PROPERTY APPRAISAL

MODULE PURPOSE

The purpose of this module is to enable participants to gain the knowledge and practical experience required to undertake the appraisal of residential real property and to estimate the likely market price range of the property.

PREREQUISITES / CO-REQUISITES

Module ABH500	Real Estate Industry Overview
Module ABH501	Introduction to Sales
Module ABH502	Introduction to Property Management
Module ABH507	Property Research and Analysis
Module ABH511	Property Law
Module ABH513	Recognising Common Building Styles and Faults

CONTENT SUMMARY

Methods of appraisal
Types of appraisals
Property features - internal and external
Determining make price range
Role of real estate agent and valuer

LEARNING OUTCOME 1

Explain the value of real property

READING

1.1 Explain the concept of market value

Read Parts 1 and 2 Appraisal One

The concept of *market value* is the most important single concept in Australian valuation theory. It introduces the importance of the legal environment to the valuation system. The practising valuer is always subject to the powerful legal environment because ultimately, the final determiner of value is the court. Therefore, the valuer can only ignore court judgments on valuation at his/her risk. Why is the legal environment so important? Because the courts have defined what market value is. The legal definition of market value is the *willing buyer willing seller theory* as defined in the High Court decision *Spencer v The Commonwealth* (1907) 5 CLR 418. The full text is provided in Part 2 of Appraisal One but it can be summarised as follows:

- a sale is envisaged. Therefore, it is immaterial whether or not at the date of valuation, there was an actual buyer or seller of the subject property;
- the parties are assumed to have particular knowledge and expertise. That is, they are fully "cognisant" of ALL factors that may affect the value of the land at the date of valuation. Subsequent factors that could not be reasonably foreseen at the date of valuation are ignored.
- both parties are willing to sell and buy. That is, it is not a "forced" sale.

You can see that the above requirements are necessary for an "ideal" sale. A number of sales may not meet this criteria and they cannot be used to determine market value. Therefore, the definition describes an ideal or normative sale model - see Part 2 Appraisal One. However, in practice it is not necessary to look at each of the normative requirements to determine whether or not the sale is a suitable one for the determination of market value. A better model is *modified Spencer* that looks at only how the sold property was promoted and marketed. *Modified Spencer* states that as long as the sale property has been marketed and promoted in the normal manner (for example, after a number of advertisements and inspections, the property is sold at auction with genuine bidders) then it must have met the requirements and conditions of the *willing buyer willing seller theory*.

HOW IS THE MARKET VALUE OF THE SUBJECT PROPERTY DETERMINED?

By comparing the subject property with sales of properties that are both:

- comparable; and
- meet the requirements of *Modified Spencer.*

1.2 EXPLAIN OTHER TYPES OF VALUE

Value to the owner (special value to the owner)

Read the introductory parts of Part 19, Appraisal One.

Special Value to the Owner is the value used to pay compensation to a dispossessed owner after the compulsory taking of his/her land for government purposes. For example, for a road widening. Generally, it is more than market value as it includes a number of heads of compensation that do not apply in the definition of *market value* above. That is, it is market value plus. A detailed look at this concept will be covered in a later module.

STATUTORY VALUES

Statutory values are specialised values defined in acts of Parliament. For example, the special value to the owner outlined above is defined by statute; s55 in the *Land Acquisition (Just Terms Compensation) Act* 1991 (NSW) and s55(1) *Lands Acquisition Act* 1989 (Cth). Other important statutory valuations are for property tax purposes for example, in the determination of *Land Value* in NSW.

SECURITY VALUE

See the end of Part 11, Appraisal One.

Security value is that value provided to lenders of finance such as banks where property is offered as security (collateral). The most common form of finance is by way of a mortgage over the mortgagor's property. Old valuation theory argued that *security value* should be less than *market value* that is, assuming a *forced sale*. However, the modern approach is that is exactly the same as market value as described above. This is because the mortgagee is under a duty of care not to sacrifice the mortgaged property but rather to market and sell it in the normal manner.

