space for bathroom and kitchen storage

Common Building Feature Descriptions

- Building size, model (for tract homes) and custom or tract construction
- Type of construction with descriptions of exterior features including foundation walls, framing, roofs, facade, special features, storage, stairs, and ramps
- Substructures including basements, slabs, raised foundations, and crawl spaces
- Description of interior features including painting and finishing, flooring and floor coverings

Improvements

- Improvements should conform to the neighborhood in terms of age, type, design, and materials used for their construction
- If there is market resistance to a property because its improvements are not compatible with the neighborhood, the appraiser must address the impact to the value and marketability of the subject property

Exterior Inspection

- Two sections make up the exterior of a home
  - **Superstructure.** Refers to all the above grade improvements.
  - **Above grade.** Refers to anything above ground level.
  - **Substructure.** Refers to all the below grade improvements.
  - **Below grade.** Refers to improvements below ground level.
- Take note of the exterior characteristics of the home and use a tape measure to get the accurate dimensions of the home for a sketch
- Also note exterior amenities, such as yards and car storage

Interior Inspection

- Once inside the home, the appraiser uses the perimeter sketch and fills in the room layout and other interior details
- Most appraisal reports contain a checklist that reminds the appraiser to check all the important features and provides a space for noting the condition of features
- Appraisers count the number of “rooms” in the home, which are identified as the total of above grade rooms, not including bathrooms, foyers, laundry rooms, attics, or basements

Sales Comparison Approach

- Step 1. Collect Market Data
- Step 2. Select Comparables
- Step 3. Evaluate Elements of Comparison
- Step 4. Verify Data
- Step 5. Apply Adjustments
- Step 6. Reconcile Adjusted Comparable Property Values

Step 1. Collecting Market Data

- Questions to ask before collecting market data
  - What are the characteristics of the subject property?
  - What area should be searched for sales?
  - What period should be investigated for sales?
  - What sources should be used to find sales?
- Characteristics and features of a subject can be found in the MLS, in county records, from previous appraisals done for tax or mortgage loan purposes, and from online subscription services offering sales histories and property profiles

Real Estate Appraisers' Workfiles

- Most appraisers maintain a workfile of the sales data collected from prior appraisals
- This may be a very good source of information, but appraisers must be careful to maintain confidentiality

Step 2. Selecting the Comparables

- **Comparables (comps)** are properties that are similar to a subject property and are used in the appraisal process
- The geographic area for comparable sales data depends upon the nature of the real estate being appraised
- Comparables should have a sales date as close to the subject as possible, similar chronological age or have a similar effective age, and a similar location

Step 3. Evaluate Elements of Comparison

- An **element of comparison** is any aspect of a real estate transaction or any characteristic of the property that may affect the property's sales price
- Appraisers need to consider different elements of comparison for different assignments
- Elements of comparison are used to explain the differences of prices paid for real estate

Property Rights Conveyed

- Appraisers may be asked to appraise the fee simple interest in a property
- Appraisers are requested to estimate partial interests in a property
  - **Partial interest.** An interest in real estate that represents less than the fee simple estate.
- The owner of a leasehold interest in a property does not own the complete bundle of rights in that property.
  - **Leasehold estate.** The tenant's interest in the leased property during the term of the lease.

Property Rights Conveyed

- When the owner does not own the land, determine the value of the leased fee estate
- **Life estate.** An estate that is limited in duration to the life of its owner or the life of another designated person.
- Use comparable properties that include the same property rights as the subject property in their analyses

Financing Terms

- Differences in financing can impact the sales price
- Determine whether any existing financing is assumable, retirable, or replaceable
- Estimate the potential value impact of the cost items
- Comparable sales that include financing concessions must be adjusted to reflect the impact on the sales price of the comparables based on the market at the time of sale

Cash Equivalent Sales

- Adjustments for financing are based upon the difference in financing for the comparable sale and financing typically found in the market
  - If typical financing was used, the sale is referred to as a **cash equivalent sale**—a sale in which the financing does not affect the price
- When adjusting for financing, appraisers typically adjust for **cash equivalency**
  - **Cash equivalency.** The conversion of a sales price with favorable or unfavorable financing terms into the equivalent price if the consideration had been all cash.

