

APPRAISING (PROPERTY VALUATION)

An appraisal is the process and conclusion by an appraiser who arrives at an opinion or estimate of value, supported by data, of real estate at a certain point in time.

TYPES OF VALUE

Market Value - the probable price a willing, informed seller would accept and a willing, informed buyer would pay, neither being under pressure to act; an “arm’s length transaction”; value-in-exchange; fair market value.

Market Price - the amount actually paid in the market.

Value-in-Use - the value to a particular user of income property not offering it for sale (includes value of business).

Cost - the total amount to produce the property.

Investment Value - the value to a particular investor.

Insurable Value - the value of the real property for insurance purposes.

Assessed Value - the value for property taxes.

Liquidation Value - the value on a forced sale, such as a lender’s foreclosure auction.

ELEMENTS OF VALUE- what is needed to achieve value (D.U.S.T.)

(D)emand (Effective) -Ability of someone to buy; purchasing power of buyer.

(U)tility -Usefulness; with ability to satisfy wants and desires in the minds of others.

(S)carcity - increases value because buyers compete (Overabundance decreases value because sellers compete).

(T)ransferability – Seller must have good title free of “clouds on title”.

FORCES INFLUENCING VALUE

Social - Characteristics and customs of people; attitudes toward public education; life-styles; family sizes (but actual people living in the neighborhood are not an influence).

Economic - Price levels; employment trends; availability of credit; interest rates; supply and demand in housing.

Government/Legal -Zoning and land-use regulations; building codes; police, fire and health protection services; environmental laws.

Environmental/ Physical -Topography, climate, soil, natural resources and developed resources; highway and recreation systems.

PRINCIPLES OF VALUE

Anticipation: a forecast of expected benefits during ownership and at time of resale.

Change: real estate values always move up or down. Change includes business cycles, interest rates and neighborhood cycle -- growth, stability, decline and renewal.

Competition: excess profits attract competition that increases supply and choice, thus increasing price competition and lowered profits.

Conformity: maximum value is created when a reasonable degree of economic and sociological harmony is present in a neighborhood.

Contribution: added investment in a site is measured by added value to original value.

Increasing and Decreasing Returns: More money spent on the site may not add more value (over-improvement), or not enough is spent (under-improvement).

Highest and Best Use: A site will be improved to its most profitable or optimal use in a competitive market over a period of time.

Substitution: When two or more like properties with more or less the same utility become available, the one with the lowest price attracts the greatest demand.

Supply and Demand: Increase of supply will lower prices; increase of demand drives up prices. Supply and demand intersect to form the price.

Regression: Value is reduced by the presence of nearby properties having lesser value. The opposite of progression.

Plottage: Acquisition through assemblage of one or more adjoining plots to form a larger parcel. Likely higher value of the new larger parcel is known as plottage value.

THE VALUATION PROCESS

DEFINITION OF THE PROBLEM:

- ◆ Identify real estate and property rights
- ◆ Effective date of value and objective of appraisal
- ◆ Definition of value and any limiting conditions

PRELIMINARY SURVEY & APPRAISAL PLAN

- ◆ Data and sources needed
- ◆ Personnel needed and time chart
- ◆ Fee proposal and contract

DATA COLLECTION AND ANALYSIS

General Data (Economic)

- ◆ Market analysis
- ◆ Forecast

General Data (Locational)

- ◆ Region and community
- ◆ Neighborhood

Specific Data (Appraised Property)

- ◆ Title and record data
- ◆ Physical characteristics of site and improvement

Specific data (Comparative Properties)

- ◆ Sales and rentals
- ◆ Listings
- ◆ Costs

HIGHEST AND BEST USE ANALYSIS

SITE VALUATION

THE THREE APPROACHES TO VALUE

- ◆ Sales Comparison Approach
- ◆ Income (capitalization) Approach
- ◆ Cost Approach

RECONCILIATION [Final Step] THROUGH WEIGHTED AVERAGING

ESTIMATE OF VALUE GIVEN IN THE APPRAISAL REPORT

- ◆ Narrative
- ◆ Form – (Fannie Mae/Freddie Mac Form 1004)

THREE APPROACHES TO VALUE

SALES COMPARISON APPROACH

Useful for midlife residential properties and land sales. Formally known as Market Data Approach. Basic principle is one of **substitution** (informed buyers will not pay more for a property than they have to for a comparable substitute). Agent **CMA** (competitive market analysis) resembles this.