1.3 EXPLAIN THE COMPARABLE SALES METHOD
See Learning Outcome 2

1.4 EXPLAIN THE FORCES THAT CREATE VALUE IN PROPERTY
See also Learning Outcome 3.2

Read Part 7, Appraisal One

The market value of land is determined by a number of factors or environments. These can be classified into:

- micro - those factors on the land. These are sometimes called components of the land. For example, poor drainage.
- macro - environments outside the boundaries of the land. For example, the effect of a nearby shopping centre.

The most important outside environment; the legal environment is illustrated in the definition of market value above. Other important outside environments are:

SOCIAL

An example of an important social factor, is the market's image of a particular suburb. For example, the buying public differentiate between suburbs on the basis of image and prestige. Some suburbs are known in the market place as a "good" suburb while others are known as "bad" suburbs. The basis for such assessments are invariably socio-economic as they include such things as the level of household income.

ECONOMIC

The economic environment is closely allied to the social environment described above. It is most important as a factor determining the value of non residential land uses such as commercial, industrial and retail. For example, there is an underlying correlation between the economic growth of Australia (as measured by *Gross Domestic Product*) or of a state or territory (*Gross State Product*) and land values. Because it is difficult to separate a number of economic factors from social factors, the better term is *socio-economic* factors. For example, the level of migration is an important variable that helps to determine the value of residential real estate in the capital cities. This variable has both social and economic (and even political) characteristics.

POLITICAL

The political environment is also difficult to separate from the social environment. Political decisions that affect land values are usually quick and sudden and therefore, having an immediate (and sometimes, a quite dramatic effect) on value. For example, a political decision to release "green belt" land for residential development by way of a change of zone. Obviously such a decision has important social and economic overtones as well.

PHYSICAL

The physical factors that affect value are generally, internal or micro factors on the land itself. Obviously these are most important for rural land uses including soil fertility and structure. It is less important in urban areas because advances in technology have overcome a number of physical problems of the construction of buildings. For example, houses today can be built on very steep sites using modern building construction methods. However, there are basic physical factors that favour or make it cheaper to build particularly, large buildings. For example, the sandstone foundations used for the construction of high rise office towers in Sydney offer a comparative advantage over other cities such as Melbourne where deep piles may have to be sunk into the foundation to support a large office tower.

These factors are further considered in 3.2.

1.5 EXPLAIN THE ROLE OF THE ESTATE AGENT IN PROVIDING ESTIMATES OF VALUE

See Learning Outcomes 2 and 3.

EXERCISE

Do not send to your assessor.

Itemise those factors and environments, both at the micro and macro levels that have an important influence on the market value of the house in which you live. Rank these factors in descending order of importance. Classify these into social, economic, political and legal factors. Note that a number of the factors will come under different classifications.

LEARNING OUTCOME 2

Explain the different methods of appraising the market price/rental value of residential real estate.

READING

2.1 DIFFERENTIATE BETWEEN THE TYPES OF APPRAISAL METHODS - COMPARATIVE SALES, SUMMATION, REPLACEMENT COST (LESS ACCRUED DEPRECIATION) AND HYPOTHETICAL DEVELOPMENT

See Learning Outcome 2.3

2.2 IDENTIFY SOURCES OF INFORMATION FOR UNDERTAKING APPRAISALS

Read *Appraisal One*, Part 3, Market Transactions
Read *Appraisal One*, Part 4, Methods of Valuation 1

Valuers analyse recent sales to determine value. In this module we are only concerned with residential land and cottages. The use of comparable sales is the basis of the Australian valuation method. For a sale to be useful it must satisfy two criteria:

- comparable to the subject land. For example, it would be extremely difficult to use the sale of a 1975 "modern" style house to value a 1915 Federation cottage.
- Not "out of line". For example, a sale at a very low price between relatives.

The common 11 *out of line* sales are covered in Part 4, *Appraisal One*. The ideal sale should be recent, near the subject property, comparable to the subject property and meet the requirements of the *willing buyer willing seller* theory (see Part 2 of *Appraisal One*). If a sale meets all these criteria it is a good sale for determining the market value of the subject property. If it is highly comparable the *direct comparison* method should be used as this the method has least error. If it is less comparable but still comparable, the *summation method* should be used.

