Glossary & Terms

Real Estate Appraiser Glossary & Terms
There are several types and definitions of value sought by a real estate appraisal. Some of the most common are:

- Market Value – The price at which an asset would trade in a competitive Walrasian auction setting. Market Value is usually interchangeable with Open Market Value or Fair Value. International Valuation Standards (IVS) define Market Value as:

Market Value is the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arms-length transaction after proper marketing wherein the parties had each acted knowledgably, prudently, and without compulsion.[2]

- Value-in-use – The net present value (NPV) of a cash flow that an asset generates for a specific owner under a specific use. Value-in-use is the value to one particular user, and is usually below the market value of a property.

- Investment value - is the value to one particular investor, and is usually higher than the market value of a property.

- Insurable value - is the value of real property covered by an insurance policy. Generally it does not include the site value.

- Liquidation value -- may be analyzed as either a forced liquidation or an orderly liquidation and is a commonly sought standard of value in bankruptcy proceedings. It assumes a seller who is compelled to sell after an exposure period which is less than the market-normal timeframe.

Price versus value

It is important to distinguish between Market Value and Price. A price obtained for a specific property under a specific transaction may or may not represent that property's market value: special considerations may have been present, such as a special relationship between the buyer and the seller, or else the transaction may have been part of a larger set of transactions in which the parties had engaged. Another possibility is that a special buyer may have been willing to pay a premium over and above the market value, if his subjective valuation of the property (its investment value for him) was higher than the Market Value. An example of this would be the owner of a neighbouring property who, by combining his own property with the subject property, could thereby obtain economies-of-scale. Such situations often arise in corporate finance, as for example when a merger or acquisition is concluded at a price which is higher than the value represented by the price of the underlying stock. The usual rationale for these valuations would be that the 'sum is greater than its parts', since full ownership of a company entails special privileges for which a potential purchaser would be willing to pay. Such situations arise in real estate/property markets as well. It is the task of the real estate appraiser/property valuer to judge whether a specific price obtained under a specific transaction is indicative of Market Value.

Market value definitions in the US

In the US, appraisals are performed to a certain standard of value (e.g. -- foreclosure value, fair market value, distressed sale value, investment value). The most commonly used definition of value is Market Value. While USPAP does not define Market Value, it provides general guidance for how Market Value should be defined:

...a type of value, stated as an opinion, that presumes the transfer of a property (i.e., a right of ownership or a bundle of such rights), as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal.

Thus, the definition of value used in an appraisal analysis and report is a set of assumptions about the market in which the subject property may transact. It becomes the basis for selecting comparable data for use in the analysis. These assumptions will vary from definition to definition but generally fall into three categories:

- The relationship, knowledge, and motivation of the parties (i.e., seller and buyer);

- The terms of sale (e.g., cash, cash equivalent, or other terms); and

- The conditions of sale (e.g., exposure in a competitive market for a reasonable time prior to sale).

In the US, the most common definition of Market Value is the one promulgated for use in Federally regulated residential mortgage financing:

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.[3]

For example, adjustments must be made to the comparables sales prices 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.[4]

Three approaches to value

There are three general groups of methodologies for determining value. These are usually referred to as the "three approaches to value":

- The cost approach

- The sales comparison approach and

- The income approach

The appraiser will determine which one or more of these approaches may be applicable, based on the scope of work determination, and from that develop an appraisal analysis. Costs, income, and sales vary widely from one situation to the next, and particular importance is given to the specific characteristics of the subject.

Consideration is also given to the market for the property appraised. Appraisals of properties that are typically purchased by investors (e.g. - skyscrapers) may give greater weight to the income approach, while small retail or office properties, often purchased by owner-users, may give greater weighting to the sales comparison approach. While this may seem simple, it is not always obvious. For example, apartment complexes of a given quality tend to sell at a price per apartment, and as such the sales comparison approach may be more applicable. Single family residences are most commonly valued with greatest weighting to the sales comparison approach, but if a single family dwelling is in a neighborhood where all or most of the dwellings are rental units, then some variant of the income approach may be more useful.

The cost approach

The cost approach was formerly called the summation approach. The theory is that the value of a property can be estimated by summing the land value and the depreciated value of any improvements. The value of the improvements is often referred to by the abbreviation RCNLD (reproduction cost new less depreciation or replacement cost new less deprecation). Reproduction refers to reproducing an exact replica. Replacement cost refers to the cost of building a house or other improvement which has the same utility, but using modern design, workmanship and materials. In practice, appraisers use replacement cost and then deduct a factor for any functional disutility associated with the age of the subject property.

In most instances when the cost approach is involved, the overall methodology is a hybrid of the cost and sales comparison approaches. For example, while the replacement cost to construct a building can be determined by adding the labor, material, and other costs, land values and depreciation must be derived from an analysis of comparable data.

The cost approach is considered reliable when used on newer structures, but the method tends to become less reliable for older properties. The cost approach is often the only reliable approach when dealing with special use properties (e.g. -- public assembly, marinas).

The sales comparison approach

The sales comparison approach examines the price or price per unit area of similar properties being sold in the marketplace. Simply put, the sales of properties similar to the subject are analyzed and the sale prices adjusted to account for differences in the comparables to the subject to determine the value of the subject. This approach is generally considered the most reliable if adequate comparable sales exist. In any event, it is the only independent check on the reasonability of an appraisal opinion.

Note that this approach develops value from a purely pricing scheme, and as such is an example of a revealed preference model. An interesting perspective on the relationship between relatively subjective human estimation as compared with that obtained by purely mathematic modeling is contained in "Simple Heuristics That Make Us Smart" by Gerd Gigerenzer. Dr. Gigerenzer, a psychologist, asked people to estimate some real world facts based simply on their knowledge, experience and impressions. Common knowledge and some simple rules created models which were close to those produced by multiple regression analysis (MRA) and neural networks. The predictive value of the human models applied to a new sample was a bit better than the mathematical models, suggesting that the mathematical models may have described the data better but missed the predictive relationships. Similarly automated valuation models frequently find building size (square feet or meters) predictive of value, even when that information is not explicitly advertised. This is similar to the example in "The Wisdom of Crowds", Surowiecki, in which the scientist Francis Galton observed a crowd at a fair to, on average, accurately estimate the size of an ox.

The income capitalization approach

The income capitalization approach is used to value commercial and investment properties.

In a commercial income producing property this approach capitalizes an income stream into a present value. This can be done using revenue multipliers or single-year capitalization rates of the Net Operating Income. The Net Operating Income (NOI) is gross potential income (GPI), less vacancy (= Effective Gross Income) less operating expenses (but excluding debt service or depreciation charges applied by accountants).

Alternatively, multiple years of net operating income can be valued by a discounted cash flow analysis (DCF) model. The DCF model is widely used to value larger and more expensive income-producing properties, such as large office towers.