Terms and Conditions of Sale

- Using primary verification of comparable sales allows the appraiser to discover a buyer's and seller's motivation
- **Primary verification** is accomplished by talking to someone who was involved in the transaction
- Use comparable sales that do not have any unusual conditions of sale
- Make appropriate, market-based adjustments to compensate for these conditions and their effect on the sales price of the comparable property

Expenditures Immediately after Purchase

- A knowledgeable buyer often analyzes a potential purchase in terms of improvements needed to make it suitable to his or her needs
  - Curing deferred maintenance
  - Updating flooring and window treatments
  - Removing and remodeling parts of the structures
  - Change in use with special use permits and sometimes zoning changes
  - Costs for remediation of any contamination

Market Conditions & Time Considerations

- An appraisal is an opinion of value as of a specific date
- Adjustment for time reflects the change in value between the date of the comparable sale and the valuation date of the subject property
- In a rapidly changing market, the most recent sales, and listings of property for sale should be given considerable weight in the sales comparison approach
- Fannie Mae has a general guideline that comparable sales over six months old should not be used

Location

- Adjustment for location includes differences in desirability or locations within a neighborhood
- Comparable sales are normally to the neighborhood of the subject property
- The location of comparable properties should resemble that of the subject property within the market area
- Sales affected by natural amenities, such as trees, views, creeks, or mountains can provide problems, as the value of these amenities are often difficult to measure

Physical Characteristics

- An appraiser must adjust for differences by analyzing market response
  - How much more will buyers pay for an inside utility room, additional bathroom, remodeled kitchen, pool and spa, or extra garage space?
  - Each significant difference between the comparable property and the subject property must be translated into dollars

Non-Realty Components of Value

- Other physical, legal, and economic characteristics of the subject and comparable properties should be considered
- Properties with similar zoning (legal) or similar income-producing capacity (economic) are better indicators of value
- On occasion, **non-realty components** (personal property) may be sold along with real property

Economic Characteristics

- If the subject property is producing income, the comps should produce similar amounts
- Economic considerations are considered in terms of the financial capacity of a market or neighborhood's occupants and their ability to rent or own property, to maintain it in an attractive and desirable condition, and then to perform renovations when applicable
- With the trend toward urban and suburban sprawl, communities tend to overlap one another

Step 4. Verify the Comparable Information

- After selecting appropriate comparable properties, the next step is to verify the information
- **Verification** is an inquiry into the circumstances surrounding and affecting a sale
  - **Primary verification** involves talking to someone who was involved in the transaction
  - **Secondary verification** involves using sources to confirm the sale

Step 5. Applying Adjustments to the Comps

- Narrow down the number of sales, listings, and pending sales to those most similar to the subject
- **Apply adjustments** to the comps
  - Adjustments "equalize" the comparable sale to the subject property

Paired Sales Analysis

- **Paired sales analysis** is a method of estimating the amount of adjustment for the presence or absence of any feature by pairing the sales prices of otherwise identical properties with and without that feature

Sale-Resale Analysis

- **Sale-resale analysis** is a method for determining adjustment amounts that is useful when a property is sold and resold in a relatively short period
- **Flipping** occurs when a person buys a property at one price and quickly sells it to another at an inflated price, usually within a short period

Applying Adjustments to the Comps

- The appraiser attempts to find properties as similar as possible to the subject property and adjusts for differences
- To be considered comparable, the sale property must be similar to the subject property in location, utility, and date of sale
- Adjustments are normally not made for elements less than 1% of the sales price of the comparable sale

Make the Adjustments in Order

- The first five elements of comparison (**transactional adjustments**) are made first, followed by adjustments that only affect individual property features (**property adjustments**)
- Order of transactional adjustments
  1. Property rights conveyed
  2. Financing terms
  3. Terms and conditions of sale
  4. Expenditures immediately after purchase
  5. Market and time conditions

Questions When Applying Adjustments

- What are the major differences between the comparable and the subject?
- Do the differences make the comparable more or less valuable?
- What is the value of the difference?

