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Published by:
RICHARD K. CITRON
DAVID R. DEUTSCH
MICHELLE LeCOLST-JOHNSTON
Attorneys

REAL ESTATE VALUATION AND APPRAISAL

The proper valuation of real estate is an essential element of all real estate transactions. All parties to a real estate transaction, including the seller, buyer, lender and real estate broker will need to determine the "fair market value" of the property, which is generally defined as the price the property would bring if freely offered on the open market with both a willing buyer and a willing seller. The actual sale price of a property is not necessarily equal to its fair market value since the price may be affected by the knowledge, negotiating skills, economic strength and motives (distress sale or forced purchase) of the buyer and seller, as well as financing terms, interest rates, similar available properties, and other factors. Frequently, in order to determine the fair market value of a property, a formal appraisal of the property is conducted.

There are three general approaches used in appraising real property. The three approaches are: (a) the sales comparison or market data approach; (b) the cost approach; and (c) the income capitalization approach.

Sales Comparison or Market Data Approach. This approach involves the use of sales and market data for similar properties which have recently been sold or offered for sale. In this approach, the appraiser assembles data on comparable properties which are similar to the subject property with regard to neighborhood location, size, age, architectural style, design features, view, financing terms and general price range. The value of the subject property is then determined by comparing the qualities of the subject property with the comparable properties. The sales comparison approach seems simple, but in practice it is often difficult to apply. For example, how should the appraiser value a three bedroom, two bath house with a remodeled kitchen and an ocean view when compared with a three bedroom, two and one-half bath house with a pool and a spa but no view? The sales comparison approach is the most easily understood method of valuation, and is particularly useful in the appraisal of residential or other property which has a high degree of similarity and for which a ready market exists. The disadvantages of using the sales comparison approach include possible lack of similar properties upon which to make a comparison, the difficulty in making appropriate adjustments to account for the differences in each property, and the lack of reliability of using older sales data in a changing market.

Cost Approach. The cost approach values property as the sum of the value of the land if vacant plus the cost to reconstruct a new building similar to the appraised building, less the accrued depreciation of the appraised building. There are three ways of determining the reconstruction cost: (a) the historic cost indexed to cost new basis, which takes the actual cost of the building when originally constructed and determines the cost to construct a new building by indexing the original cost to current costs; (b) the reproduction cost new basis, which is the cost of reconstructing a replica of the appraised building, including all original designs and materials; and (c) the replacement cost new basis, which is the cost to reconstruct the appraised building using modern methods, design and materials to most closely replace the use of the appraised building (for example, an older brick warehouse would be replaced today with concrete block or tilt-up cast slab construction). The replacement cost new basis is the most commonly used cost approach.

After determining which cost basis to use, the appraiser then selects an appropriate method of estimating the actual cost of reconstruction. The most common method used by appraisers on the West Coast is the square-foot method in which the property being appraised is compared with other similar buildings where costs are known, and which have been reduced to units per square foot of floor area. Adjustments are then made for the size of the building and various exterior and interior features. In the eastern United States, the cubic-foot method, which compares the cubic contents of the building instead of the square footage of the floor area, is popular. If properly used, this method is more accurate than the square foot area since the height as well as area of the building is considered. The quantity survey method, which consists of a detailed estimate of all labor and materials for each part of the building, including direct costs, overhead, insurance and contractor's profit, is a very accurate but time-consuming method to determine costs; because of this it is used mostly by building contractors and professional cost estimators. The reproduction cost approach is used most frequently when the improvements are relatively new and in the appraisal of special purpose or one-of-a-kind properties for which no comparable data is available.

Income Capitalization Approach. The income capitalization approach values the property on the basis of its capacity to continue to produce an income stream. Capitalization is the process of calculating the present value of income property based on the anticipated annual net income it will produce. In certain circumstances, the value of income property may be determined by using the Gross Rent Multiplier, which uses gross income of the property, rather than net income.

The capitalization (or "cap") rate is the rate of return on invested capital plus the rate on which original invested funds are returned. Capitalization rates are generally estimated by the sales comparison or market data method. Once the capitalization is selected, the net income of the property is capitalized by dividing the net income of the property by the cap rate. Net income is determined by reducing the potential gross income of the property by an annual allowance for vacancies and rent collection losses, to obtain the "effective gross income" or "adjusted gross income", and then subtracting the estimated probable future annual expenses of operation (including fixed expenses such as taxes and insurance, variable expenses such as utilities, management fees and maintenance, and reserves for replacements such as carpets, draperies and appliances). Small variations in the cap rate make a substantial difference in the capitalized value of the property. For example, if the property has an annual net income of $60,000, the value of the property using a cap rate of 6% is $1,000,000; using a cap rate of 7%, the value of the property is $857,143, a difference of $142,857.

The Gross Rent Multiplier of a property is equal to the sales price of the property divided by its gross monthly rent. To determine the value of an income property, an appraiser may multiply the gross monthly rent of the property by the Gross Rent Multiplier of similar properties. For example, if the gross annual rent of the property is $95,000 and the Gross Rent Multiplier is 8.50, the value of the property would be $807,500. The Gross Rent Multiplier can be misleading as an indicator of value in that it does not consider the expenses of the building which may vary greatly depending upon the age of the building, whether or not utilities are separately metered, and other variable expense factors.

There is no single correct way to value real property. Typically, all three of the methods described above are used to determine a property's value. The appraiser then arrives at a final valuation by a reconciliation or weighing of the various appraisal methods.