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APPRAISAL: INS AND OUTS OF MARKET VALUE

Market value remains a centrally important metric (measure) to real estate investors, mortgage lenders, and homebuyers. Only the foolish would buy, sell, or loan against a property without knowledge of its market value. Nevertheless, hundreds of bank failures and millions of foreclosures has laid bare the idea that this popularly relied upon figure should serve as the only figure that matters.

Never again should anyone believe the once-entrenched view, “Buy for less than market value, you’ve scored a good deal. Pay more than market value, you’ve overpaid.”

Never again should anyone rely upon appraisers (without question) to provide accurate, disinterested estimates of market value. Although always known among real estate insiders, the market value estimates of appraisers are not only subject to unintentional errors of fact, interpretation, or both, in many instances, appraisers manipulate their numbers to deliver whatever value estimate makes a deal work (at least, that is, appear to work—in the short run.)

So, this chapter will help you in two ways:

1. You will understand how to review and critique a professionally prepared market value appraisal; and, correspondingly, you will wisely decide how much confidence you should place in the appraiser’s estimate of value.
2. You will see that for purposes of investment, even an accurately prepared market value appraisal fails to provide a figure that offers a fair or reasonable price to pay. For that guide, forecast future demand and supply, not rely on past sales prices.

WHAT IS MARKET VALUE?

To the naive, appraised value, sales price, and market value all refer to the same idea. But, actually, appraised value might refer to an insurance policy appraisal, a property tax appraisal, an estate tax appraisal, or a market value appraisal. Sales price itself reveals the nominal price at which a property has sold. That sales price might equal, exceed, or fall below market value. Sales price represents market value only when a property is sold according to these five assumptions:

1. Buyers and sellers are typically motivated. Neither acts under duress.
2. Buyers and sellers are well informed about the market and negotiate in their own best interest.
3. The marketing period and sales promotion bring the property to the attention of willing and able buyers.
4. No atypically favorable or unfavorable terms of financing apply. Easy money inflates demand. Tight money suppresses demand. (During the most recent property boom, lenders offered dangerously easy financing, thus pushing demand and sales prices far above the market values that would have prevailed under normal loan underwriting standards.)
5. Neither the sellers nor the buyers offer any extraordinary sales concessions or incentives. (For example, the builders in many countries offered off-plan buyers three years of rent guarantees—clearly a red flag that the builders' prices exceed market value.)

To illustrate the assumed conditions underlying the concept of market value, say that two properties recently sold in a neighborhood where you might like to invest:

The house at 37 Oak sold at a price of \$258,000, and 164 Maple sold at a price of \$255,000. Each of these three-bedroom, two-bath houses was in good condition, with around 2,100 square feet. You locate a nearby house of similar size and features at 158 Pine. It's priced at \$234,750. Is that a below-market price? Maybe, maybe not. Before you accept this sales evidence, investigate the terms and conditions of the other two comparable sales.

What if the sellers of 164 Maple had carried back a nothing-down, 4 percent, 30-year mortgage for their buyers (that is, favorable financing)?

What if the buyers of 37 Oak had just flown into Peoria from San Francisco and bought the first house they saw because "It was such a steal. You couldn't find anything like it in San Francisco for less than \$1.2 million" (that is, uninformed buyers)?

What if the sellers of 37 Oak had agreed to pay all of their buyer's closing costs and leave their authentic Chippendale buffet because it was too big to move into their new condo in Florida (that is, extraordinary sales concessions)? What if 37 Oak were a bank REO?

Sales Price Doesn't Necessarily Equal Market Value

When you value property, learn more than the past prices at which so-called similar properties have recently sold. Investigate whether the buyers or sellers in these transactions acted with full market knowledge, negotiated any favorable terms of financing, bought (or sold) in a hurry, or conceded something that pushed up the nominal selling price—or perhaps pulled it down. If you find that the sales of comparable properties do not meet the conditions of a market value sale, then that sales price (unadjusted) does not necessarily imply a market value price.

To confidently rely on comp sales prices: verify the accuracy of your information, verify the date of sale, and verify the terms and conditions of the sale. Faulty information about a comp property's features or terms of sale can make overpriced deals look good (or vice versa). Market value assumes no hidden defects or title issues. A comp (or subject) house with a termite infestation or unpaid tax liens should sell at a price less than market value (see later discussion).

Underwriting Rules Determine the Value in LTV

Banks loan against market value, not purchase price, unless your purchase price falls below market value. When you apply for a mortgage, you may tell the lender that you've agreed to a price of \$200,000 and would like to borrow \$160,000 (an 80 percent LTV). Yet the lender will not necessarily agree that this price matches the property's market value.

The lender will ask about special financing terms (for example, a \$20,000 seller second) and sales concessions (for example, the seller's plan to buy down your interest rate for three years and pay all closing costs). If your transaction differs from market norms, the lender won't lend 80 percent of your \$200,000 purchase price—even if it routinely does make 80 percent LTV loans. The lender may find that easy terms of financing or sales concessions are worth \$10,000. So, the lender may calculate your 80 percent LTV ratio against \$190,000, not the \$200,000 nominal purchase price.

To verify that your purchase price of \$200,000 equals or exceeds market value, the lender will order a market value appraisal. If that appraisal report comes back with a figure that's less than \$200,000, the lender will

use the lesser amount to calculate an 80 percent LTV loan. Take notice: Do not passively accept the results of any low (or high) appraisal. Review and critique the report. Ask the appraiser to correct errors. Or you can ask the lender to order a new appraisal with another firm. The lender needs a file document (appraisal) to justify its lending decision. If you provide an acceptable (revised or remade) appraisal of a satisfactory amount, you'll often get the loan you want.

Danger: Just because a lender's appraiser comes up with a market value estimate that matches your purchase price, never assume that the appraisal accurately sets market value. Accept personal responsibility for your offering price. In the past, loan reps routinely told their appraisers the value estimate they needed to make a deal work. In return, appraisers know that if they fail to hit the desired numbers, loan reps will select another, more accommodating appraiser to prepare their reports.

If you're a good customer of a bank (or if the bank would like you to become a good customer), the loan rep may encourage the appraiser to issue an MAI (made as instructed) appraisal. I know of many instances in which appraisers have acquiesced to not-so-subtle hints from a loan rep and submitted appraisals that overstated a property's value. (Indeed, as early in the property boom as 2003, government investigators found that loan reps were pressing appraisers to lift their value estimates.)

New lender and appraisal regulations supposedly will stop this abuse. I would not bet on it. People in the business know each other—and word gets around. There's no Chinese Wall in real estate. Recently, a property that I own was reappraised so that I could refinance and pull cash out (to reinvest, not spend) some of that almost free money (3.75 percent interest rate). When inspecting the house, the appraiser asked me what I thought it was worth. His market value estimate came in a mere \$5,000 less than the number I suggested. In this instance, my estimate was accurate. I am not accusing the appraiser of over- or undervaluing. But it does illustrate that he did not want to nix the loan with an out-of-range opinion.

You will work with appraisers, and you will solicit their opinions, but never accept those opinions as the final word. To protect yourself against inaccurate appraisals (your own, as well as others), understand how to calculate, apply, and interpret the three basic methods used to estimate market value.

HOW TO ESTIMATE MARKET VALUE

To estimate market value, rely on multiple methods. During the property and credit boom, appraisal practice focused on the comparable sales approach and ignored (or slighted) the cost and income approaches.

In doing so, appraisers missed the danger signals that the cost and income methods were flashing.

Cost approach

- ◆ Calculate how much it would cost to build a subject property at today's prices.
- ◆ Subtract accrued depreciation.
- ◆ Add the depreciated cost figure to the current value of the lot.

Comparable sales approach

- ◆ Compare a subject property with other similar (comp) properties that have recently sold.
- ◆ Adjust the prices for each positive or negative feature of the comps relative to the subject property.
- ◆ Estimate market value of the subject property from the adjusted sales prices of the comps.

Income approach

- ◆ Estimate the rents you expect a property to produce.
- ◆ Convert net rents after expenses (net operating income) into a capital (market) value amount. Alternatively, estimate the gross amount of rents that a property could bring in and multiply that amount by an applicable market-derived GRM.

When you evaluate a property from three perspectives, you check the value estimates of each against the others. Multiple estimates and techniques enhance the probability that your estimate reflects reality. If your three value estimates don't reasonably match up, either your calculations err, the figures you're working with are inaccurate, or the market is acting crazy and property prices are about to head up (or down).

Figure 3.1 shows a sample residential appraisal form for a single-family house. Refer to this form as you read the following pages and you'll see how to apply these three techniques to appraise properties. Photocopy this form (or print a copy from the Internet). Use the forms to fill in property and market information as you value potential property investments.