For all of the methods covered in this module it is necessary to have good sales evidence.

SOURCES OF INFORMATION

The sources of information are covered in Part 3, *Appraisal One*. There are 3 main sources of sales information in decreasing order of reliability:

- **PRIMARY EVIDENCE**
  The actual sale contracts or transfers of sale

- **SECONDARY EVIDENCE**
  Reporting services that summarise sale information generally, in a table form. Oral evidence from real estate agents.

- **TERTIARY EVIDENCE**
  Articles and reports in trade papers such as the Australian Property News (APN) and the Financial Review.

Courts will only accept the contract of sale or notice of transfer as documentary evidence of price. Therefore, it is important that the valuer ratify the sales he/she has used by at least obtaining a copy of the Notice of Transfer.

2.3 MATCH APPROPRIATE APPRAISAL METHODS TO TYPES OF PROPERTIES

Read *Appraisal One*, Part 2, Market Value
Read *Appraisal One*, Part 4, Methods of Valuation 1

An appraisal is the same as a valuation and therefore, an appraiser is a valuer. There is a common but erroneous belief in real estate that an appraisal is a lessor assessment and not subject to the same rigour as that required for a valuation. This is a wrong and dangerous assumption under modern liability law. Therefore, a real estate agent should not carry out a valuation as defined under the various states' definition of "valuation". For example, a valuer in NSW must be licensed if he/she carries out a valuation for a fee. On the other hand, there are no licensing requirements for valuers in the ACT.

There are 3 common methods of residential valuation used by the valuer:

- direct comparison
- summation
- capitalisation.

In this module we are only concerned with the first two. Capitalisation is covered in a later module. The other two mentioned in the heading; *cost less accrued depreciation* comes under *summation* and *hypothetical development* is a combination of *summation*, *direct comparison* less costs of development. Therefore, they are covered under those headings.

DIRECT COMPARISON

Direct comparison is used where the subject land and the sale land are highly comparable. That is, only a small amount of adjustment is required to the sale price to determine the market value of the subject site. The size of the difference is arguable but the figure of 40% has been used as a maximum. That is, if the sale price requires a 45% adjustment to make it comparable to the subject land, *direct comparison* should not be used. *Direct comparison* is particularly useful where subject building is new and *opportunity cost* can be used to make the sale price comparable to the subject land.

EXAMPLE

There are 2 highly comparable houses next door to each other. One has sold recently for $200 000. You are required to value the other house. The sale and subject houses are identical except that the subject house has a new swimming pool. You have ascertained that swimming pools are typical in this locality and represent *highest and best use* of the land. The installed cost of the new swimming pool is $25 000. Therefore, the value of the subject land is:

200 000 + 25 000 = 225 000

Direct comparison is most suitable where the only difference between the two properties is condition. For example, the opportunity cost could be the cost of painting or repairs. *Opportunity cost* and *highest and best use* is covered in Part 8 of Appraisal One. Also read *under* and *over capitalisation.*

SUMMATION

Unfortunately in practice and particularly with residential properties there can be a great deal of difference between the sale price and the subject site. For example, the sale price has a 1955 cottage on it whereas the subject land has a 1915 Federation cottage. In this circumstances it is necessary to analyse data and construct a database that will allow you to value the subject site using the summation method. The summation method requires the valuer to have knowledge of *effective* or *equivalent* area measurement of cottages (see Part 4, Appraisal One).

A database is constructed by the valuer by analysing a number of sales of different types of cottages. From this database the valuer is able to ascertain the value/m^2 (*effective* area) of different types of cottages particularly those with different architectural style. For example, he/she may find that 1925s bungalows are selling for about $500/$m^2$ whereas 1970s Japanese Californian's (also known as Pettit and Sevitt's) are selling for about $700/$m^2$. These values are obtained by analysing sales of cottages of that era.

