

## **RE 310 – Principles of Real Estate Real Estate Appraisal**

### 1) Real Estate Appraisal

- a) Having an external estimate of a property's value can be useful for a variety of market participants:

It is important to note that a *competitive market analysis* performed by a broker is not the same thing as an appraisal, and does not serve the same purpose.

### b) Appraisal Regulation

- FIRREA (The Financial Institutions Reform, Recovery and Enforcement Act) in 1989 established a federal regulatory hierarchy for the appraisal industry. Now, appraisals for properties involved in “federally related” transactions must be performed by state-licensed or state-certified appraisers.

- Uniform Standards of Professional Appraisal Practice (USPSP) are put together by the Appraisal Foundation

[www.appraisalfoundation.org](http://www.appraisalfoundation.org)

- The Federal Financial Institutions Examination Council (FFIEC) is responsible for overseeing the regulator agencies through its appraisal subcommittee  
[www.ffiec.gov](http://www.ffiec.gov)
  
- State licensing is administered by the Kansas Real Estate Appraisal Board  
[www.ink.org/public/kreab](http://www.ink.org/public/kreab)
  - State licensed real property appraiser
  
  - Certified residential real property appraiser
  
  - Certified general real property appraiser
  
  - State licensed provisional real property appraiser (trainee)
  
- Professional organizations
  - Appraisal Institute's MAI designation

## 2) Market Value

### a) Definition of market value

- The *market value* of real estate is the most \_\_\_\_\_ that a property should bring in \_\_\_\_\_ market in which market participants have \_\_\_\_\_.
  
- Market value estimates are calculated assuming that
  - The buyer and seller are typically motivated;
  - Both parties are well informed or well advised, and acting in what they consider their best interests;
  - A reasonable time is allowed for exposure in the open market;
  - Payment is made in cash (U.S. \$) or with financial arrangements that are comparable; and
  - The price represents normal consideration for the property sold, unaffected by special or creative financing or sales concessions by anyone associated with the sale.

b) Important things to remember about market value:

- Market value is not the same thing as \_\_\_\_\_.
  
- Market value is not always equal to the \_\_\_\_\_.
  - Investment value is the value of a particular parcel of real estate to a specific investor.

Market value = investment value for the \_\_\_\_\_.

- Market value may also differ from \_\_\_\_\_.

c) Other types of value appraisers may be asked to estimate:

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d) Sometimes appraisers must come up with \_\_\_\_\_ appraisals.

3) Basic Principles of Value

a) Anticipation

b) Change

c) Substitution

d) Contribution

e) Other principles of value

#### 4) The Appraisal Process

a) Define the problem

b) Collect the data

c) Highest and best use determination

d) Estimate the value of the land

e) Apply the three approaches to value

- Sales comparison approach
- Cost approach
- Income approach

f) Reconcile the approaches

g) Report declared value

## 5) Sales Comparison Approach

### a) Basic concepts

- Based on the principle that a property's value must be close to that of similar properties that have recently sold.
- This approach is best used for residential real estate in which comparables are easily found.
- Multiple regression analysis is a logical extension of this approach and is being adopted by the secondary market agencies in their automated underwriting models.

### b) Steps in the sales comparison approach

- Identify comparables
- Identify the major characteristics that determine value
- Adjust the sales price of each of the \_\_\_\_\_ to make them more like the \_\_\_\_\_.
- Reconcile the comparables adjusted sales prices to come up with a single estimate of value.

c) Types and sequences of adjustments

Transaction price of comparable

+ / - Conditions of sale

+ / - Financing terms

Normal sale price

+ / - Market conditions

Market adjusted normal sale price

+ / - Property characteristics

Final adjusted sale price

- Why the order?
  - Often on (residential) appraisal reports all adjustments will be listed as dollar amounts, even if they were calculated using percentages. Nevertheless, the order matters, since percentages were used to determine the dollar amounts.

d) Adjustment Example

- The subject property is a 3 bedroom, 1 bath home in excellent condition.
- The comparable is a 3 bedroom, 1½ bath home in good condition that recently sold for \$80,000.
- You have estimated the following adjustments are appropriate:
  - Each bedroom is worth \$5,000;
  - A ½ bath is worth \$1,000; and
  - The difference between good and excellent condition is \$2,000.
- Calculations

e) Multiple regression analysis

## 6) Cost Approach

### a) Basic concepts

- The cost approach is based on the principle that a property's value must be close to its construction cost.
- The cost approach is most applicable for properties that are \_\_\_\_\_.

### b) Steps in the cost approach

- Estimate the cost of the improvements on the land (the buildings)
  - Reproduction cost
  - Replacement cost
- Subtract off accrued depreciation
- Add in the value of the raw land

c) Estimating reproduction or replacement cost

- Quantity-survey method
- Square-foot method
- Unit-in-place method
- Index method

d) Estimating accrued depreciation

- Physical deterioration
- Functional obsolescence
- External obsolescence

## 7) Income Approach

### a) Basic concepts

- The income capitalization approach is based on the principle that a property's value should be related to the cash flows that the property can generate for an investor.
- This approach is most useful for income producing properties or those could be used to produce income.

### b) Gross income multiplier (GIM)

$$\text{GIM} = \text{Value} / \text{Gross Income}$$

- Typically used with \_\_\_\_\_.
- Appraisers can estimate the GIM for a given property type in an area and use it to estimate the value of a specific property:

$$\text{Value} = \text{Gross Income} \times \text{GIM}$$

A related concept is the *gross rent multiplier*.

- Used with residential properties
- Uses monthly gross rents rather than annual gross income

- Example: The GIM for warehouses in a downtown area is 8. A subject property is a warehouse with an estimated effective gross income of \$25,000 per year. The estimated value of this property is
- The weakness of the GIM is that it \_\_\_\_\_.

c) Net income capitalization

$$\text{Capitalization Rate} = \text{Net Income} / \text{Value}$$

- Appraisers can estimate the capitalization rate that has prevailed in recent transactions and use it to estimate the value of a specific property:

$$\text{Value} = \text{Net Income} / \text{Cap Rate}$$

- Example: The capitalization rate for properties in the area is 12%. A subject property has an expected first-year NOI of \$240,000. It's estimated value is

d) Discounted cash flow analysis

- The methods above looked only at \_\_\_\_\_ income to value the property.
  - In many cases, the property's income will change over time. In this case, discounted cash flow techniques are more appropriate.
  
- Appraiser must estimate values for
  - Rental rates (potential gross income)
  
  - Vacancy and collection rates (effective gross income)
  
  - Operating expenses (net operating income)
  
  - Future selling price of the property (equity reversion)
  
  - Discount rate