PROPERTY DESCRIPTION

To accurately estimate the market value of a property, first describe the features of the property and its neighborhood in detail. List all facts that might influence value favorably or unfavorably. Investors err in their appraisals because they casually inspect rather than carefully detail and compare. Focus on each of the neighborhood and property features listed

Uniform Residential Appraisal Report

File #

The purpose of this summary appraisal report is to provide the lender/client with an accurate, and adequately supported, opinion of the market value of the subject property.

Property Address _____ City _____ State _____ Zip Code _____
 Borrower _____ Owner of Public Record _____ County _____
 Legal Description _____
 Assessor's Parcel # _____ Tax Year _____ R.E. Taxes \$ _____
 Neighborhood Name _____ Map Reference _____ Census Tract _____
 Occupant ☐ Owner ☐ Tenant ☐ Vacant _____ Special Assessments \$ _____ ☐ PUD HOA \$ _____ per year ☐ per month
 Property Rights Appraised ☐ Fee Simple ☐ Leasehold ☐ Other (describe) _____
 Assignment Type ☐ Purchase Transaction ☐ Refinance Transaction ☐ Other (describe) _____
 Lender/Client _____ Address _____
 Is the subject property currently offered for sale or has it been offered for sale in the twelve months prior to the effective date of this appraisal? ☐ Yes ☐ No
 Report data source(s) used, offering price(s), and date(s) _____

☐ I did not analyze the contract for sale for the subject purchase transaction. Explain the results of the analysis of the contract for sale or why the analysis was not performed. _____

Contract Price \$ _____ Date of Contract _____ Is the property seller the owner of public record? ☐ Yes ☐ No Data Source(s) _____
 Is there any financial assistance (loan charges, sale concessions, gift or downpayment assistance, etc.) to be paid by any party on behalf of the borrower? ☐ Yes ☐ No
 If Yes, report the total dollar amount and describe the items to be paid. _____

Note: Race and the racial composition of the neighborhood are not appraisal factors.

Neighborhood Characteristics			One-Unit Housing Trends			One-Unit Housing		Present Land Use %	
Location ☐ Urban ☐ Suburban ☐ Rural	Property Values ☐ Increasing ☐ Stable ☐ Declining	PRICE	AGE	One-Unit	%				
Built-Up ☐ Over 75% ☐ 25-75% ☐ Under 25%	Demand/Supply ☐ Shortage ☐ In Balance ☐ Over Supply	\$ (000)	(yrs)	2-4 Unit	%				
Growth ☐ Rapid ☐ Stable ☐ Slow	Marketing Time ☐ Under 3 mths ☐ 3-6 mths ☐ Over 6 mths			Multi-Family	%				
Neighborhood Boundaries _____				High	Commercial	%			
				Pred.	Other	%			

Neighborhood Description _____

Market Conditions (including support for the above conclusions) _____

Dimensions _____ Area _____ Shape _____ View _____
 Specific Zoning Classification _____ Zoning Description _____
 Zoning Compliance ☐ Legal ☐ Legal Nonconforming (Grandfathered Use) ☐ No Zoning ☐ Illegal (describe) _____
 Is the highest and best use of the subject property as improved (or as proposed per plans and specifications) the present use? ☐ Yes ☐ No If No, describe _____

Utilities Public Other (describe) _____ Public Other (describe) _____ Off-site Improvements—Type Public Private
 Electricity ☐ ☐ Water ☐ ☐ Street ☐ ☐
 Gas ☐ ☐ Sanitary Sewer ☐ ☐ Alley ☐ ☐
 FEMA Special Flood Hazard Area ☐ Yes ☐ No FEMA Flood Zone _____ FEMA Map # _____ FEMA Map Date _____
 Are the utilities and off-site improvements typical for the market area? ☐ Yes ☐ No If No, describe _____
 Are there any adverse site conditions or external factors (easements, encroachments, environmental conditions, land uses, etc.)? ☐ Yes ☐ No If Yes, describe _____

General Description		Foundation		Exterior Description		materials/condition		Interior		materials/condition	
Units ☐ One ☐ One with Accessory Unit	☐ Concrete Slab ☐ Crawl Space	Foundation Walls		Floors							
# of Stories _____	☐ Full Basement ☐ Partial Basement	Exterior Walls		Walls							
Type ☐ Det. ☐ Att. ☐ S-Det./End Unit	Basement Area _____ sq. ft.	Roof Surface		Trim/Finish							
☐ Existing ☐ Proposed ☐ Under Const.	Basement Finish _____ %	Gutters & Downspouts		Bath Floor							
Design (Style) _____	☐ Outside Entry/Exit ☐ Sump Pump	Window Type		Both Windows							
Year Built _____	Evidence of ☐ Infestation	Storm Sash/Insulated		Car Storage ☐ None							
Effective Age (Yrs) _____	☐ Dampness ☐ Settlement	Screens		Driveway # of Cars _____							
Attic ☐ None ☐ Heating ☐ FWA ☐ HANG ☐ Radiant	Amenities ☐ Woodstove(s) # _____	Driveway Surface									
☐ Drop Stair ☐ Stairs ☐ Other ☐ Fuel	☐ Fireplace(s) # _____	Fence		Garage # of Cars _____							
☐ Floor ☐ Scuttle ☐ Cooling ☐ Central Air Conditioning	☐ Patio/Deck ☐ Porch	Carport		# of Cars _____							
☐ Finished ☐ Heated ☐ Individual ☐ Other	☐ Pool ☐ Other	Att. ☐ Det. ☐ Built-in									

Appliances ☐ Refrigerator ☐ Range/Oven ☐ Dishwasher ☐ Disposal ☐ Microwave ☐ Washer/Dryer ☐ Other (describe) _____

Finished area above grade contains: _____ Rooms _____ Bath(s) _____ Square Foot of Gross Living Area Above Grade _____

Additional features (special energy efficient items, etc.) _____

Describe the condition of the property (including needed repairs, deterioration, renovations, remodeling, etc.) _____

Are there any physical deficiencies or adverse conditions that affect the livability, soundness, or structural integrity of the property? ☐ Yes ☐ No If Yes, describe _____

Does the property generally conform to the neighborhood (functional utility, style, condition, use, construction, etc.)? ☐ Yes ☐ No If No, describe _____

Freddie Mac Form 70 March 2005

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Fannie Mae Form 1004 March 2005

Figure 3.1 Appraisal Report

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Eldred, Gary W.. Investing in Real Estate, John Wiley & Sons, Incorporated, 2012. ProQuest Ebook Central, <http://ebookcentral.proquest.com/lib/apus/detail.action?docID=818138>. Created from apus on 2018-07-09 11:44:38.

Uniform Residential Appraisal Report

File #

There are comparable properties currently offered for sale in the subject neighborhood ranging in price from \$		to \$	
There are comparable sales in the subject neighborhood within the past twelve months ranging in sale price from \$		to \$	
FEATURE	SUBJECT	COMPARABLE SALE # 1	COMPARABLE SALE # 2
Address			
Proximity to Subject			
Sale Price	\$	\$	\$
Sale Price/Gross Liv. Area	\$ sq. ft.	\$ sq. ft.	\$ sq. ft.
Data Source(s)			
Verification Source(s)			
VALUE ADJUSTMENTS	DESCRIPTION	DESCRIPTION	+(-) \$ Adjustment
Sale or Financing Concessions			
Date of Sale/Time			
Location			
Leasehold/Fee Simple			
Site			
View			
Design (Style)			
Quality of Construction			
Actual Age			
Condition			
Above Grade	Total Bdrms. Baths	Total Bdrms. Baths	Total Bdrms. Baths
Room Count			
Gross Living Area	sq. ft.	sq. ft.	sq. ft.
Basement & Finished Rooms Below Grade			
Functional Utility			
Heating/Cooling			
Energy Efficient Items			
Garage/Carport			
Porch/Patio/Deck			
Net Adjustment (Total)	☐ + ☐ -	☐ + ☐ -	☐ + ☐ -
Adjusted Sale Price of Comparables	Net Adj. % Gross Adj. %	Net Adj. % Gross Adj. %	Net Adj. % Gross Adj. %
☐ did not research the sale or transfer history of the subject property and comparable sales. If not, explain			
My research ☐ did ☐ did not reveal any prior sales or transfers of the subject property for the three years prior to the effective date of this appraisal.			
Data source(s)			
My research ☐ did ☐ did not reveal any prior sales or transfers of the comparable sales for the year prior to the date of sale of the comparable sale.			
Data source(s)			
Report the results of the research and analysis of the prior sale or transfer history of the subject property and comparable sales (report additional prior sales on page 3).			
ITEM	SUBJECT	COMPARABLE SALE # 1	COMPARABLE SALE # 2
Date of Prior Sale/Transfer			
Price of Prior Sale/Transfer			
Data Source(s)			
Effective Date of Data Source(s)			
Analysis of prior sale or transfer history of the subject property and comparable sales			
Summary of Sales Comparison Approach			
Indicated Value by Sales Comparison Approach \$			
Indicated Value by: Sales Comparison Approach \$ Cost Approach (if developed) \$ Income Approach (if developed) \$			
This appraisal is made ☐ "as is" ☐ subject to completion per plans and specifications on the basis of a hypothetical condition that the improvements have been completed, ☐ subject to the following repairs or alterations on the basis of a hypothetical condition that the repairs or alterations have been completed, or ☐ subject to the following required inspection based on the extraordinary assumption that the condition or deficiency does not require alteration or repair:			
Based on a complete visual inspection of the interior and exterior areas of the subject property, defined scope of work, statement of assumptions and limiting conditions, and appraiser's certification, my (our) opinion of the market value, as defined, of the real property that is the subject of this report is \$, as of , which is the date of inspection and the effective date of this appraisal.			