Once a reliable database of cottage values have been established the summation formula is applied to determine market value. An example is as follows:

VALUE OF A BUNGALOW COTTAGE

Effective area of 180m^2 @ 500m^2	90 000
Garage	5 000
Ground improvements	6 000
Land (by direct comparison)	100 000
TOTAL	**201 000**

Ground improvements are those improvement that merge with or become part of the land, The common ground improvements are fencing, paths, retaining walls, gardens, BBQ, and rotary clothes hoist. They are valued as a lump sum as they are only a small part of the total valuation. Note that the land is valued as a lump using direct comparison with vacant (or nearly vacant) land sales.

It is important that the valuer have good knowledge and a high appreciation of cottage styles or architecture - see Part 4, Appraisal One.

COST LESS ACCRUED DEPRECIATION

This method of valuation is really the same as the summation method described above. The method is concerned with the value of the improvements only, for example, the bungalow above. Instead of using the value/m^2 directly from analysed sales the accrued depreciation can be subtracted from the *replacement cost new* (RCN).

EXAMPLE

The replacement cost new of the above bungalow:	1 000/ m^2
Accrued depreciation:	500/ m^2
Therefore, the market value of the cottage is:	500/ m^2

An example is shown in Part 4 Appraisal One. Depreciation and the cost method is covered in Part 9 of Appraisal One. You can see the conceptual problem with using the *cost less accrued depreciation* model. To prove your accrued depreciation you must analyse sales of comparable properties. However, if you are analysing sales to determine the amount of accrued depreciation, why not use the value/m^2 ($500 in the above example) that is analysed directly from the sale? That is, there is not need to go into the indirect accrued depreciation model.

HYPOTHETICAL DEVELOPMENT

Read only the first part of Part 6 Appraisal One.

Hypothetical Development is a valuation method for the valuation of *development* land. The method assumes that the value of the land is directly proportional to the size of development possible. For example, if unsubdivided residential land is valued, its value is directly determined by the number of residential lots that can be obtained through subdivision. This is known as *notional* or paper development. The value before subdivision is known as *in globo* value.

The method is covered in Part 6, Appraisal One. You need only consider the residential *in globo* valuation shown in that part. The ability to carry out such a valuation requires knowledge of town planning and other codes that control development, costs and consumer demand. Therefore, it is a method suitable only for the experienced valuer and in this module you need only know the rudiments of the method. These can be summarised as follows:

- The expected gross realisation is calculated
- From this amount is deducted selling expenses and then an amount for *profit and risk*
- The resulting amount is known as the *net realisation after profit and risk*. From this is deducted the expected costs of development.
- The resulting amount is the value in the name of the purchaser
- Finally, market value is found by deducting the costs of transferring the land into the purchaser's name (ie stamp duty and legal on purchase).

ASSESSMENT

To be submitted to your supervisor.

You are to value the house in which you live. Using the methods described above and by referring to Appraisal One:

- prepare a sketch of the cottage's effective area
- summarise comparable sales nearby
- analyse the comparable sales into $/square metre
- analyse comparable sales to determine the value of the ground improvements (lump sum) and land value (direct comparison).
- apply the analysed values to your house using the summation method.

LEARNING OUTCOME 3

Determine and prepare reports detailing the likely market price range/rental value of various types of properties

READING

3.1 CALCULATE LIKELY PRICE RANGES/RENTAL VALUES FOR A SELECTION OF HOUSES, FLATS AND UNITS.

This module is only concerned with residential property and non investment properties. Investment properties will be covered in a later module.

PRICE RANGES

It is good practice for the agent when carrying out a valuation to provide the final answer as a range, rather than a single figure. However, this will depend on the needs of your client. For example, a Certificate of Valuation of the *unimproved value* for property tax purposes would be a single value only and for a full valuation report your client may require a single valuation figure. For example, to submit to his/her bank manager as the basis for a loan.

The advantage of submitting a range of value is that the range can be extended for valuations where the valuer is less sure of the final figure. For example, where there is a dearth of sales evidence, the range will be large and where the valuation evidence is reliable and plentiful (for example, when direct comparison is used) the final range will be small. It is a fault with the valuation profession that they are not prepared to use valuation ranges enough.