Sequence: Compilation, verification and analysis of comparable sales.

Financial adjustments for differences between subject and comparables.

Example: Subject property has two bathrooms and a one-car garage. Market indicates that public values a 1/2 bath at \$5,000, a full bath at \$10,000 and a one-car garage at \$20,000.

Market grid	Elements	Subject	Comp. #1	Comp. #2	Comp.#3	Comp.#4
	Price	?	\$100,000	\$ 85,000	\$110,000	\$115,000
	Baths	2	2	2 1/2	3	1 1/2
	Garage	1	1	0	1	2
	Adjustments		0	-\$5,000	-\$10,000	+\$ 5,000
				+20,000		-\$20,000
Adjusted Price			\$100,000	\$100,000	\$100,000	\$100,000

The value of the subject property is \$100,000 (use **weighted** averaging, not averaging).

Note: Adjustments are made to comparables, never to subject property.

INCOME APPROACH: SINGLE FAMILY HOMES

Sequence:

- Determine the gross monthly rent of recently sold single-family houses (adjusted as with sales comparison) that were rentals.
- Divide each sales price by gross monthly rent to determine gross rent multiplier (GRM).
- Examine all the GRM to find the best composite number (not the average).
- Using the GRM, multiply this number by the gross monthly rent probable of the subject property if it were rented today. (Note: utilities are not a factor in this approach.)

Example:	<u>Sale #</u>	<u>Sale Price</u>	<u>Gross Monthly Rental</u> (unfurnished)	<u>GRM</u>
	1	\$200,000	\$1,600	125
	2	\$225,000	\$1,800	125
	3	\$187,500	\$1,500	125

GRM of 125 is multiplied by the probable monthly rent (\$1,600) of the subject property if it were rented: $125 \times \$1,600 = \$200,000$ – value of subject property.

INCOME APPROACH: INCOME PROPERTY

EFFECTIVE GROSS RENTAL INCOME (APOD-annual property operating data, used by prospective buyers/lenders to see operations for a given year)

⇒ Potential Gross Annual Income:	\$
(-) less vacancy	-\$
⇒ Effective Gross Rental Income:	_____
(actually collected)	\$
(-) operating expenses	\$

⇒ Net Operating Income (NOI)	\$
(-) mortgage (debt service)	-\$

⇒ Cash Flow (before income taxes)	\$

Operating expenses are repeatable expenses to keep the property up and running, such as property taxes, insurance premiums, management fees and other salaries, utilities, maintenance costs, landscaping, snow removal, etc. In theory they are the same no matter who owns the property.

Annual debt payments are not operating expenses. Capital expenses, such as roof replacement, are improvements with multi-year value and not operating expenses.

NOI is the most important factor to buyers/lenders. The higher the rate of return, the higher the risk, and the lower the value. Cash flow divided by equity (downpayment) equals cash-on-cash return.

Capitalization refers to a method of estimating the market value of income property by taking the net **annual** income and dividing it by the appropriate rate of return.

Here is our model:
$$\frac{\text{net operating income (N.O.I.)}}{\text{market value} \times \text{capitalization rate (\%)}}$$

- ◆ A hotel has an annual net operating income of \$112,500. An appraiser has determined an appropriate rate of return for this type of investment is 7.5%. What is its maximum value for an investor?

$$\frac{\$112,500}{\text{market value} \times .075} = \$1,500,000 \text{ ANSWER – (Divide } \$112,500 \text{ by } .075)$$

- ◆ What is the expected net income of a property valued at \$1,500,000 with a rate of return (cap rate) of 7.5%?

$$\frac{\text{net income}}{\$1,500,000 \times .075} = \$112,500 \text{ ANSWER}$$

- ◆ Expected net annual income is \$112,500 and asking price is \$1,500,000. What would be the rate of return (capitalization rate) on the investor's purchase price?

$$\frac{\$112,500}{\$1,500,000 \times \text{cap rate}} = 7.5\% \text{ ANSWER}$$

COST APPROACH

Used for improvements that lack adequate sales comparison data, such as for unique buildings (churches) and new properties.