Adjustment Grids to Identify Differences

- In performing the sales comparison analysis, the subject and the comparable sales are usually entered onto an **adjustment grid**, or matrix
- The **adjustment grid** lists important items affecting value such as site area, location, design and appeal, quality, condition, gross building area, basement area, room count, view, age, and amenities
- Using this grid ensures that the comparable sales are adjusted consistently

Rules for Making Adjustments

- **Adjustments are always made to the comps**
  - When the comparable is **superior** to the subject property, the appraiser **subtracts from the comparable** to make them equal
  - When the comparable is **inferior** to the subject, the appraiser **adds to the comparable** to make the properties equal

Determine the Adjustment Value

- Adjustments must be market derived, and in some situations, readily available market data is inconclusive
- Appraisers need to be aware of all the methods and exercise sound judgment in determining the applicability of any particular method to the appraisal problem at hand

Step 6. Reconciling Adjusted Comps

- When the adjustment process is completed, each comparable sale produces an adjusted sales price that is an indicator of value for the subject property
- Appraisers do not simply average the adjusted sales prices—appraisers choose the comparable sales that are most important
- Use sound reasoning and judgment to reconcile the individual comps into a value estimate of the subject property based on the sales comparison approach

Key Terms

- Amenity
- Comparables
- Comparative market analysis (CMA)
- Demand
- Effective demand
- Paired sales analysis

Key Terms

- Principle of anticipation
- Principle of substitution
- Sales comparison approach
- Subject property
- Supply
- Value

Summary

- When using the sales comparison approach, appraisers must collect, verify, and analyze all information applicable to the appraisal problem
- An appraiser's inspection of a residence usually has two main parts
  - Exterior inspection
  - Interior inspection
- Once an appraiser has examined the exterior and interior of the home, he or she should also make note of automobile storage and yard utility

Summary

- The sales comparison approach has a systematic procedure
  1. Collect market data
  2. Select market data
  3. Verify data
  4. Apply adjustments
  5. Reconcile adjusted comparable property value
- Data sources include Multiple Listing Services, public records, title insurance companies, and other real estate appraisers

Summary

- When appraising single-family residential properties, the appraiser considers numerous elements of comparison
  - **Element of comparison.** Any aspect of a real estate transaction or any characteristic of the property that may affect the property's sales price.
- Verification is an inquiry into the circumstances surrounding and affecting a sale.
  - **Primary verification.** Includes inspection of the property and first-hand interviews
  - **Secondary verification.** Includes confirmation through the MLS or public records.

Summary

- An adjustment is a dollar or percentage amount that is added to or subtracted from the sales price of a comparable property
- The adjustment is to account for a feature that the property has or does not have which differentiates it from the subject property
- Reconciliation in the sales comparison approach involves weighing the results of adjusted comps to arrive at an opinion of value of subject property

Chapter 3
Cost and Income Approaches

Learning Objectives

- After completing this chapter, you should be able to:
  - Recall the purpose and use of the cost approach
  - Explain depreciation as used in the cost approach
  - Describe the purpose and use of the income approach

Overview

- **Cost approach** assumes an informed buyer will pay no more than the cost of producing a substitute property with equal utility
  - **Land.** Includes the ground itself, and the rights inherent in the use of that ground.
  - **Improvements.** Buildings or other structures that are attached permanently to the land.
- **Income approach** is based on the principle of anticipation
  - **Principle of anticipation.** Value is created by the expectation of future benefits.