RENTAL VALUES

Rental values are exactly the same as lump sum values as far as valuation methodology is concerned. Rental values can be thought of as the annual value of thé property. The *willing buyer willing seller* theory covered in Part 2, Appraisal One is simply converted to the *willing landlord willing tenant* theory. Rental evidence is analysed in a similar manner to that for lump sum valuations. This is explained in greater detail in Part 5, *Appraisal One.* However, rental determinations for commercial leases is a very complex and a difficult assignment requiring specialised knowledge and the ability to use discounted cash flows. The agent would most likely only be concerned with residential rental values as advice to the property management department, client landlords and certificates of annual values for property tax purposes.

HOUSES, FLATS AND BUILDINGS

Houses have been covered above. As mentioned, the valuer must have a very good appreciation of and understanding of architectural styles. He/she should know at least the meaning of the following terms:

- federation style
- art deco style
- bungalow
- Victorian terrace
- free standing
- double fronted
- semi detached.

These terms are explained in Part 4 of Appraisal One and/or the glossary at the end of this module.

FLATS
Flats are investment residential units usually within a multi unit building and being let to tenants. That is, they are usually found in a "block of flats". Although the valuation factors for a flat is basically the same as that for a free standing house (both are residential land uses) in the same area, tenants tend to concentrate on some factors of value such as access to work and public transport. Further, the quality of the building may be less important for the tenant than for the *owner occupier.*

OWNER OCCUPIED
Owner occupied residences are the most common valuation subject matter. This applies to strata units (unit title) as well as to free standing houses. A block of strata (unit title) units may be largely rented out as its location and features suit the needs of tenants. For example, the locality may be a "dormitory suburb". On the other hand, you may find a block of strata units where all the units are owner occupied. In this case the factors affecting value are almost identical to that for free standing cottages. The valuation of a strata unit requires consideration of a number of extra variable not applicable to the valuation of free standing cottages. These include:

- an analysis of the property management skills of the body corporate
- the amount of the body corporate levy
- the likelihood of a large levy in the future to pay for necessary maintenance or replacements
- any debts or mortgages over the common property
- whether or not the unit entitlement of the subject unit is fair?

3.2 ACCOUNT FOR ECONOMIC, SOCIAL AND POLITICAL FACTORS

Read Part 7, Appraisal One, Valuation Reports

These are factors that affect the value of the land and were covered in 1.4. You are only required to include those factors that are important in the valuation report. They can be classified into:

MICRO OR INTERNAL FACTORS

These include the improvements, occupancies, site, access, zoning, existing land use and physical condition. All of these together help determine the *highest and best use* of the site. Note the need for appropriate endorsements, disclaimers and appendices.

MACRO OR EXTERNAL FACTORS

These are all those factors OUTSIDE the subject property's boundaries. For example, traffic flow, demographic features, general legal and economic environment. A number of macro factors can be used as background or secondary data in the valuation report. The acquisition and presentation of some of these data was covered in the module *Property Research and Analysis ABH507*.

3.3 PRESENT AN APPRAISAL ACCORDING TO AGENCY MARKET REQUIREMENTS.

Read Part 7 *Appraisal One* which covers Valuation Reports.

Part 7 in *Appraisal One* also includes the common factors affecting value that should be included in the valuation report. Also take particular notice of the beginning of that part covering duties and liabilities of valuers in the collection of information and the preparation of the report. Reports can be classified as:

- **COMMISSIONED**
  The valuer is responding to a contract with a client

- **SPECULATIVE**
  The report is used in a general manner for example, as part of the marketing kit for a property on the market.

The agent commonly prepares valuation reports as part of a marketing and promotion exercise of a sale property particularly, an investment property. Another report classification covered in Part 7 Appraisal One is as follows:

- **CERTIFICATE**
  A short statement on value. Used for the confirmation of values used for statutory purposes such as those for property tax purposes.

- **FULL VALUATION**
  Also known as a "speaking" valuations. These are detailed valuations that include all relevant matters including a comment or summary of the calculations.