The procedure is to estimate the new cost of a **reproduction** or **replacement** of the subject property at today's prices and subtracting the depreciation. The value of the land is calculated using the sales comparison approach and added to the cost.

Reproduction creates a **replica**; **replacement** creates a property with **similar utility, current materials and design**.

Three main methods of estimating **reproduction/replacement** cost:

1. **Comparative-Unit Method** - the total value of recently constructed similar buildings are divided by the number of square feet to produce a dollar value per square foot. Used to estimate **replacement** cost.
2. **Unit-In-Place Method** - Various individual main systems and components (i.e., roof, electrical outlets, etc.) are priced often using available cost manuals. Used for both **replacement** and **reproduction** cost.
3. **Quantity Survey Method** - The quantity and quality of all materials plus labor, builder's profit, and cost of permits are used to arrive at a total **reproduction** cost.

Measurement for single-family is from the *outside* above the foundation to determine the Gross Living Area (GLA) per square foot of living space per floor. Space must be above grade, heated, enclosed, habitable.

Three methods of estimating **depreciation** cost:

1. **Deterioration** – physical depreciation, wear and tear, deferred maintenance, such as worn electrical wires, roof leakage, termite damage, sagging floors and faulty heating.
2. **Functional Obsolescence** - Loss of value due to original poor design or floor plan, changes in building standards and market preferences. Examples: well-maintained kitchen and bathrooms with old-fashioned fixtures, fieldstone foundation, four story building with no elevator or narrow elevator, four bedroom colonial with one bath on first floor, inadequate electrical service for contemporary demands, inadequate closets, inadequate parking.
3. **Economic Obsolescence** - Loss in value due to *external* (economic) factors that have a negative effect on value of subject property, such as inadequate street lighting, constant rubbish-strewn neighbor's yard, change in zoning, many for sale or rent signs in neighborhood, change of homes to rooming house use, loss of public transportation. Not curable (fixable).

\$400,000	Reproduction cost at today's prices
<u>- 50,000</u>	Less accrued depreciation
\$350,000	Present improvement value
<u>+100,000</u>	Present site value
\$450,000	Market value

Straight Line Depreciation/Appreciation – changes in value

A property was worth \$100,000.

It depreciated 6.5% of the original value each year for 4 years. What is its new value?

$$.065 \times 4 = 26\% \quad \$100\% - 26\% = 74\%$$

$$\frac{\$74,000}{\$100,000} \times .74 \quad \text{[Answer]}$$

It appreciated 6.5% of the original value each year for 4 years. What is its new value?

$$.065 \times 4 = 26\% \quad \$100\% + 26\% = 126\%$$

$$\frac{\$126,000}{\$100,000} \times 1.26 \quad \text{[Answer]}$$

A property is now worth \$44,900.

This value represents a 5% gain each year for 5 years. What was its original value?

$$.05 \times 5 = 25\% \quad \$100\% + 25\% = 125\%$$

$$\frac{\$44,900}{\$35,920} \times 1.25 \quad \text{[Answer]}$$

This value represents a 5% loss each year for 5 years. What was its original value?

$$.05 \times 5 = 25\% \quad \$100\% - 25\% = 75\%$$

$$\frac{\$44,900}{\$59,867} \times .75 \quad \text{[Answer*]}$$

*Math answers on state exam may be approximate. Round up if necessary.

Income Property Tax Treatment - \$125,000 income property is purchased.

1. Separation of improvement value from land value (land does not depreciate).

$$\begin{array}{r} \$125,000 \\ - 25,000 \text{ land value} \\ \hline \$100,000 \text{ improved value} \end{array}$$

2. Using, for example, a 25 year economic life, divide 1 by 25 = .04. $\$100,000 \times .04 = \$4,000$ annual depreciation. After 25 years, the entire property has a basis (the amount against which taxable gain is measured) of \$25,000 (original value of land). **Note:** basis increases with capital improvements.
3. The property is sold at the end of 25 years for \$250,000. $\$250,000 - 25,000$ adjusted basis = \$225,000, amount subject to tax, which can be delayed through a 1031 Like Kind Exchange (buying another investment of equal or greater worth). Cash not reinvested is immediately taxable as boot.