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Figure 3.1 (Continued)

Uniform Residential Appraisal Report

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ADDITIONAL COMMENTS				
COST APPROACH TO VALUE (not required by Fannie Mae)				
Provide adequate information for the lender/client to replicate the below cost figures and calculations. Support for the opinion of site value (summary of comparable land sales or other methods for estimating site value)				
COST APPROACH	ESTIMATED ☐ REPRODUCTION OR ☐ REPLACEMENT COST NEW		OPINION OF SITE VALUE = \$	
	Source of cost data		Dwelling	Sq. Ft. @ \$ = \$
	Quality rating from cost service	Effective date of cost data		Sq. Ft. @ \$ = \$
	Comments on Cost Approach (gross living area calculations, depreciation, etc.)		Garage/Carport	Sq. Ft. @ \$ = \$
			Total Estimate of Cost-New	= \$
			Less Physical Functional External	
			Depreciation	=()
			Depreciated Cost of Improvements	= \$
			"As-is" Value of Site Improvements	= \$
	Estimated Remaining Economic Life (HUD and VA only) Years		Indicated Value By Cost Approach	= \$
	INCOME APPROACH TO VALUE (not required by Fannie Mae)			
	Estimated Monthly Market Rent \$		X Gross Rent Multiplier = \$	Indicated Value by Income Approach
	Summary of Income Approach (including support for market rent and GRM)			
	PROJECT INFORMATION FOR PUDs (if applicable)			
	Is the developer/builder in control of the Homeowners' Association (HOA)? ☐ Yes ☐ No Unit type(s) ☐ Detached ☐ Attached			
Provide the following information for PUDs ONLY if the developer/builder is in control of the HOA and the subject property is an attached dwelling unit.				
Legal name of project				
Total number of phases	Total number of units	Total number of units sold		
Total number of units rented	Total number of units for sale	Data source(s)		
Was the project created by the conversion of an existing building(s) into a PUD? ☐ Yes ☐ No If Yes, date of conversion				
Does the project contain any multi-dwelling units? ☐ Yes ☐ No Data source(s)				
Are the units, common elements, and recreation facilities complete? ☐ Yes ☐ No If No, describe the status of completion.				
Are the common elements leased to or by the Homeowners' Association? ☐ Yes ☐ No If Yes, describe the rental terms and options.				
Describe common elements and recreational facilities				

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Figure 3.1 (Continued)

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This report form is designed to report an appraisal of a one-unit property or a one-unit property with an accessory unit, including a unit in a planned unit development (PUD). This report form is not designed to report an appraisal of a manufactured home or a unit in a condominium or cooperative project.

This appraisal report is subject to the following scope of work, intended use, intended user, definition of market value, statement of assumptions and limiting conditions, and certifications. Modifications, additions, or deletions to the intended use, intended user, definition of market value, or assumptions and limiting conditions are not permitted. The appraiser may expand the scope of work to include any additional research or analysis necessary based on the complexity of this appraisal assignment. Modifications or deletions to the certifications are also not permitted. However, additional certifications that do not constitute material alterations to this appraisal report, such as those required by law or those related to the appraiser's continuing education or membership in an appraisal organization, are permitted.

SCOPE OF WORK: The scope of work for this appraisal is defined by the complexity of this appraisal assignment and the reporting requirements of this appraisal report form, including the following definition of market value, statement of assumptions and limiting conditions, and certifications. The appraiser must, at a minimum: (1) perform a complete visual inspection of the interior and exterior areas of the subject property; (2) inspect the neighborhood; (3) inspect each of the comparable sales from at least the street; (4) research, verify, and analyze data from reliable public and/or private sources; and (5) report his or her analysis, opinions, and conclusions in this appraisal report.

INTENDED USE: The intended use of this appraisal report is for the lender/client to evaluate the property that is the subject of this appraisal for a mortgage finance transaction.

INTENDED USER: The intended user of this appraisal report is the lender/client.

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, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby: (1) buyer and seller are typically motivated; (2) both parties are well informed or well advised; and each acting in what he or she considers his or her own best interest; (3) a reasonable time is allowed for exposure in the open market; (4) payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and (5) the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions* granted by anyone associated with the sale.

*Adjustments to the comparables must be made for special or creative financing or sales concessions. No adjustments are necessary for those costs which are normally paid by sellers as a result of tradition or law in a market area; these costs are readily identifiable since the seller pays these costs in virtually all sales transactions. Special or creative financing adjustments can be made to the comparable property by comparisons to financing terms offered by a third party institutional lender that is not already involved in the property or transaction. Any adjustment should not be calculated on a mechanical dollar for dollar cost of the financing or concession but the dollar amount of any adjustment should approximate the market's reaction to the financing or concessions based on the appraiser's judgment.

STATEMENT OF ASSUMPTIONS AND LIMITING CONDITIONS: The appraiser's certification in this report is subject to the following assumptions and limiting conditions:

1. The appraiser will not be responsible for matters of a legal nature that affect either the property being appraised or the title to it, except for information that he or she became aware of during the research involved in performing this appraisal. The appraiser assumes that the title is good and marketable and will not render any opinions about the title.
2. The appraiser has provided a sketch in this appraisal report to show the approximate dimensions of the improvements. The sketch is included only to assist the reader in visualizing the property and understanding the appraiser's determination of its size.
3. The appraiser has examined the available flood maps that are provided by the Federal Emergency Management Agency (or other data sources) and has noted in this appraisal report whether any portion of the subject site is located in an identified Special Flood Hazard Area. Because the appraiser is not a surveyor, he or she makes no guarantees, express or implied, regarding this determination.
4. The appraiser will not give testimony or appear in court because he or she made an appraisal of the property in question, unless specific arrangements to do so have been made beforehand, or as otherwise required by law.
5. The appraiser has noted in this appraisal report any adverse conditions (such as needed repairs, deterioration, the presence of hazardous wastes, toxic substances, etc.) observed during the inspection of the subject property or that he or she became aware of during the research involved in performing this appraisal. Unless otherwise stated in this appraisal report, the appraiser has no knowledge of any hidden or unapparent physical deficiencies or adverse conditions of the property (such as, but not limited to, needed repairs, deterioration, the presence of hazardous wastes, toxic substances, adverse environmental conditions, etc.) that would make the property less valuable, and has assumed that there are no such conditions and makes no guarantees or warranties, express or implied. The appraiser will not be responsible for any such conditions that do exist or for any engineering or testing that might be required to discover whether such conditions exist. Because the appraiser is not an expert in the field of environmental hazards, this appraisal report must not be considered as an environmental assessment of the property.
6. The appraiser has based his or her appraisal report and valuation conclusion for an appraisal that is subject to satisfactory completion, repairs, or alterations on the assumption that the completion, repairs, or alterations of the subject property will be performed in a professional manner.