Overview of the Cost Approach

- The **cost approach** is based on the principle of substitution
  - Substitution is not purchasing another similar improvement—it is building it
  - Appraisers compare the value of the subject improvement with the cost of building a similar improvement
- Determines the overall value of a property by adding the contributory values' two elements to get the overall value
  - Value of the land as if vacant
  - Cost to rebuild the appraised building, less the accrued depreciation

Applications of the Cost Approach

- Cost approach is often used for appraising new buildings and special-purpose or unique structures
  - Depreciation on a new building is relatively easy to determine, so cost approach is at its most accurate
- Cost approach is also used with buildings where it is difficult to find comparables because they are unique or one-of-a-kind or if there have been no recent sales of comparable properties
- Cost approach is impractical with older buildings because of the difficulty in estimating depreciation

Appropriate Use of the Cost Approach

- Unique or one-of-a-kind buildings
- Government-owned properties
- Properties that are significantly overbuilt for the neighborhood
- Single or special-use properties

Inappropriate Use of the Cost Approach

- Condominiums—the ownership is of air rights and a portion of the common space and improvements
- Unimproved land—the land/site valuation techniques can be applied, but there are no improvements to cost

Steps in the Cost Approach

1. Develop an opinion of land value
2. Estimate the cost of reproducing the existing improvements or replacing them with improvements of equivalent utility
3. Estimate and deduct the accrued depreciation
4. Add entrepreneurial incentive
5. Estimate "as-is" value of additional site improvements
6. Add land value, depreciated value of improvements, entrepreneurial incentive, and value of "as-is" site improvements to calculate the value indication

Formula

- The type of improvements and use of the property do not change the basic process
- The cost approach is the only approach that can be used for all types of improved property.

Cost of Structure — Depreciation of Structure + Value of Land = Overall Value of Property

Step 1: Land Value

- Principles of supply and demand, change, anticipation, substitution, and balance all influence land value
- If there is another interest in land required in an assignment, such as a leasehold, leased fee, or reversionary interest, the land value estimate will need to be adjusted

Step 1. Sales Comparison

- The **sales comparison method** follows the same steps as the sales comparison approach
- It is best used with recent comparables of vacant land sales
- Be sure to use the same units of comparison
  - Acre, square foot, front foot, etc.

Step 1. Allocation

- The **allocation method** is based upon the principle of balance and the concept of contributory value
- Assumes that there is a typical ratio between the land value of a property and the value of its improvements
- The ratio varies by area and must be extracted from the local market then applied to other improved sales in the subject's neighborhood to establish land value
- Does not produce conclusive value estimates, but can be used in situations when recent comparable land sales are scarce or non-existent

Step 1. Extraction

- **Extraction method** is a variation on the allocation method
  - Derive the land value of a comparable property by deducting the depreciated costs of the improvements from the property's known sale price
  - The remaining value represents value attributable to the land

Step 1. Land Residual

- **Land residual technique** is based on the premise that the income of a property is generated by both the land and the improvements, and that there is a relationship between the income a property produces and the value of that property

Step 1. Ground Rent Capitalization

- In the **ground rent capitalization method**, the annual ground rent is divided by a market derived capitalization rate
  - **Ground rent.** The rent that is payable under a ground lease, which is a long-term lease.
- Income is determined by the land lease amount
- Useful when comparable sales of leased land are available, and the terms of those leases are known

Step 1. Subdivision Development

- The **subdivision development method** (or land development method) is used to value land when subdivision and development of the subject site represent the highest and best use of the property and sales information for finished lots is available
- Applicable to all kinds of land including residential, commercial, recreational, or industrial
- Requires accurate forecasting of market demand and risk factors

Step 2. Reproduction Cost

- **Reproduction cost** is the cost of replacing the improvement with one that is the exact replica
- Assumes the cost of using like kind and quality of materials, identical construction, and workmanship standards, as well as identical design and layout
- Reflects construction prices current as of the date of the appraisal
- More suited to estimating unique or historical structures when an exact replica is requisite

Step 2: Replacement Cost

- **Replacement cost** is the dollar amount required to construct improvements having the same utility and quality as the subject property using current construction materials, methods, and techniques
- To estimate the replacement costs for an older subject property, find the costs of newer homes similar in size, structures, quality, and utility

Step 2. Methods Used to Estimate Cost

- Size of the improvements is incorporated into the cost approach using any of the four commonly used methods
  - Index method
  - Comparative unit method
  - Unit-in-place method
  - Quantity survey method