Primary Residence Property Tax Treatment

Single-family owner-occupants may deduct **interest** on the mortgage loan and **municipal** property taxes. If you have lived in your personal residence for two of the last five years, single taxpayer shelters \$250,000 in gain, married couple shelters \$500,000.

LEASES, RENTS, AND PROPERTY MANAGEMENT

Non-Freeholds (possession and use of another's real property)

Leasehold

- ◆ Lease/tenancy for years/estate for years
- ◆ Lessor (owner/landlord) and Lessee (tenant)
- ◆ Must be in writing with expiration date

Tenancy At Will

- ◆ May be verbal or in writing, binding for 30 day increments

Tenancy At Sufferance

- ◆ Holdover tenancy *after* lease expires and tenant stays without permission

The Lease

A written contract and a conveyance of a possessory real estate interest. **Lessor** transfers **possession and use** to a **lessee** for a specific period of time under certain conditions in consideration of rent. Lessor retains reversionary interest - to recover at end of lease term.

If lessor sells before end of lease, new owner must honor remaining leasehold. If lessor dies before the end of lease, lease remains enforceable by lessee. A lease for more than 7 years should be recorded.

Essentials of Lease

1. Name of parties (who have capacity).
2. "Sufficient" description of premises (address).
3. Rental amount, time and manner of payment.
4. Term of lease.
5. Intention to rent must appear.
6. Signature of lessor.
7. Delivery of lease and acceptance by lessee (actual with signature or implied by actions of lessee).

Residential rental money – landlord is allowed to collect only the following at the beginning of the rental period:

- ◆ First month's rent and reasonable lock and key fee.
- ◆ Security deposit limited to **one month's** rent. Landlord's statement of condition required within 10 days of rental beginning. Landlord's itemized/notarized claim against deposit or its return must be made within 30 days of rental ending. Lesser of 5% interest or current bank rates on security deposit due each year to tenant within 30 days of annual tenancy anniversary.
- ◆ Last month's rent collected in advance. Interest earned due to tenant each year within 30 days of annual tenancy anniversary, but last month's rent does not have to be deposited, in which case 5% interest is owed.

Transfer of Lease

Lessee may sublet, assign or novate unless lease prohibits.

- ◆ Sublet - transfer portion of interest to third party such as 2nd year only of three year lease.
- ◆ Assign - transfer remaining interest to third party.
- ◆ Novation - a third party signs a new lease with the lessor, thereby relieving the original lessee of further responsibility.

Termination of Lease

1. Performance: automatically terminates at expiration with no notice necessary.
2. Surrender of premises by tenant: mutual cancellation before expiration.
3. Action of law: condemnation by law of eminent domain or bankruptcy.
4. Destruction: premises destroyed with no covenant to repair.
5. Foreclosure: prior lien holder has right to void lease and convert it to tenancy-at-will (federal law now gives a tenant 90 days to leave).
6. Eviction: court order on action by lessor.
7. Constructive Eviction: premises no longer fit for tenancy.

Lessee remains responsible at abandonment/sublet/assignment/title transfer.

Breach of Lease

When lessee has breached leasehold terms by creating a nuisance, non-payment of rent (even if late by one day, unless there is a grace period), committing waste, "holding over" or unlawful use of property – lessor may evict by court action of unlawful detainer after giving tenant 14 (7 if destruction) days' notice to vacate (not to be confused with 30 day notice under tenancy-at-will).

When lessor has breached leasehold terms by not keeping property fit for human occupancy or not providing tenant with "quiet enjoyment" -- lessee may bring court action for compliance or vacate by **constructive eviction**. Obligation to pay rent ends.

Covenant of Quiet Enjoyment

Landlord Promises:

- ▶ Not to trespass (may enter upon reasonable notice for good reason (inspection, repairs, etc.)).
- ▶ Not to threaten expulsion.
- ▶ Not to attempt to lease or rent to others.
- ▶ To render premises fit or suitable for occupancy (habitable, clean, safe, meets Mass sanitary code).
- ▶ To provide for services included in tenancy.

Insurance

Lessor -- obtains insurance coverage for **common** areas and keeps common areas in good repair.

Lessee -- obtains insurance coverage for **leased** areas and remains responsible for third party claims arising from actions on leased premises.

