THE APPRAISAL

# Real Estate Appraisal

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## REAL ESTATE VALUES

Heterogeneous nature of the property arises need for appraisals. No two properties are identical, and all properties differ in their locations, which is the most important determinant of property value.

There are several definitions of value sought by a real estate appraisal:
**Market value** – is the estimated amount for which an asset should exchange on the valuation date between a willing buyer and a willing seller in an arm's-length transaction.

**Value-in-use** – is the Net Present Value of a cash flow that an asset would generate for a specific owner for a specific use. Value-in-use is generally estimated at a use value which is less than the highest-and-best use, and therefore it is generally lower than the **market value**.

**Investment value** – is the value of an asset for a particular investor. It is greater than the market value because the investor may put the asset into a proper use which is greater than the highest-and-best use. The investor may have three advantages over other market participants:

- *Extraordinary financing* – this include below market financing terms for a lender.
- *Grandfathered use* – the investor may take advantage of the property which would not be available to other buyers.
- *Agglomeration advantages* – the investor owns other neighboring properties that can be profitably developed only if the particular property can be bought.

**Liquidation value** – is a likely price of an asset when it is allowed insufficient time to sell on the open market, thereby reducing its exposure to potential buyers. It is typically lower than the fair market value.

## VALUATION METHODS

There are generally three groups of methodologies for determining value:

- *Cost approach* – is the summation approach – the sum of land and undepreciated value of any improvements. The value of improvements is referred to by the abbreviation RCNLD (reproduction cost new less depreciation)
- *The sales comparison approach* – this approach compares a subject property's characteristics with those of comparable properties which have recently sold in similar transactions. The process uses one of several techniques to adjust the prices of the comparable transactions according to the presence, absence, or degree of characteristics which influence value.
- *The income capitalization approach* (*income approach*) – is used to value commercial and investment properties. Three methods are used in valuation of income approach:

- *Direct capitalization* – Net Operating Income (Net income of the real estate + interest expense + non-cash items – reserve for replacement) divided by CAP rate (Annual cash flow/Cost (value). Annual cash flow=annual gross lease income – fixed and variable cost).
- *Discounted Cash Flow* – Analogous to NPV. However, appraisers often mistakenly use a market-derived cap rate and NOI as substitutes for the discount rate and/or the annual cash flow.
- *Gross Rent Multiplier* – is used to estimate the value of income producing properties. Sales price and gross rents are required to calculate GRM. It can be used to estimate the market value of other similar properties in this area. Some use monthly and some use yearly GRM. If the sales price for a property is $200,000 and the monthly potential rental income for a property is $2,500, the GRM is equal to 80.

# USEFUL REFERENCES

Top 10 Real Estate Financial Calculator Problems Explained

*Gross Potential Income*
Example: An apartment complex with six units. Three rent for $700 per month and the other three rent for $800 per month.

3 units * $700/month = $2100
$2100 * 12 = $25,200
3 units * $800/month = $2400
$2400 * 12 = $28,800
$25,200 + $28,800 = $54,000 Annual income.

*Gross Operating Income*
Once we know the Gross Potential Income of a real estate investment property,we arrive at the Gross Operating Income by subtracting out the estimated annual losses due to non-payment or vacancies.
We estimate that our losses due to vacancies and non-payment will be 5%.
$54,000 *.05 = $2700
$54,000 - $2700= $51,300 for our Gross Operating Income

*Break-Even Ratio for Real Estate Investment*
Lenders use the break-even ratio as one of their analysis methods when considering providing financing for a real estate investment property. Too high of a break-even ratio is a cautionary indicator. We'll assume an annual debt service of $32,000, that management and direct operating costs annually are $47,000. We'll assume a gross operating income of $98,000 annually.
Add Debt Service to Operating Expenses and divide by Operating Income:
$32,000 + $47,000 / $98,000 = .81 or an 81% Break-Even Ratio