VALUATION APPROACHES

There are three traditional approaches to estimating market value. These are: the Cost Approach, the Sales Comparison Approach, and the Income Approach.

THE COST APPROACH

COST APPROACH DEFINED:	"A set of procedures through which a value indication is derived for the fee simple interest in a property by estimating the current cost to construct a reproduction of, or replacement for, the existing structure; deducting accrued depreciation from reproduction or replacement cost; adding the estimated land value plus an entrepreneurial profit. Adjustments may then be made to the indicated fee simple value of the subject property to reflect the value of the property interest being appraised." **Source: The Dictionary of Real Estate Appraisal-Fifth Edition, © 2010**
METHOD	The Cost Approach to Value deducts accrued depreciation from the cost new of the improvements. The result is added to the land value. The sum of the land value and the depreciated cost of the improvements indicate the value of the whole property via the cost approach, and generally the land value is obtained via the Sales Comparison Approach. Reproduction / Replacement cost new is estimated on the basis of current prices for the component parts of the building and depreciation analysis considers the disadvantages of deficiencies of the existing building as compared to a new building.
DEPRECIATION DEFINED:	"A loss in Value from all causes; the difference between current cost new and current value." **Source: Principles of Residential Real Estate Appraisal – First Canadian Edition © 2007 Calvin W. Moye**

The Cost Approach "AS IMPROVED" Valuation

1. Valuation of Land as if vacant according to its highest and best use based on sales of comparable vacant sites. In substantially built up urban neighborhoods where comparable vacant land sales are scarce or unavailable, the extraction method is utilized. This is the method of estimating land value in which the depreciated cost of the improvements is estimated and deducted from the total sales price of improved properties to arrive at an estimated sales price of the land. Generally, but not necessarily, this methodology utilizes the comparables incorporated in the sales comparison approach. The steps in the extraction process are: 1. Locate sales of improved properties with underlying land similar to the subject. 2. Estimate the cost for the sale's improvements when new. 3. Estimate the depreciation of the improvements, if any. 4. Subtract the depreciation from the "cost new" to obtain the present value of the improvements. Subtract the resulting depreciated cost of the sale's improvements from the sales price. The remainder represents the value of the land.
2. Estimate of the Replacement Cost New of the improvements based on construction cost as of the date of value.
3. Estimate of the Accrued Depreciation and Obsolescence resulting from physical deterioration and/or obsolescence.
4. Estimate of Depreciated Value of the Site Improvements based on the age, condition and utility as of the date of value.
5. Cost Approach Valuation developed by adding the estimated land value to the depreciated value of the improvements (building(s) and site).

THE SALES COMPARISON APPROACH

SALES COMPARISON APPROACH DEFINED:	"The Sales Comparison Approach is the process in which a market value estimate is derived by analyzing the market for similar properties and comparing these properties to the subject property. Estimates of market rent, cost, depreciation, and other value parameters may be derived in other approaches to value using comparative techniques. Often, these elements are also analyzed in the sales comparison approach to determine the adjustments to be made to the sales prices of the comparable properties. The comparative techniques of analysis applied in the sales comparison approach are fundamental to the valuation process." **Source: The Dictionary of Real Estate Appraisal-Fifth Edition, © 2010**
METHOD	The Sales Comparison Approach is used to estimate either the land as if vacant, or the whole property as improved, or both. The approach involves gathering data regarding sales of similar properties and analyzing the nature and condition of each sale. Subsequently, the analyst makes logical adjustments to the sale prices of the comparable properties for the various dissimilar characteristics between the subject and each of the properties used in the analysis. Typically, a common denominator is found. In land value, this usually involves either a price per square foot, price per acre, or price per unit. In improved properties, the common denominator involves such units as price per square foot, price per unit, or gross rent multiplier. The Sales Comparison Approach is based upon the principle of substitution and is a good value indicator of the property being appraised when sales of highly similar properties are available.

Sales Comparison Approach AS IMPROVED METHODOLOGY

The process of the Sales Comparison Approach can be summarized in four steps:

1. Data Collection
2. Data Analysis
3. Adjustment Process
4. Reconciliation

General and specific data are sought during the collection of information for the sales comparison approach. General data includes economic trends, external influences, value trends and the numbers necessary for statistical analysis.

The information collected is analyzed to isolate recognizable differences between the properties being compared and the most reliable data is separated for the adjustment process. A broad image that identifies the parameters of the market is obtained by arrangement and manipulation of the information; then specifics are extracted for direct comparison to the subject property. The data is manipulated to determine the ranges of pertinent facts and to build a "box" for the conclusions in the appraisal. Sales from several economic neighborhoods can be examined to isolate economic variances or to prove that variances do not exist. The mean, median and mode are often used when analyzing data. The trends revealed by comparison allows the appraiser to draw conclusions about price changes, buyer preferences, market activity level as well as the price range for a subject property with characteristics nestled in the tables extremes.

There are four types of possible adjustments to consider in the comparison of the subject to the recent sales or listings used for comparison and they are applied in the following order: 1. Concessions, 2. Market conditions (Date of Sale), 3. Economic Characteristics, 4. Physical dissimilarities. It should be recognized that sales adjustment processes require a sufficient number of sales from which to extract the adjustments. Often, there may not be enough sales to provide a basis for all adjustment calculations. In such situations, appraisers commonly look to a broader array of market sales for bracketing and indirect market support.

When correlating to arrive at a final value estimate, the quality of each comparable is assessed by examining: 1. The Number of adjustments, 2. The Size of a single adjustment, 3. The Gross adjustment, 4. The Net adjustment.