TYPES OF LEASES

Gross Lease - lessee pays fixed rent and lessor pays expenses of ownership and operation. Residential means rent covers occupancy, heat, electricity and water. Commercial means rent covers occupancy and estimate of proportionate share of operating expenses.

Net Lease - lessee pays all or some of operating expenses in addition to base rent, thus giving lessor **net** income. Lessee rarely pays principal or interest (debt service) of any mortgage debt of lessor. Residential tenant pays for heat and electricity directly to utility company, landlord may collect reimbursement for water (for new tenants only and with water-saving devices installed). Commercial landlord will audit expenses for past year and any overpayment or underpayment will be made up at the beginning of next year.

Percentage Lease - rental with a monthly base amount (usually less than other tenants per square foot) *plus* percent of **gross** sales of lessee; used in mall especially for but no longer restricted to **anchor** tenants such as department stores.

Lessee pays monthly base rent of \$1,200 plus 2 1/2% of annual gross sales over \$150,000. What were annual sales if annual rent was \$22,000?

\$1,200 X 12 = \$14,400 annual base rent

\$22,000	<u>\$7,600</u>	\$150,000
<u>-14,400</u>	? X .025	<u>+304,000</u>
\$7,600	[\$304,000]	\$454,000 [A]

Graduated Lease – rent schedule for some period of time is agreed to by landlord and tenant and stated in the lease for automatic changes.

Index Lease - provides for an increase (or decrease, although landlords typically will not agree to it going down) in rent annually, or after some period of graduated payments, using a cost of living index or some other acceptable outside economic indicator; an **escalator** (escalation) **clause** addresses this issue. For example, if index number goes up by 2%, then so does the rent. Favors landlords in an inflationary cycle.

Reappraisal Lease - increased rent based on independent appraisals of fair market rent if lessor/lessee cannot agree on new rent. Landlord and tenant each pick an appraiser and sometimes a third one is picked.

Sublease (Sandwich) Lease - lease between original lessee and sublet tenant. It refers back to original lease (now master or prime lease) and contains no terms contrary to it. Landlord always controls who is on property.

Ground Lease - lease of *land* only. Land improved by lessee and these improvements become security for lease or mortgage. Also known as a long-term land lease. Popular with fast food franchises. Improvement remains with the land once lease ends.

Sale-Leaseback – owner/user sells property and simultaneously leases it from new owner. Advantages to seller/lessee: retains possession, cash from sale for capital expenditures, future lease payments are tax deductible expense and no mortgage debt. Advantages to buyer/lessor: investment that hopefully will increase, possible pyramid financing (taking money out for another acquisition), tax deductions for building depreciation, built-in tenant for long term.

Property Manager is a *special agent* of owner and a *fiduciary* working in the best interests of owner who provides a monthly report of income and operating expenses. Compensation to management firms is usually a *percentage* of effective gross rental income (the amount of rent earned in a given year). Manager's responsibilities/authority defined in a management agreement.

PROPERTY MANAGEMENT REVIEW

1. A vacancy rate for an apartment building is calculated by dividing the number of vacant apartments by the total apartments.
2. A lessee is released from the obligation to pay rent if constructively evicted by lessor's failure to comply with lease terms.
3. If lessee defaults on unexpired lease and abandons the leased premises, the lessor can demand that lessee pay remaining lease payments.
4. A property manager's agreement with the owner of the property includes a description of manager's responsibilities with landlord's money, authority and compensation.
5. A lease is the strongest interest of possession and use for a tenant.
6. A clause in a lease requiring the owner to give the tenant an opportunity to meet landlord's terms for buying is called a **right of first refusal**.
7. An increase in interest rates usually makes home ownership less affordable, increasing demand for rental property.
8. A commercial lease allows the lessee to deduct rent as business expenses on lessee's income tax.
9. A lessee whose lease is interrupted by the property being taken by eminent domain must be compensated by the condemnor (cost or relocation and cost of improvements made by tenant, if any).
10. A clause in a lease providing the tenant with the right to purchase the leased property at a specific time frame is known as **lease option**.
11. An anchor tenant is a large retailer in a mall that typically makes the mall successful.
12. Lessor holds in fee simple (standard real estate ownership) and maintains a reversionary interest in possession during the term of the lease; lessee holds a leasehold interest during this period.