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Figure 3.1 (Continued)

Uniform Residential Appraisal Report

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APPRAISER'S CERTIFICATION: The Appraiser certifies and agrees that

1. I have, at a minimum, developed and reported this appraisal in accordance with the scope of work requirements stated in this appraisal report.
2. I performed a complete visual inspection of the interior and exterior areas of the subject property. I reported the condition of the improvements in factual, specific terms. I identified and reported the physical deficiencies that could affect the livability, soundness, or structural integrity of the property.
3. I performed this appraisal in accordance with the requirements of the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place at the time this appraisal report was prepared.
4. I developed my opinion of the market value of the real property that is the subject of this report based on the sales comparison approach to value. I have adequate comparable market data to develop a reliable sales comparison approach for this appraisal assignment. I further certify that I considered the cost and income approaches to value but did not develop them, unless otherwise indicated in this report.
5. I researched, verified, analyzed, and reported on any current agreement for sale for the subject property, any offering for sale of the subject property in the twelve months prior to the effective date of this appraisal, and the prior sales of the subject property for a minimum of three years prior to the effective date of this appraisal, unless otherwise indicated in this report.
6. I researched, verified, analyzed, and reported on the prior sales of the comparable sales for a minimum of one year prior to the date of sale of the comparable sale, unless otherwise indicated in this report.
7. I selected and used comparable sales that are locationally, physically, and functionally the most similar to the subject property.
8. I have not used comparable sales that were the result of combining a land sale with the contract purchase price of a home that has been built or will be built on the land.
9. I have reported adjustments to the comparable sales that reflect the market's reaction to the differences between the subject property and the comparable sales.
10. I verified, from a disinterested source, all information in this report that was provided by parties who have a financial interest in the sale or financing of the subject property.
11. I have knowledge and experience in appraising this type of property in this market area.
12. I am aware of, and have access to, the necessary and appropriate public and private data sources, such as multiple listing services, tax assessment records, public land records and other such data sources for the area in which the property is located.
13. I obtained the information, estimates, and opinions furnished by other parties and expressed in this appraisal report from reliable sources that I believe to be true and correct.
14. I have taken into consideration the factors that have an impact on value with respect to the subject neighborhood, subject property, and the proximity of the subject property to adverse influences in the development of my opinion of market value. I have noted in this appraisal report any adverse conditions (such as, but not limited to, needed repairs, deterioration, the presence of hazardous wastes, toxic substances, adverse environmental conditions, etc.) observed during the inspection of the subject property or that I became aware of during the research involved in performing this appraisal. I have considered these adverse conditions in my analysis of the property value, and have reported on the effect of the conditions on the value and marketability of the subject property.
15. I have not knowingly withheld any significant information from this appraisal report and, to the best of my knowledge, all statements and information in this appraisal report are true and correct.
16. I stated in this appraisal report my own personal, unbiased, and professional analysis, opinions, and conclusions, which are subject only to the assumptions and limiting conditions in this appraisal report.
17. I have no present or prospective interest in the property that is the subject of this report, and I have no present or prospective personal interest or bias with respect to the participants in the transaction. I did not base, either partially or completely, my analysis and/or opinion of market value in this appraisal report on the race, color, religion, sex, age, marital status, handicap, familial status, or national origin of either the prospective owners or occupants of the subject property or of the present owners or occupants of the properties in the vicinity of the subject property or on any other basis prohibited by law.
18. My employment and/or compensation for performing this appraisal or any future or anticipated appraisals was not conditioned on any agreement or understanding, written or otherwise, that I would report (or present analysis supporting) a predetermined specific value, a predetermined minimum value, a range or direction in value, a value that favors the cause of any party, or the attainment of a specific result or occurrence of a specific subsequent event (such as approval of a pending mortgage loan application).
19. I personally prepared all conclusions and opinions about the real estate that were set forth in this appraisal report. If I relied on significant real property appraisal assistance from any individual or individuals in the performance of this appraisal or the preparation of this appraisal report, I have named such individual(s) and disclosed the specific tasks performed in this appraisal report. I certify that any individual so named is qualified to perform the tasks. I have not authorized anyone to make a change to any item in this appraisal report; therefore, any change made to this appraisal is unauthorized and I will take no responsibility for it.
20. I identified the lender/client in this appraisal report who is the individual, organization, or agent for the organization that ordered and will receive this appraisal report.

Figure 3.1 (Continued)

Uniform Residential Appraisal Report

File *

21. The lender/client may disclose or distribute this appraisal report to the borrower, another lender at the request of the borrower, the mortgagee or its successors and assigns, mortgage insurers, government sponsored enterprises, other secondary market participants, data collection or reporting services, professional appraisal organizations, any department, agency, or instrumentality of the United States, and any state, the District of Columbia, or other jurisdictions, without having to obtain the appraiser's or supervisory appraiser's (if applicable) consent. Such consent must be obtained before this appraisal report may be disclosed or distributed to any other party (including, but not limited to, the public through advertising, public relations, news, sales, or other media).

22. I am aware that any disclosure or distribution of this appraisal report by me or the lender/client may be subject to certain laws and regulations. Further, I am also subject to the provisions of the Uniform Standards of Professional Appraisal Practice that pertain to disclosure or distribution by me.

23. The borrower, another lender at the request of the borrower, the mortgagee or its successors and assigns, mortgage insurers, government sponsored enterprises, and other secondary market participants may rely on this appraisal report as part of any mortgage finance transaction that involves any one or more of these parties.

24. If this appraisal report was transmitted as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or a facsimile transmission of this appraisal report containing a copy or representation of my signature, the appraisal report shall be as effective, enforceable and valid as if a paper version of this appraisal report were delivered containing my original hand written signature.

25. Any intentional or negligent misrepresentation(s) contained in this appraisal report may result in civil liability and/or criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code, Section 1001, et seq., or similar state laws.

SUPERVISORY APPRAISER'S CERTIFICATION: The Supervisory Appraiser certifies and agrees that:

1. I directly supervised the appraiser for this appraisal assignment, have read the appraisal report, and agree with the appraiser's analysis, opinions, statements, conclusions, and the appraiser's certification.

2. I accept full responsibility for the contents of this appraisal report including, but not limited to, the appraiser's analysis, opinions, statements, conclusions, and the appraiser's certification.

3. The appraiser identified in this appraisal report is either a sub-contractor or an employee of the supervisory appraiser (or the appraisal firm), is qualified to perform this appraisal, and is acceptable to perform this appraisal under the applicable state law.

4. This appraisal report complies with the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place at the time this appraisal report was prepared.

5. If this appraisal report was transmitted as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or a facsimile transmission of this appraisal report containing a copy or representation of my signature, the appraisal report shall be as effective, enforceable and valid as if a paper version of this appraisal report were delivered containing my original hand written signature.

APPRAISER

Signature _____

Name _____

Company Name _____

Company Address _____

Telephone Number _____

Email Address _____

Date of Signature and Report _____

Effective Date of Appraisal _____

State Certification # _____

or State License # _____

or Other (describe) _____ State # _____

State _____

Expiration Date of Certification or License _____

ADDRESS OF PROPERTY APPRAISED _____

APPAISED VALUE OF SUBJECT PROPERTY \$ _____

LENDER/CLIENT

Name _____

Company Name _____

Company Address _____

Email Address _____

SUPERVISORY APPRAISER (ONLY IF REQUIRED)

Signature _____

Name _____

Company Name _____

Company Address _____

Telephone Number _____

Email Address _____

Date of Signature _____

State Certification # _____

or State License # _____

State _____

Expiration Date of Certification or License _____

SUBJECT PROPERTY

☐ Did not inspect subject property

☐ Did inspect exterior of subject property from street

Date of Inspection _____

☐ Did inspect interior and exterior of subject property

Date of Inspection _____

COMPARABLE SALES

☐ Did not inspect exterior of comparable sales from street

☐ Did inspect exterior of comparable sales from street

Date of Inspection _____

Figure 3.1 (Continued)

on an appraisal form. You will judge properties more profitably. (Here I focus on *market value* inspection and description. Valuing for investment and entrepreneurial improvements differs in perspective and purpose. We address those perspectives in following chapters.)

Identify the Subject Property

To identify the subject property seems straightforward. But all is not as simple as you may think. The street address for one of my previous homes was 73 Roble Road, Berkeley, California 94705. However, that property does not sit in Berkeley. It is actually located in Oakland. The house sat back from Roble Road (which is in Berkeley) about 100 feet—just far enough to place it within the city limits of Oakland. As a result, the city laws governing the property (zoning, building regulations, permits, rent controls, school district, and so forth) were those of Oakland, not Berkeley.

Similarly, Park Cities (University Park and Highland Park) are high-income, independent municipalities located within the geographic boundaries of Dallas, Texas. Among other amenities, Park Cities are noted for their high-quality schools. Yet (in the past) if you lived in Park Cities on the west side of the North Dallas Tollway, your children would attend the lesser-regarded schools of the Dallas Independent School District.

The lesson: Street and city addresses don't tell you what you need to know about a property. Strange as it may seem, a property may not be located where you think it is. The property may not receive the services you think it does. The laws of zoning and other regulations may not apply as you think they do. (See also the discussion of site identification further on.)

Neighborhood

As the appraisal form shows, a neighborhood investigation should note the types and condition of neighborhood properties, the percentage of houses and condominiums that are owner occupied, vacancy rates, property price (and rental) ranges, the types and quality of government services, and the relative convenience of the property to shopping, schools, employment centers, and parks and recreational areas—the appeal of the neighborhood to potential buyers.

Next, bring the future into view. Envision the changes that are likely to occur in the neighborhood during the coming three to five years. Is the neighborhood stable? Is it moving toward higher rates of owner occupancy? Are property owners fixing up their properties? Do neighborhood residents and local merchants take pride in their properties and the

surrounding area? Is a neighborhood (or homeowners') association working to improve the area? If not, could such an association make the neighborhood a better place to live, shop, work, and play?