- **FEASIBILITY STUDY**
  A specialist valuation for development land. The hypothetical development method covered above is an example of a feasibility study.

- **INVESTMENT**
  Often part of the feasibility study. It is an analysis of the expected return from the development and commonly uses *discounted cash flows* (DCFs).

- **LITIGATION**
  Also a specialist valuation designed for use as an expert witness in court proceedings.

The agent would only be involved in the preparation of certificates (for example, for the property management department) and full valuations.

ASSESSMENT

To be submitted to your assessor.

Applying the summation valuation in the previous assessment, complete a speaking valuation of the house you live in according to the criteria covered above and in Appraisal One. Include appropriate disclaimers and qualifications.

CONCLUSION

The agent who prepares an "appraisal" or an "opinion of value" is in exactly the same position as if he/she has carried out a valuation from a liability point of view. Under the modern law of duty of care a negligent agent can be sued in exactly the same manner as a negligent valuer because he/she holds him/herself out as an expert in that area. It does not make any difference under the common law whether or not the valuation is provided to your client free or for a fee.

The basic concept is market value and that also provides the base or starting point for the determination of other values such special value to the owner. Further, the 3 basic valuation methods are *direct comparison*, *summation* and *capitalisation*, that can be used to cover all valuations that the agent is likely to be called upon to make.

RECOMMENDED READING

Hornby D J (1996) *Appraisal One,* D D Products, PO Box 853, Woden ACT 2606

GLOSSARY OF TERMS

DEVELOPMENT LAND
Land suitable or "ripe" for development. For example, broad hectare land zoned residential.

DISCOUNTED CASH FLOW (DCF)
A specialised method of determining the present value of a cash flow. It is only useful in valuation practice where the expected cash flow is complex and reasonably certain.

DORMITORY SUBURB OR LOCALITY
A suburb that is particularly attractive to renters who are young and single tenants. Such suburbs have good access to the CBD.

EFFECTIVE OR EQUIVALENT AREAS
The gross or outside dimensions of a cottage are adjusted to an equivalent area based on the main part. For example, the equivalent area of a verandah may be 0.2 of its outside dimensions because it is only 0.2 (per m^2) of the main part of the cottage.

FORCED SALE
A sale where one or both parties are unwilling. For example, a bankrupt may be forced to sell his/her property as part of the settlement.

FREE STANDING
A cottage not attached to another. That is, unlike terrace or semi detached cottages.

FOUNDATIONS
Technically speaking, foundations are the soil or base on which a cottage is built.

HIGHEST AND BEST USE
That land use that generates the highest land value commensurate with the risk of development.

IN GLOBO VALUE
The value of a large area of land suitable for subdivision but yet subdivided.

INVESTMENT PROPERTY
A property that an investor buys for future rental income and capital gains. For example, a home unit that is rented out.

LAND
When "land" is referred to in this context it does not mean vacant land or land with nothing on it. When "land" is sold it includes all fixtures attaching to that land which can be substantial improvements. Therefore, a block of land as referred above means a land plus the house and garage on the land. In this module, an introductory module we are only concerned with residential land, that is, the valuation of houses or cottages.

MARKET VALUE
The value of land according to the *willing buyer willing seller theory*. It is important to note that it is the market's assessment of value and not the expert's personal opinion. That is, the valuer analyses the market place.

NORMATIVE THEORY
A theory that sets an ideal that concepts can be compared with. Usually concepts strive towards the ideal.

OPPORTUNITY COST
The cost of an alternative. The opportunity cost of renting is the cost of buyer. That is, rent is the opportunity cost of mortgage repayments. All costs are better expressed in terms of opportunity cost.

OWNER OCCUPIED
A cottage or unit in which the owner lives. As opposed to an investment property where the owner rents it out.

REPLACEMENT COST NEW (RCN)
The economical cost of replacing a building. The concept becomes more difficult, the older the building.

SALE PROPERTY
The property that has been sold and against which the subject property is being compared for valuation purposes.

SUBJECT PROPERTY
The subject of the valuation. The property being valued.