Step 3. Accrued Depreciation

- **Depreciation** means loss in value from any cause
  - **Accrued depreciation** is depreciation that has already occurred
- After estimating accrued depreciation, deduct it from the replacement cost of the building on a property to get the **depreciated cost of the improvements**
- The chronological age of the structure is its **actual age**
- **Effective age** describes the age of a structure based on its condition and usefulness

Step 3. Accrued Depreciation

- Buildings have a certain **useful life** in which a property's improvements contribute to property value
  - For residential properties, the structure's utility and physical appeal contribute to its useful life
  - For income-producing properties, the estimated period during which the structure will profitably produce income is its economic life

Step 3. Types of Depreciation

- Adverse physical, functional, and locational influences cause property improvements to depreciate
  - Physical deterioration
  - Functional obsolescence
  - External obsolescence
- A property may suffer from any combination of the three types of depreciation, or it may not suffer from any depreciation at all

Step 3. Types of Depreciation

- **Physical deterioration** is the loss in value from all causes of age and action of the elements
  - Wear and tear, disintegration, decay or rot, or physical damage by the elements

Step 3. Types of Depreciation

- **Functional obsolescence** is depreciation attributable to an item or feature within the subject property that is no longer useful or functional
- **Over-improvements** are features that are too large or of a higher quality than needed for a property

Step 3. Types of Depreciation

- **External obsolescence** takes place when locational or economic influences that are external to a property adversely affect that property
- **Locational obsolescence** is caused by the physical location of the subject property and its proximity to a negative influence
- **Economic obsolescence** occurs when changes in the local economy affect the subject property's value

Step 3. Curable and Incurable Depreciation

- Physical deterioration and functional obsolescence are divided into two-subcategories
  - **Curable depreciation.** Refers to a loss in value that is economically feasible to correct.
  - **Incurable depreciation.** Refers to items of depreciation that either are physically impossible to cure or are too expensive to be worth curing.

Step 3. Calculating Accrued Depreciation

- Methods of calculating accrued depreciation include the economic age/life method, modified age/life method, cost to cure method, breakdown method (or observed condition method), market extraction using sales comparison techniques, and income capitalization method
- Accrued depreciation is calculated for improvements only because land does not depreciate

Step 3. Economic Age/Life Method

- The **economic age/life method** compares a structure's effective age to its economic life
- An equal amount of accrued depreciation is attributed to each year of the economic life of the structure
- An effective age is estimated and assigned to the structure, and the remaining economic life is determined
- Accrued Deprecation = Effective Age divided by Economic Life and multiplied by Replacement/Reproduction Cost

Step 3. Modified Age/Life Method

- In the **modified age/life method**, curable physical and functional items of accrued depreciation are identified
- The cost to cure these items is deducted from the reproduction or replacement cost of the improvements
- The ratio derived from the age/life method is then multiplied by the remaining cost to arrive at an estimate of accrued depreciation from all other causes

Step 3. Cost to Cure Method

- The **cost to cure method** is based on observed deferred maintenance and the application of current building costs
  - The cost required to replace an item is the amount lost due to accrued depreciation

Step 3. Breakdown Method

- In the **breakdown** or **observed condition method**, analyze each type of accrued depreciation separately, measure the amount of each, and add the individual estimates to determine the total accrued depreciation
- Total accrued depreciation is then deducted from the reproduction or replacement cost

Step 3. Market Extraction Method

- **Market extraction** involves using sales comparison techniques and the extraction method to estimate accrued depreciation
  - Sales prices of all the sales must be truly indicative of the market

Step 3. Income Capitalization Method

- Depreciation is calculated differently for income-producing properties
  - Formulate an estimate based upon a loss of income attributable to the item(s) causing the depreciation

Step 4. Entrepreneurial Incentive

- **Entrepreneurial incentive** represents the amount an entrepreneur expects to receive for his or her contribution to a project and risk
- **Entrepreneurial profit** is the compensation the owner or developer actually receives from the undertaking
  - Reflected as the property value once construction is completed minus the developer's costs and the land value