Have builders added large numbers of new housing units to the area? Is the neighborhood filled with foreclosures, For Sale signs or For Rent signs, or both? Has excess supply driven down property prices? How many months (or years) might be needed to clear existing and pipeline inventories?

Investment value looks to the future. Market value chiefly looks to past sales of similar properties. When you invest, you buy the future more than the present. View the neighborhood with a magnifying glass and with the use of a crystal ball. How will (or could) the neighborhood appear, look, feel, and be made to live in within the coming 5 to 10 years?

Site (Lot) Characteristics

Depending on the neighborhood, the size and features of a lot can account for 20 to 80 percent of a property's current and future value. Smart investors pay as much attention to the lot (and its potential) as they do to the building(s).

In addition to site size and features (see appraisal form), review the rules and restrictions that govern a site. Determine whether the buildings conform to zoning, occupancy, environmental, and safety regulations. Many two- to four-unit (and larger) properties have been modified (rehabbed, cut up, added to, repaired, renovated, rewired, reroofed, and so on) in ways that violate current law. Laws also change. Even if the property originally conformed to all rules and regulations, it may now violate today's legal standards.

Land use law classifies properties as (1) legal and conforming, (2) legal and nonconforming, and (3) illegal. When a property meets all of today's legal standards, it's called legal and conforming. If it met past standards that don't meet current law, but have been grandfathered, the property qualifies as legal but nonconforming.

If the property includes features or uses that violate standards not grandfathered as permissible, those features or uses remain illegal. Even work that conforms to the law might place the owners (present and future) in jeopardy if such work was performed without a valid building or renovation permit.

If you buy a property that fails to meet current law, buy with your eyes open. Lower your offering price to reflect risk. At some future time, city inspectors may require you to bring the property up to code. Or if the property suffers major fire damage, the city may not permit a rebuild (for

example, a grandfathered office building in a single-family-zoned district). Health, safety, and environmental violations may present these risks:

- ◆ Subject your tenants to injury.
- ◆ Motivate a rent strike.
- ◆ Expose you to a lawsuit.
- ◆ Expose you to civil or criminal penalties (fines and, in serious cases, prison).

Before you decide upon the price to pay for a property, verify code compliance. To bring a nonconforming property up to code (or to tear out and reinstall unpermitted work) can cost thousands (or even tens of thousands) of dollars.

Improvements

After you investigate the legal restrictions relative to site size, features, and improvements (for example, parking, driveways, fencing, landscaping, utilities, sewage disposal), detail the size, condition, quality, and appeal of the house or apartment units located on the site. Building size itself ranks as one of the most important determinants of value. To determine size (room count, square footage) requires more than pulling out a tape measure.

As you inspect properties, you'll see converted basements, garages, and attics; you'll see heated and cooled and unheated and uncooled living areas; you'll see bedrooms without closets and dining areas without space for a family-size table and chairs, let alone a buffet or china cabinet; you'll see rooms with 6-foot ceilings or lower, and rooms with 12-foot ceilings or higher; you'll see some storage areas that users can access easily and others that you can reach only by crawling on your hands and knees or standing on a ladder. You'll see decks, patios, and porches constructed of all sorts of materials in all shapes and sizes.

You'll see that all space does not live equally well. You must look beyond measured size, purported space use, or room count. Judge quality, livability, traffic patterns, and functionality.

Even more challenging, not everyone measures square footage in the same way: a builder asked five appraisers to measure one of his new homes. In sales promotion literature, the builder listed the home as 3,103 square feet. One appraiser came up with a square-footage count of 3,047 square feet. The other appraisers came up with measures that ranged between 2,704 square feet and 3,312 square feet. Differences such as these occur not only by mistake but because no square-footage police prescribe or enforce measurement methods.

When you read or hear a property's room count or size, verify that information. Judge the quality, size, and desirability of the space. I once owned a lakefront house with a large master bedroom (MBR) that faced the lake through a full, wall-sized window. In valuing that house, an appraiser rated as equivalent another lakefront home—only its MBR was 40 percent smaller and faced street-side.

In his report, the appraiser made no note of that huge difference (as perceived by most would-be buyers). To compound his errors, the appraiser also rated the lakefront lots equivalent—even though the subject's lot was 40,000 square feet with 165 feet of frontage versus the comp lot at 20,000 square feet with 100 feet of lake frontage. Never accept—without verification—an appraiser's comparable data, properties, or feature adjustments. (I might note that as part of my verification process, I actually visited the owner of that comp house and he even invited me in to look around. Throughout my career, I have often been amazed at how accommodating and forthcoming people will become when you speak with them in a courteous and curious manner.)

THE COST APPROACH

The cost approach recognizes that you can either build (or buy) a new property or buy an existing one. Replacement cost typically sets the upper limit to the price you would pay for an existing property. If you can build a new property for \$380,000 (including the cost of a lot), then why pay \$380,000 for a like-kind existing property located just down the street? In fact, why pay \$380,000 for that older property? It suffers (at least some) physical deterioration.

Calculate Cost to Build New

To follow the logic of the cost approach, refer to the appraisal form. First, calculate the cost to build the property using dollars per square foot. Use a figure that would apply in your area for the type of property you're valuing. To learn these per-square-foot costs, talk with local contractors or consult the Marshall & Swift construction cost manuals in the reference section of your local library or on the Internet (marshallswift.com).

Because replacement costs correlate directly with the size and quality of buildings, accurate measurement precedes accurate valuation. Notice, too, that you add the expense of upgrades and extras (crystal chandelier, high-grade wall-to-wall carpeting, Italian tile, granite countertops, high-end

appliances or plumbing fixtures, sauna, hot tub, swimming pool, garage, carport, patios, porches, and so on) to the cost of the basic construction.

Deduct Depreciation

After you calculate today's building costs for the subject property, deduct three types of depreciation: physical, functional, and external.

As a building ages, it becomes less valuable than new construction because of physical depreciation (wear and tear): The property is exposed to time, weather, use, and abuse; it deteriorates. Frayed carpets, faded paint, cracked plaster, rusty plumbing, and leaky roofs bring down a property's value when cocontrasted to new construction. What amount of depreciation remains is your call. To fill in a physical depreciation figure for a building in good condition, estimate, say, 10 percent or 20 percent; if the property appears run-down, you might justify 50 percent depreciation or greater. Or instead of applying a percentage depreciation figure, itemize the costs of the repairs and renovations that would restore the property to like-new condition.

Itemized repairs do not work as well as percentage estimates, because you can't economically upgrade an eight-year-old roof, four-year-old carpeting, or a nine-year-old furnace to like-new condition. Still, one way or another, estimate the degree to which the subject property has depreciated relative to a newly built property of the same size, quality, and features.

Next, estimate the amount of functional depreciation. Unlike wear and tear, which occurs naturally through use and abuse, functional depreciation creates loss of value due to undesirable features such as outdated dark wood paneling, a weirdly designed floor plan, low-amperage electrical systems, fuse boxes, out-of-favor color schemes, or linoleum flooring. A property may show little physical depreciation but still lack appeal to most potential buyers or renters.

External (locational) depreciation occurs when a property fails to reflect the highest and best use for a site. You find a small, well-kept house located in an area now filling up with offices and retail stores. Zoning of the site has changed. More than likely, the house (as a house, *per se*) may not add much to the site's value. The investor who buys the house would likely tear it down or renovate it and create a retail store or offices.

For such duck-out-of-water properties, external (locational) factors make the buildings obsolete. External depreciation can approach 100 percent. With or without the building, the site should sell at approximately the same price. This principle also applies when neighborhoods move upscale, and well-kept three-bedroom, two-bath houses of 1,600 square feet are torn down and replaced with 5,000-square-foot McMansions. Investors

and builders refer to these smaller existing houses as teardowns—even though their owners may have lovingly maintained them. The house adds nothing to the property's value. In fact, it diminishes value to the degree of teardown costs and permitting fees. (Yes, you often pay a permit fee to knock down a structure.)

Lot Value

To estimate lot value, find similarly zoned (vacant) lots that have recently sold, or lots that have sold with teardowns on them. When you compare sites, note all features such as size, frontage, views, topography, legal restrictions, subdivision rules, and other features that can affect the values of the respective sites.

In the Vancouver, Canada, neighborhood where I spend summers, 40- to 50-year-old 1,200-square-foot houses on 33-foot by 120-foot lots sell to builders for \$600,000 to \$700,000. A lot with a 50-foot frontage and a tear-down can sell for \$800,000. In Vancouver's Point Grey area, similar neighborhood teardowns on 50-foot lots will easily sell for \$1.2 million (perhaps \$2 million with bay or mountain views).

Although most people refer to the price increases for *houses*, more often than not, the real increase occurs in the *site*. If you seek price increase as a primary goal, choose your property's site with that goal in mind (see Chapter 4).