Source: Principles of Residential Real Estate Appraisal – First Canadian Edition © 2007 Calvin W. Moye

POSSIBLE ADJUSTMENTS:

There are four possible sources or causes that necessitate adjustments when comparing the subject to recent sales or listings. To preserve the integrity of the adjustment process, there is an appropriate order of adjustment. If the four possible adjustments are necessary, they are executed in the following order:

1. **Concessions:** The first adjustment includes consideration for sale terms, atypical financing, concessions or motivations that are not typical of the market. Consideration may also be required for the property rights conveyed, as the contract of a comparable sale may stipulate the transfer of rights, either more or less, than the bundle of rights demonstrated by the subject. Where possible such sales are removed from the analysis. If other sales are available, the credibility of the value estimate is enhanced if such sales are excluded.
2. **Market Conditions (time):** Comparable sales that occurred under market conditions different from those applicable to the subject on the effective date of the appraisal require adjustment for any differences that affect their value. An adjustment for market conditions is made if general property values have appreciated or depreciated since the transaction dates due to inflation or deflation or a change in investor's perceptions of the market over time. When possible, sales with older sales dates are removed from the analysis. If other sales are available, the credibility of the value estimate is enhanced if such sales are excluded. If sufficient data is available, the adjustment may be statistically derived. In the absence of sufficient data for a statistical analysis, the adjustment is typically obtained by bridging two or more individual sales with a process called "paired sales" analysis. Re-sales (the sale and re-sale of the same property over a period of time) can sometimes provide a good indication of the change in market conditions over time. However, the adjustments obtained from one or two paired sales, or re-sales, are not necessarily an indication of the market's reaction.
3. **Physical Dissimilarities:** These include adjustments for differences in building size, quality of construction, architectural style, building materials, age, condition, functional utility, site size, attractiveness and amenities.
4. **External Influences:** These include adjustments for the economic characteristics such as location (i.e. views, parks, traffic etc.) or in the case of income properties, include all attributes that directly affect its income.

The adjustments for concessions and time are accumulative. If the sale price of the comparable does not represent market value at the date of sale, it is modified. A time adjustment, if any, is then applied to the modified sales price. The order of application for the last two possible sources of adjustments is not significant to the process.

In the Sales Comparison Approach, there is a substantial amount of economic and physical data extracted from the market. The process requires the isolation of external influences, on-site inspections, off-site inspections, collection of information from third party sources and the application of several techniques. Each facet of the process has weaknesses and strengths, depending on the assignment. The validity and strength of the value estimate is affected by:

- The quantity and quality of reliable economic data
- The quality of reliable physical data
- Volatility of the market
- The physical complexity of the subject property
- The size of the sales sampling

The number of sales researched has a direct influence upon the validity of the value conclusion. If three sales are selected from 30 prospective comparables, those three sales are probably better comparables than three sales selected from only ten candidates.

Sources:

Principles of Residential Real Estate Appraisal – First Canadian Edition © 2007 Calvin W. Moye

The Appraisal of Real Estate –Second Canadian Edition ©2002 by the Appraisal Institute of Canada and the Appraisal Institute

THE INCOME APPROACH

INCOME APPROACH DEFINED:	"A set of procedures through which an appraiser derives a value indication for an income-producing property by converting its anticipated benefits (cash flows and reversion) into a property value. This conversion can be accomplished in two ways: One year's income expectancy can be capitalized at a market- derived capitalization rate that reflects a specified income pattern, return on investment and change in value of the investment; alternately, the annual cash flows for the holding period and the reversion can be discounted at a specified yield rate." **Source: The Dictionary of Real Estate Appraisal-Fifth Edition, © 2010**
METHOD	The Income Approach is predicated on the assumption that there is an identifiable relationship between the amount of income a property will earn and its value. A number of appraisal principles form the basis of this approach, with the Principle of Anticipation being particularly applicable. This Principle affirms "value is created by the expectation of benefits to be derived in the future". The income approach is an appraisal technique in which the anticipated annual net income of the subject is processed to arrive at an indication of value. Net income in the appraisal process is that income generated before payment of any debt service and the process of converting the net income to value is called capitalization. This involves dividing the net income by a rate, which weighs considerations such as risk, time, interest on the capital investment and recapture of the depreciating asset. The appropriateness of this rate is critical and there are a number of techniques by which it may be developed.

THE INCOME APPROACH METHODOLOGY

Capitalization methods used for valuing investment properties are not commonly used to estimate the value of single family dwellings because:

- Single family homes are not generally purchased for investment.
- Single family homes typically have two potential uses, rental or owner occupancy.
- Capitalization techniques often do not produce value estimates that are consistent with the sales prices on single family houses.
- Capitalization techniques are often too elaborate and complex to be practical for appraising a single family home.

Even when uncommonly undertaken, the appraisal profession has historically preferred one income evaluation method when valuing single family homes, the Gross Rent Multiplier (GRM). The GRM extraction process does not require adjustments for the physical and economic variances between the subject property and the sales. Therefore, the validity of the extracted GRM is directly related to the quantity and quality of the sales collected. The process relies upon the volume of data to compensate for the absence of adjustments to the sales. A sufficient volume of recent sales very similar to the subject that were predominantly leased at the time of sale were not available to the appraiser. Therefore, it was impossible to determine a legitimate GRM necessary in calculating a valid income Approach.

For all of these reasons, an income approach was not undertaken by the appraiser.

Source: Principles of Residential Real Estate Appraisal – First Canadian Edition © 2007 Calvin W. Moye