Steps 5 & 6. Estimate Value of Site Improvements and Calculate the Value Indication

- Adding the value of on-site improvements is one of the final steps in the cost approach
- Items like landscaping, sprinkler systems, driveways, brickwork, fences, etc. fall into the category of site improvements

Steps 5 & 6. Estimate Value of Site Improvements and Calculate the Value Indication

- This method is used because the cost to install site improvements does not necessarily equal the value they contribute to the site
- After appraisers have determined the land value and developed a depreciated value of improvements, those two factors are combined with the "as-is" value of site improvements to create an entire property value based on the cost approach to value

Income Approach

- Recognizes the direct relationship between the value of a property and the income it is expected to produce
  - The more income a property generates for its owner, the more valuable it is
- Depends on a property's income—real or potential
- To arrive at a value, estimate the income and apply it to arrive at a verifiable value
  - Income is estimated both as potential gross income, effective gross income, and as net operating income

Income Approach Applications

- Most useful when appraising properties whose ability to produce income is considered by potential investors
- Depends on a property's income—real or potential
- If a property's ability to produce income is an important factor to potential buyers, then this approach is the best indicator of value

Income Approach Limitations

- Limited usefulness when current rental data and operating statements are not available
- Requires current market data for rentals of like properties as well as careful analysis of the operating statements
- Determining the appropriate capitalization rate is very difficult and complex
- This approach is not pertinent if the income-producing capability of the subject and comparable properties is not a factor to potential buyers

Potential Gross Income

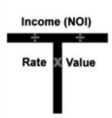
- **Potential gross income (PGI)** is the income a property produces from the rent paid by the tenants
- Maximum rental income a property could generate if it is 100% leased at market rent without vacancy or credit losses
- Based on market rent rather than contract rent
  - **Market rent.** The amount the rental could bring in an open market.
  - **Contract rent.** The amount actually paid by a renter for use of the premises.

Effective Gross Income

- **Effective gross income** (EGI) is the property's potential gross income plus any other income less vacancy and collection losses
  - **Vacancy loss.** The amount of income lost due to vacant units in a property
  - **Collection loss.** Represents an amount due to bad debts or losses attributed to slow pay.

Net Operating Income

- **Net operating income** (NOI) is the income remaining after the operating expenses are deducted from the effective gross income
- Best value indicator for any income property since it most accurately reflects the income for a given property
- To calculate net operating income, deduct operating expenses from effective gross income



Operating Expenses

- **Operating expenses** are those expenses necessary to maintain the property and to help ensure the continued production of income
  - Fixed expenses
  - Variable expenses
  - Replacement reserves

Additional Expenses

- **Fixed expenses** are ongoing expenses regardless of whether the property is occupied, e.g., property taxes and insurance premiums
- **Variable expenses** are operating expenses that vary based on occupancy, income generated, and the number of services provided to the tenants
- **Replacement reserves** are funds set aside by the property owner to pay for the replacement of building components and fixtures that periodically wear out in a property

Multipliers or Capitalization Rates

- The income approach to value uses mathematical techniques to identify the present value of future benefits from ownership of a property
- **Capitalization** is any method used to convert an income stream into value
  - Relies upon the premise that there is a relationship between the income a property produces and the value of that property
  - Involves the use of income multipliers or capitalization rates

Income Multipliers

- An **income multiplier** is a number that, when multiplied by the income, gives an indicator of value
  - Gross rent multiplier (GRM)
  - Gross income multiplier (GIM)
  - Effective gross rent multiplier (EGIM)
- GRM uses rental income (monthly or annual) and GIM uses all income derived from the property (rent, laundry and vending fees, parking fees, etc.)