Estimate Market Value (Cost Approach)

As you can see on the appraisal form, after you complete these steps (calculate a property's construction cost as if newly built, deduct depreciation, and add in site value), you have computed market value. Because you can't precisely measure construction costs, depreciation, or site value, the cost approach won't give you a perfect answer (of course, neither do the comparable sale or income approaches—reason and judgment rule). But the cost approach does provide a reference point to use with the comp sales and income approaches. It also helps to reveal when a market (or property) is overvalued—priced beyond reason—or perhaps priced below investment value.

Here's an example of the cost approach:

Property description: Six-year-old, good-condition, single-family house of 2,200 square feet. The house includes a two-car, 500-square-foot garage, a deck, in-ground pool, sprinkler system, and premium carpets, appliances, and kitchen cabinets. Nearby vacant lots have recently sold for \$60,000.

Dwelling (2,200 × \$108 per-square-foot base construction costs)	\$237,600
Upgrades	13,500
Deck, lap pool, sprinklers	21,750
Garage (500 × \$33 per square foot)	16,500
Total	\$289,350
<i>Less</i>	
Physical depreciation at 10 percent	(28,935)
Functional depreciation at 5 percent	(14,438)
Depreciated building value	\$245,978
Site improvements (sidewalks, driveway, fencing, landscaping)	18,750
Lot value	60,000
<i>Equals</i>	
Indicated market value, cost approach	\$324,728

Builders typically build only when they think they can construct properties that will sell (or rent) to yield enough revenue to cover their construction costs and a competitively determined profit margin. You can usually expect market prices of existing properties to increase when construction costs for newly built houses significantly exceed the market values of those houses (or apartments).

Why? Because without the expectation of profit, builders stop building. When growing demand begins to push against a scarce supply, builder profit margins eventually return. The real estate construction cycle starts anew.

When builder profits fatten, sooner or later, they overbuild. High, expected profits lead to a surplus of new construction. Too much housing inventory brings down market values for new as well as existing properties.

Did I hear someone say Las Vegas, Miami, Dublin, or Dubai? Easy financing encouraged buyers to pay prices that (temporarily) supported inflated builder profit margins. Builders overbuilt. Buyers overpaid and overleveraged. Indeed, they overpaid because they could borrow excessive amounts with few qualifying standards.

During the boom, the house valued at \$324,728 by the cost approach example would likely have sold for \$550,000 to \$600,000. The cost to build was far less than the prices at which older properties were selling—a sure sign that home prices had reached unsustainable amounts. But many appraisers paid little attention because they were being paid so well to justify such excessive prices.

Investors rejoice. Overbuilding leads to underbuilding. During the current downturn, new housing starts have nosedived to fewer than

400,000 units—down from 1,600,000 units in 2006. Only large price gains will bring builders back into the game. Until market values significantly increase, homebuilders will not build many new houses (and even fewer condominiums—as their prices in many cities have fallen even more than single-family residences). As new construction sinks—and as inventories of foreclosures and REOs are eventually sold—the market generates the conditions to support the next cyclical upswing.

THE COMPARABLE SALES APPROACH

For houses, condominiums, co-ops, townhouses, and apartment buildings, the comparable sales approach often provides a good estimate of market value. Understand the recent sales prices, terms of sale, physical features, and locational differences of similar properties. Even income approaches require knowledge of comp sales to derive market rent levels, GRMs, and capitalization (cap) rates.

Select Comparable Properties

To apply the comp sales approach, the appraiser (or you) finds recently sold properties that closely match a subject property. Ideally, find comp sales that resemble one another in property size, age, features, condition, quality of construction, room count, floor plan, and location. As a practical matter, you seldom find perfect comp matches because each property, each location, displays unique characteristics.

But you don't need a perfect match. When you find comp sales that appear to be similar to a subject property, ballpark a market value estimate: compare price per square foot of living area.

You research three sales: (Comp 1) 1,680 square feet, (Comp 2) 1,840 square feet, and (Comp 3) 1,730 square feet. These properties sold recently for the respective prices of \$225,120, \$213,440, and \$211,060. To figure the selling price per square foot of living area for these houses, divide the sales price of each house by its total square footage.

Comp 1

$$\$225,120 / 1,680 = \$134$$

Comp 2

$$\$213,440 / 1,840 = \$116$$

Comp 3

$$\$211,060 / 1,730 = \$122$$

If the house you’re interested in has 1,796 square feet of living area, it will probably sell in the range of \$120 to \$130 per square foot, or \$215,520 to \$233,480.

Approximate Value Range–Subject Property

$$\begin{aligned} \$120 \times 1,796 &= \$215,520 \\ \$130 \times 1,796 &= \$233,480 \end{aligned}$$

Sales price per square foot provides a first-pass estimate. To gain more insight, compare and contrast similar properties to your subject property on a feature-by-feature basis. You adjust the sales price for each of the comps—up or down—depending on whether its features look inferior or superior to the subject property.

Adjust for Differences

Here’s a brief example of this adjustment process:

Adjustment Process (Selected Features Only)			
	Comp 1	Comp 2	Comp 3
Sales price	\$225,120	\$213,440	\$211,060
Features			
Sales concessions	0	−10,000	0
Financing concessions	−15,000	0	0
Date of sale	0	10,000	0
Location	0	0	−20,000
Floor plan	0	5,000	0
Garage	11,000	0	17,000
Pool, patio, deck	−9,000	−13,000	0
Indicated value of subject	\$212,120	\$205,440	\$208,060

As you adjust the selling prices of similar houses, you move toward your best estimate of the market value range for the subject property. Whereas price-per-square-foot indicated a market value range for the subject

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property between \$215,520 and \$233,480, after adjustments, a price range between \$212,120 and \$205,440 seems closer.

Explain the Adjustments

To adjust for differences in size, quality, or features, equalize a subject property and each of its comparables: "At what price would the comparable have sold if it exactly matched the subject property?" Look at the \$15,000 adjustment to Comp 1 for financing concessions.

In this sale, the sellers carried back a 90 percent LTV mortgage (10 percent down) on the property at an interest rate of 5.5 percent. At the time, investor financing usually required a 75 percent LTV (25 percent down) and a 6.50 percent interest rate. Without this favorable owner financing, Comp 1 would probably have sold for \$15,000 less than its actual sales price of \$225,120. Remember, favorable terms of financing often gain sellers a bonus in price. Because the definition of market value assumes financing on terms typically available in the market, the sales price premium generated by this OWC (owner will carry) financing is subtracted from Comp 1's actual selling price. Here are the explanations for other adjustments:

Comp 1 garage at (+) \$11,000. The subject property stands superior with its oversize double-car garage, whereas Comp 1 has only a single-car garage. With a larger garage like the subject's, Comp 1 would have brought an \$11,000 higher sales price.

Comp 1 pool, patio, and deck at (–) \$9,000. Comp 1 is superior to the subject property on this feature because the subject lacks a deck and tile patio. Without this feature, Comp 1 would have sold for \$9,000 less.

Comp 2 sales concession at (–) \$10,000. The \$213,440 sales price in this transaction included the seller's custom-made drapes, a washer and dryer, and a backyard storage shed. Because these items aren't customary in this market, the sales price is adjusted downward to equalize this feature with the subject property, whose sale will not include these items.

Comp 2 floor plan at (+) \$5,000. Unlike the subject property, Comp 2 lacked convenient access from the garage to the kitchen. The garage was built under the house; residents must carry groceries up an outside stairway to enter the kitchen. With more conventional and convenient access, the selling price of Comp 2 would probably have increased by \$5,000.

Comp 3 location at (–) \$20,000. Comp 3 was located on a cul de sac, and its backyard bordered an environmentally protected wooded area. In contrast, the subject property sits on a typical subdivision street, and its rear yard abuts that of a neighbor. Because of its less favorable location (heavier traffic four-lane street), the subject property could be expected to sell for \$20,000 less than Comp 3.

Now, you might ask: “How can I or anyone else come up with accurate amounts for each of these adjustments?” Sorry, there’s no easy answer. Stock up knowledge by talking with sales agents and tracking sales transactions over a period of months and years. Or, use the PFA technique that many appraisers rely on. What’s PFA? Pulled from the air. That’s why appraisers offer opinions of market value—not definitive answers.

Even without professional (or PFA) knowledge, critique the opinions of appraisers and real estate agents against your own judgment. Ask questions. Explore their reasoning. Verify their facts. As you look at properties, discipline your mind to list and detail all features that make a difference. Before you attach adjustment numbers to each property’s unique features, first observe those differences.

