APPRAISAL PRACTICES

Categories of Property

Real estate can be categorized several ways. Real property can be grouped as either existing or proposed, investment or noninvestment, residential or nonresidential. Perhaps the most common method of categorizing real estate is according to its marketability. General wide market acceptance includes residential property, and select commercial and industrial properties. Special purpose includes special-use properties, such as hotels or nursing homes, and single-use properties, such as schools or churches.

Estimating Value: Three Approaches

There are three approaches to estimating value: the cost approach, the income approach, and the market (or sales comparison) approach. Each approach to value has merits for specific property types. All three approaches should be included in an appraisal report unless the appraiser explains and supports the omission of one or more of the approaches.

The Cost Approach

The cost approach to value is based on the value of land as if unimproved and available for improvement to its highest and best use, plus the reproduction or replacement cost of any improvements, less depreciation. The cost approach is seldom synonymous with market value. The justification for the cost approach is the premise that an investor will pay no more for a property than the cost to construct a similar property with equal utility. This approach to value is best used for single-use properties with no similar properties being marketed.

The accuracy of this method is dependent upon proper adjustment for depreciation, as well as the estimate of the market value of the land. There are three types of depreciation: physical deterioration, functional obsolescence, and economic or external obsolescence.

- Physical depreciation represents an impairment of the physical condition of a property's improvements. Causes include wear through normal use, the action of the elements, and structural damage due to fire, vandalism, or other causes. Physical depreciation has both curable and incurable components.

- Functional obsolescence represents impairment of an improvement's value resulting from poor design, inadequacies, superadequacies, or outmoded fixtures and equipment. Functional obsolescence can be curable or incurable.

- Economic or external obsolescence represents impairment in a property's value due to factors external to the property, such as decreased demand or zoning changes. Whereas physical deterioration and functional obsolescence are evident in the property improvements, economic obsolescence is not. This type of depreciation is nearly always incurable.

The Income Approach

The income approach to value discounts the future benefits of ownership of a property to present value. This approach is best used for income-producing properties and has little relevance for a single-family residence that is to be owner-occupied. To arrive at a value estimate, projected net operating income is capitalized, or projected cash flow is discounted at an appropriate interest rate. This rate is driven by a number of factors, including risk, inflationary expectations, opportunity costs, historical returns, and the supply and demand of loanable funds. This rate should be derived from market sales data of comparable properties, and can be developed with any of several capitalization techniques. The accuracy of this method depends upon the reasonableness of estimates for potential gross income, vacancy, credit loss, and operating expenses, as well as the appropriateness of the overall rate used.

Sales Comparison Approach

The market, or sales comparison, approach to value uses market data to draw units of comparison. Information is gathered from recent sales and current listings of properties that are physically and economically similar to the subject property. Comparable properties are then adjusted for any differences between the comparable and the subject property. Aside from adjusting for physical differences or changes in market conditions, adjustment may be necessary for financing terms. Lower-than-market interest rates, higher-than-normal loan-to-value ratios, and extended amortization periods have the effect of inflating values. When data are drawn from comparable properties where favorable financing is evidenced, appropriate adjustments should be made to reflect cash equivalency. The accuracy of this method is dependent upon the suitability of the comparable properties used.

Final Estimate of Value

Once all appropriate value estimates have been made, the values should be reconciled and a final estimate of value should be derived. Reconciliation should not simply be an averaging of individual value estimates, but should be a well-supported process where the quality and quantity of data are analyzed and properly weighted in reaching one value estimate.

Note that it is inappropriate for appraisal reports to arrive at the value of fractional interests in real estate by subdividing the whole, or to arrive at the value of the whole by summing the fractional interests.