Gross Rent Multiplier

- **Gross rent multiplier** (GRM) is the relationship (ratio) between the sales price (value) and gross monthly rent for residential properties
- **GRM = Value / Gross Monthly Rent**
- **Value = Gross Monthly Rent x GRM**

Effective Gross Income Multiplier

- **Effective gross income multiplier** (EGIM) is the relationship (ratio) between sales price (value) and the annual effective gross income from income producing properties
- **EGIM = Value / Effective Gross Income**
- **Value = Effective Gross Income x EGIM**

Capitalization Rates

- **Capitalization rate** is a ratio reflecting the relationship between the net operating income a property generates and its value
- This method converts annual expected net operating income (NOI) generated by a property into a value estimate (V) for that property

Capitalization Rates

- Analyze the relationship between the sales prices of competing properties in the subject's market and the yearly net operating incomes generated by those properties to determine capitalization rate
- Capitalization rate is divided into the yearly net operating income for the subject property, resulting in a value estimate for the subject property

Capitalization Rates

- Capitalization Formulas
  - Property Value = NOI ÷ Cap Rate
  - Cap Rate = NOI ÷ Value
  - NOI = Value × Cap Rate

Key Terms

- Capitalization rate
- Cost approach
- Depreciation
- Economic life
- Economic obsolescence
- Effective age
- Effective demand
- Effective Gross Income (EGI)
- Effective Gross Income Multiplier (EGIM)
- Fixed expenses

Key Terms

- Functional obsolescence
- Functional utility
- Gross Rent Multiplier (GRM)
- Improvements
- Income approach
- Market rent
- Net operating income (NOI)
- Potential Gross Income (PGI)
- Principle of anticipation
- Principle of progression

Key Terms

- Quantity survey method
- Replacement cost
- Replacement value (insured value)
- Reproduction cost
- Reserves for replacement
- Site Valuation
- Subject property
- Supply
- Utility
- Variable expenses

Summary

- The first step in the cost approach is to develop an opinion of the value of the site
- Methods used to estimate land value
  - Sales comparison method
  - Allocation method
  - Extraction method
  - Land residual technique
  - Ground rent capitalization method
  - Subdivision development method

Summary

- The next step is to estimate the reproduction cost or replacement cost of the subject property
- Methods used to estimate cost
  - Index method
  - Comparative unit method
  - Unit-in-place method
  - Quantity survey method

Summary

- After determining the cost new of the improvements, calculate the accrued depreciation
- Depreciation can be curable or incurable and is categorized as physical deterioration, functional obsolescence, or external obsolescence

Summary

- Once the accrued depreciation has been determined, calculate the depreciated value of the improvements by adding the cost new of the improvements to the entrepreneurial incentive and then subtracting the accrued depreciation
- When the land value is added to the depreciated value of the improvements and the "as-is" value of the additional on-site improvements, the resulting number is a value estimate for the subject property

Summary

- As a part of calculating the cost new for the subject, account for the entrepreneurial incentive when necessary
- Estimating the "as-is" value of other site improvements is another separate step
- Land value and depreciated value of improvements are combined with the "as-is" value of site improvements to create an entire property value based on the cost approach to value

Summary

- The income approach to value is for properties that produce income and is based on the premise that a property is worth the amount of money it produces or is expected to produce
- Basic methods are direct capitalization and discounted cash flow analysis (or yield capitalization)

Summary

- The first determine the subject's income
- Potential gross income (PGI) is the maximum income a property could generate
- Effective gross income (EGI) is the property's income after deducting vacancy and collection losses from the estimate of projected potential gross income
- Net operating income (NOI) is the income remaining after the operating expenses are deducted from the effective gross income
  - Operating expenses are necessary to maintain the property and to help ensure the continued production of income

Summary

- Interest in real property may be estimated by direct capitalization
- Direct capitalization using an income multiplier estimates the value of income-producing real estate based on the gross
  - An income multiplier is multiplied by the income to give an indicator of value
  - Gross rent multipliers (GRMs) are based on gross rents (monthly or annual) and effective gross income multiplier (EGIMs) are based on annual income from all sources

Summary

- Direct capitalization using a capitalization rate is a method of estimating the value of income-producing real estate based on the net operating income—rather than the gross income
- Capitalization rate (R0) reflects the relationship between the net operating income a property generates and its value