[Investor Alert: Properties with similar features make the best comps for purposes of market value. As far as an appraiser is concerned, the more closely the comps mirror the subject, the easier the market value appraisal. Your discovery process should also look elsewhere. As an investor, you seek to differentiate your property from others. Search out those differences that make a difference. What unique features provide the WOW! appeal that attracts and retains tenants? Discover what few appraisers ever look for: those differences that deliver a compelling value proposition to prospective tenants. For market value appraisals, unique differences add difficulty to the appraisal task. For entrepreneurial investors, unique differences can create value.]

THE GRM INCOME APPROACH

Near the bottom of page 3 on the appraisal form, notice a line labeled “Indicated Value by Income Approach (If Applicable).” This income approach refers to the gross rent multiplier (GRM). To calculate market value using the GRM, find the monthly rents and sales prices of similar houses (or apartment buildings).

Say you discover the following single-family rental houses: (1) 214 Jackson rents for \$1,045 a month and sold for \$148,200; (2) 312 Lincoln rents for \$963 a month and sold for \$156,000; and (3) 107 Adams rents for

\$1,155 a month and sold for \$168,400. With this information, you calculate a range of GRMs for rental houses in this neighborhood:

$$\text{GRM} = \text{Sales price} / \text{Monthly rent}$$

Property	Sales Price		Monthly Rent		GRM
214 Jackson	\$148,200	÷	\$1,045	=	142
312 Lincoln	156,000	÷	963	=	162
107 Adams	168,400	÷	1,170	=	144

If the house you value could rent for \$1,000 a month, calculate a value range using the GRMs indicated by these other neighborhood rental houses:

GRM		Monthly Rent		Value
142	×	\$1,000	=	\$142,000
162	×	1,000	=	162,000
144	×	1,000	=	144,000

Thus, the value ranges between \$142,000 and \$162,000.

The GRM method does not directly adjust for sales incentives, financing concessions, features, location, property condition, or property operating expenses. This technique yields a rough estimate of market value. Nevertheless, for property investors, it works as a rule of thumb. As with the comp sales approach, the GRM derives from similar properties in the same neighborhood.

For apartment buildings, the GRM is calculated from annual rent collections rather than monthly. For example:

Multiunit Income Properties

Property	Sales Price		Total Annual Rents		GRM
2112 Pope (fourplex)	\$280,000	÷	\$35,897	=	7.8
1806 Laurel (sixplex)	412,000	÷	56,438	=	7.3
1409 Abbot (sixplex)	367,000	÷	53,188	=	6.9

The GRMs shown in these examples do not necessarily correspond to the GRMs that apply in your city. Even within the same city, neighborhoods differ in their GRMs. During the boom within the San Diego

area, GRMs for single-family houses in La Jolla exceeded 400; in nearby Claremont, you could find GRMs in the 250-to-300 range. Within the same market area, GRMs for single-family houses typically range higher than those of condominiums. In San Francisco, small multiunit buildings sold for annual GRMs of 14 or higher.

Did such historically high GRMs in San Francisco and San Diego signal overvalued? Absolutely! With such high price and rent multiples, renting cost 50 to 65 percent less than owning. Financially, buying made sense only if you assumed that home prices would continue climbing higher and higher, that is, speculators would continue to buy—no matter how high the price. (Income investors had long before dropped out of the bidding—as per John Burr Williams, p. 30.)

Today in Detroit, Michigan, I have seen annual GRMs of less than 4. Has the market overreacted to Detroit's economic problems? In my area of Florida, I am buying well-kept and appealing properties with annual GRMs of 6 to 8—down from the 10 to 12 GRMs of six years ago.

Unlike Detroit, whose price drops relate to a 40 percent decrease in population and jobs (economic base), the Florida population and job base will continue to grow (especially as the retiring boomers relocate to warmer, higher-quality-of-life Sunbelt states). With construction of new homes in Florida at post-World War II lows, patient investors can wait for inventories of foreclosures to become absorbed. Price gains are virtually assured. Fortunately, too, positive cash flows make that wait profitable.

INCOME CAPITALIZATION

To value apartment buildings, investors also use direct capitalization:

$$V = \text{NOI} / R$$

V represents market value. NOI represents the net operating income of the property. R represents the overall rate of return on capital that buyers of similar investment properties require.

Net Operating Income

Net operating income equals the annual gross potential rental income from a property less expenses (vacancy and collection losses, operating expenses, replacement reserves, property taxes, and property and liability insurance). Look through this net income statement for an eight-unit apartment building. Each unit rents for \$725 a month:

Income Statement (Annual)

1. Gross annual potential rents ($\$725 \times 8 \times 12$)	\$69,600
2. Income from parking and storage areas	6,750
3. Vacancy and collection losses at 7%	(5,345)
4. Effective gross income	\$71,005
Less operating and fixed expenses	
5. Trash pickup	\$1,440
6. Utilities	600
7. Registration fee	275
8. Advertising and promotion	1,200
9. Management fees at 6%	4,260
10. Maintenance and repairs	4,000
11. Yard care	650
12. Miscellaneous	3,000
13. Property taxes	4,270
14. Property and liability insurance	1,690
15. Reserves for replacement	2,500
Total operating and fixed expenses	\$23,885
16. Net operating income (NOI)	\$47,120

The following list explains each of the NOI statement entries:

1. *Gross annual potential rents.* The largest possible sum of rents that you could collect at market rent levels and 100 percent occupancy.
2. *Income from parking and storage areas.* This property has a 16-car parking lot. A shortage of on-street and off-street parking in the neighborhood makes it profitable for the owner to rent the parking spaces independently of the apartment units. Also, the owner built storage bins in the basement of the building that are available for rental to tenants.
3. *Vacancy and collection losses.* Market vacancy rates in the area range between 5 and 10 percent. All units in this building are rented. But even the best-managed apartments experience some vacancies when apartments turn over. Add in some losses for tenants who disappear owing rents that exceed the amounts of their security deposits.
4. *Effective gross income.* The amount of cash that an owner receives net of vacancy and collection, but before operating, fixed, and financing expenses.
5. *Trash pickup.* Self-explanatory.
6. *Utilities.* Tenants pay their own unit utilities. The property owner pays for lighting in the hallways, basement, and parking area.

7. *Licenses and permit fees.* Apartment building owners must sometimes pay for business licenses and other fees. For this property, the owner pays a rental property registration fee.
8. *Advertising and promotion.* These units rent by word of mouth, craigslist.org, or a For Rent sign that's posted on the property. To be safe, however, an advertising and promotion expense of \$150 per year per unit is allocated to the operating budget.
9. *Management fees.* The owner of this apartment building self-manages the property. Nevertheless, he should pay himself the same amount he would otherwise have to pay a property management firm. Labor deserves pay and is distinct from return on investment. Do not reward the seller for the work that you will contribute to the property. Count self-management as an expense.
10. *Maintenance and repairs.* The current owner and her husband clean, paint, and make small repairs around the property. These labors deserve payment from the property's rent collections.
11. *Yard care.* The owner pays this amount to one of the tenants to keep the grass cut, rake leaves, and shovel snow off the walks.
12. *Miscellaneous.* This expense covers legal fees, supplies, snow removal from the parking lot, municipal assessments, auto mileage to and from the property, and other items not accounted for elsewhere in the income statement.
13. *Property taxes.* City, county, and state taxes annually assessed against the property. *Beware:* Tax assessors periodically revalue properties to reflect increases in market prices. Future tax bills could jump 30 to 40 percent over the amount of the previous tax years. Similarly, if your purchase price comes in less than the assessor's current assessed value, request that the assessor reduce your taxes (see Chapter 14).
14. *Property and liability insurance.* This insurance reimburses for property damage caused by fire, hail, windstorms, sinkholes, hurricanes, and other perils. It also pays to defend against, and compensate for, lawsuits alleging owner negligence (for example, slip-and-fall cases).
15. *Reserves for replacement.* Building components wear out. The roof, plumbing, appliances, and carpeting must be replaced periodically. Average these costs on a per-year basis.
16. *Net operating income (NOI).* Total all operating expenses and subtract this sum from the effective gross income. The resulting figure equals net operating income (NOI).

When you calculate NOI, include all expenses for the coming year. Never accept a seller's income statement as accurate. Sellers notoriously

omit and underestimate expenses. (Corporate CEOs aren't the only ones who try to dress up their numbers to paint a pretty picture.)

Ask to see the seller's tax return IRS Schedule E for the subject property. The truth will probably sit somewhere between the owner-prepared income statement for sales purposes (where income is likely to be overstated and expenses understated) and a tax return (on which some owners understate income and overstate expenses). Even if the seller truthfully reports the most recent past year's income and expenses, estimate how each of those amounts might increase (or decrease) in the coming years. You buy the future, not the past.

Are property tax assessments headed up? Are vacancy rates (or rent concessions) increasing? Have utility companies scheduled any rate increases? Has the seller deferred maintenance on the property? Has the owner allocated sufficient amounts for replacement reserves? Has the seller self-managed or self-maintained the property and therefore failed to include his unpaid managerial and maintenance work as cash expenses? When calculating NOI, accept no numbers on faith. Savvy investors reconstruct seller-prepared NOIs.

Estimate Capitalization Rates (R)

You pay now for the rents the property will produce over the next 20, 30, or 40 years (more or less). The question becomes how much these future rents are worth in today's dollars (that is, the property's market value). If the appropriate capitalization (cap) rate is 8.5 percent, then the market (capital) value of this eight-unit apartment building equals \$554,365:

$$\$47,121 \text{ (NOI)} / .085 \text{ (R)} = \$554,365 \text{ (V)}$$

But where does that .085 percent cap rate come from? You estimate it from the cap rates that other investors have applied to buy similar properties. Say a real estate agent provides you NOI and sales price data on four similar apartment buildings that recently sold:

Market Data

Comparable Property	Sales Price	NOI	R
Hampton Apts. (8 units)	\$533,469	\$43,211	.081%
Woodruff Apts. (6 units)	427,381	35,900	.084
Adams Manor (12 units)	694,505	63,200	.091
Newport Apts. (9 units)	671,241	53,700	.080
Subject (8 units) (estimated)	554,365	47,121	.085

From these data, calculate a market-derived cap rate for each property (after verifying that each sale meets the criteria of a market value transaction). When investors in this area buy small income properties similar to the subject property, they figure cap rates between 8.1 and 9.1 percent. So it appears that the market of comp sales indicates a cap rate of around 8.5 percent for the subject property.

Compare Cap Rates

In your market, you may not discover sufficiently similar properties with such a narrow range of cap rates. You might find that some apartment buildings have recently sold with cap rates of 5 to 6 percent (or lower) and others have sold with cap rates of 8 to 9 percent (or higher). Why such differences?

You pay for a quantity of future rental income, and you pay for the quality of that income. Today's price also incorporates expectations about the future price or income gains for that property. The greater its *expected* rate of appreciation, the higher the price you pay now. Therefore, the higher the quality of the income stream, and the larger the expected gain in price, the lower the capitalization rate (or, conversely, the lower the quality of the property's income and price gain potential—in the eyes of the market—the higher its cap rate).

To illustrate: You compare two fourplexes. Santa Fe Villas is a relatively new property located in a well-kept neighborhood near a city's growth corridor. Several nearby office towers are under construction. Dumpster Manor is located in a deteriorating part of town. Major employers have moved out, closed, or laid off workers. Crime rates are high and moving higher. Two recent drug-related murders made front-page news.

If the annual NOI's for these two fourplexes are, respectively, \$24,960 and \$12,480, how much would investors pay for each property? If investors applied a 10 percent cap rate to each property's income stream, they would value the properties as follows:

- a. Santa Fe Villas
 $\$24,960 \text{ (NOI)} / .10 \text{ (R)} = \$249,600 \text{ (V)}$
- b. Dumpster Manor
 $\$12,480 \text{ (NOI)} / .10 \text{ (R)} = \$124,800 \text{ (V)}$

But in the real world, investors would not apply the same cap rate to these very unlike properties and neighborhoods. The *quality* of their income streams differs. Santa Fe Villas offers more stable rents, safe neighborhood, greater convenience to good jobs, and market-expected price

growth. Investors might actually capitalize the respective NOIs of these two fourplexes at rates of, say, 6 percent for Santa Fe Villas and 15 percent for Dumpster Manor.

Investors would rather own a property in a prospering area. They will pay more for each dollar of income produced by such a property. But more is not really the issue. The real issue is, how much higher price is justified for the better properties? When market expectations run ahead of reasoned analysis, prices overshoot their real potential for price and income growth. Likewise, a surfeit of bad news and pessimistic expectations can drive prices below (and, correspondingly, cap rates above) the actual risk-and-reward prospects of a disdained property.

Relative Prices: The Paradox of Risk and Appreciation (Depreciation)

Odd as it sounds, higher-priced seemingly low-risk-high-appreciation properties may actually produce more risk and slower gains in price (or even more rapid declines in price) than their low-rent, highly troubled cousins who are located on the wrong side of the railroad tracks. That's why many investors now buy rental houses in Detroit.

Consider this stock market analogy. If you could buy a quality, high-growth company's stock at a price-to-earnings ratio (P/E) of 10 or a low-growth company's stock at a P/E of 10, by all means invest in the high-growth company. If you could buy a low-risk, high-appreciation-potential property with a cap rate of 10 percent or a higher-risk, lower-expected-appreciation property with a cap rate of 10 percent, buy the low-risk, high-appreciation property. However, that's not how markets price either real estate or financial investments.¹ In the real world, investors bid up prices for high-quality, growth-area properties and reduce their bids for so-called high-risk properties in less desirable neighborhoods. To figure out which type of property and location offers the most profit potential, compare their relative prices, cash flows, amortization, and 19 other potential sources of return (see p. xxvi).

When investors optimistically bid up the prices of some properties, neighborhoods, and cities relative to other properties, neighborhoods, and cities, you can profitably redirect your investment strategy (or even withdraw and wait for good sense to return to the market—after the crash). In

¹If you bought Microsoft and JCPenney stock in 1998 and sold in 2004, JCPenney stock would have paid you higher returns. As a high-profile growth company, in 1998, Microsoft's stock included a too-hefty price premium for its expected growth.

other words, don't calculate market cap rates for just one type of property or neighborhood. Learn as much as you can about a variety of submarkets and areas of the country.

You *overpay* for a property when: (1) you apply a cap rate that's too low relative to the property and neighborhood you're buying; or (2) you do not detect that market cap rates themselves may sit too low relative to cash flows, other types of properties, other locations, or even other available investments. In some areas during the boom, cap rates for rental houses fell as low as 3 to 4 percent—well below their historical level of, say, 5 to 10 percent. And well below the level necessary to generate positive cash flows (after paying debt service).

VALUATION METHODS: SUMMING UP

Market value does not necessarily equal appraised value or sale price. Market value refers to the sale price of a property when a sale meets the criteria of a market value transaction. To estimate the market value of a subject property as it compares with other similar properties that have sold, first investigate the terms and conditions under which the comparative properties sold. A property down the street that sold for \$600,000 after just three days on the market does not necessarily indicate that a similar property nearby will sell for \$600,000. It depends on the terms of sale and the detailed features of each property.

You can apply at least three approaches to estimate the market value of a property, but those three approaches do not necessarily produce the same number. Investors and appraisers rely on imperfect and incomplete data. Decide which approaches best serves your purposes. The accuracy of your market value estimate directly relates to how well you identify and evaluate a property's features. Observe the differences (positive or negative) that make a difference. Wise investment decisions require you to identify and understand features, properties, neighborhoods, construction costs, and lot values. Technique never substitutes for knowledge, close reasoning, and well-informed (but rarely perfect) judgment.

Past price increases (or decreases) do not forecast the future. Market value itself does not warn against buying a property that's about to fall in price. And if you buy at less than market value, you have not necessarily chalked up a bargain. You can make great returns—even when you pay market value (or above)—if you have identified a property (or location) that's about to gain increased popularity or identify a property in which you envision spectacular ways to create value. (Of course, some property investments combine all of these advantages and more: lumps of coal are transformed over time into diamonds.)

Appraisal Limiting Conditions

Property appraisers hedge their estimates of value with limiting conditions. Especially relevant (Figure 3.1) are limitations 1, 2, 6, and 7.

- ◆ Appraisers do not investigate title. They assume that a property's bundle of fee simple rights is good and marketable. For a legal guarantee of property rights, consult a title insurance company.
- ◆ Appraisers do not survey the boundaries of a site, nor do they necessarily note encroachments or other potential site problems. To precisely identify site dimensions, encroachments, and easements, employ a surveyor and walk the property lines.
- ◆ Appraisers examine through casual inspection. To thoroughly assess the soundness of a property and its systems (heating, cooling, electrical, plumbing), hire a competent building inspector and skilled tradespersons.
- ◆ Appraisers gather much of their market information from second-hand sources (real estate agents, government records, mortgage lenders, and others). Appraisers seldom go inside the comp properties that they include in their appraisal reports. Because they incorporate unverified secondhand data, appraisals often err in fact and interpretation. Accept an appraisal report as for-what-it's-worth information. Never weight it more than reason warrants. (As noted, I always verify the appraiser's comp property data before I decide how much respect I should give to an appraiser's estimate of value.)

Valuation versus Investment Analysis

Before you buy, understand the property's market value. Yet market value does not inform sufficiently. Besides figuring out a best guess of market price (or, more accurately, a price range), answer these questions:

- ◆ Will the property generate adequate cash flows?
- ◆ Can you expect the property to increase in price?
- ◆ Can you add value to the property?

To address these investment issues, we turn to the following chapters.

