REAL ESTATE APPRAISAL, FINANCE, INVESTMENT, AND BUSINESS MANAGEMENT

Eighth Edition

A Text Sponsored and Approved
by the
Florida Real Estate Commission
for
FREC Course II

by the
Florida Real Estate Commission
Education and Research Subcommittee

and the
Division of Real Estate
Department of Business and Professional Regulation

REAL ESTATE APPRAISAL, FINANCE, INVESTMENT, AND BUSINESS MANAGEMENT

Eighth Edition

A Text Sponsored and Approved
by the
Florida Real Estate Commission
for
FREC Course II

by the
Florida Real Estate Commission
Education and Research Subcommittee

and the
Division of Real Estate
Department of Business and Professional Regulation

PART I

Appraisal and Market Analysis

Foreword

This edition of *Real Estate Appraisal, Finance, Investment, and Business Management* has been thoroughly updated and revised in conformance with specifications of the Florida Real Estate Commission Education and Research Foundation Advisory Committee, John T. Conroy, Jr., CCIM, Chairperson. The book serves as the prescribed text for FREC Course II, which is a prerequisite for real estate salespersons in Florida who wish to qualify for a real estate broker's license. The purpose of the text continues to be the same as for its previous editions, to provide a modern text covering all four of the subject areas specified for FREC Course II. The need for a Commission-sponsored text arose because no single commercial text contains all of the subject areas prescribed for the course.

This revision of this text was funded by the Florida Real Estate Commission Education and Research Foundation. It was prepared under the auspices of the University of Florida by Dr. Halbert C. Smith, MAI, CRE, as principal researcher, and Don N. Lloyd, MBA, DREI as secondary researcher. Important contributions were made by Richard Fryer of the Institute of Florida Real Estate Careers, John Greer and Mike Rieder of Gold Coast School of Real Estate, Robert Hogue of Bob Hogue Schools of Real Estate, and the Bert Rodgers Schools of Real Estate. The cooperation and assistance of James Mitchell, Assistant Attorney General, Real Estate and Linda L. Crawford, Education Coordinator, Division of Real Estate were invaluable. Jo Ellen Peacock, Course Evaluation Coordinator of the Education Section, Division of Real Estate provided information and assistance that could not have been obtained elsewhere. Thanks also to Margaret Mitnik, Regulation Specialist, Education Section, Division of Real Estate, who proofed the entire printing package. A major book is a large undertaking; the cooperative efforts of these people and others were essential to its successful completion.

The ultimate goal of the Commission, protection of the public, is served through this unique course in real estate education. By covering four separate areas of concern to real estate brokers, it provides the basic knowledge by which brokers can conduct their business in a competent, ethical manner. Nevertheless, no single course can cover all subject areas applicable to brokers, and the Commission wishes to encourage all licensees to continue their educational activities beyond this course in the various excellent programs offered by universities and professional organizations.

The Commission and the Foundation Advisory Committee wish each student an enjoyable and profitable education experience in FREC Course II. Professionalism in real estate can be achieved only through educated, competent, and ethical brokers and salespersons.

Table of Contents

PART V: APPENDICES

Exhibits

Number Page

PART I: APPRAISAL AND MARKET ANALYSIS

PART II: REAL ESTATE FINANCE

PART III: REAL ESTATE INVESTMENT

PART IV: REAL ESTATE BUSINESS MANAGEMENT

CHAPTER 1

The Broker's Role in Appraising

LEARNING OBJECTIVES

After studying this chapter, students should be able to:

1. explain why knowledge of the appraisal process is important to brokers
2. explain the differences among price, cost of production, and value
3. state the typical purpose of an appraisal
4. list the steps in the appraisal process
5. list and describe the four types of appraisal reports
6. list and explain the three approaches to value estimates
7. explain the process by which appraisers become state certified

I. The Appraisal Process

A. The nature of appraisal

Brokers, by the very nature of the services they provide, must be familiar with the appraisal process. Although few brokers actually prepare appraisal reports, virtually all must go through a process similar to appraising in the listing of properties.

Brokers must have a knowledge of the market to ensure that the prices at which properties are listed are neither too far above nor below the level justified by sales of competitive properties. Also, in Florida licensed brokers and salespersons can legally perform appraisals except when the appraisal is for the purpose of supporting **a federally related transaction**. Chapter 61J1 defines a federally related transaction as any real estate related financial transaction which a federal financial institution's regulatory agency or the Resolution Trust Corporation engages in, contracts for, or regulates, and which requires the services of a state-licensed or state-certified appraiser.

1. Appraisal defined

An appraisal is a supported, defended estimate of the value of property rights as of a given date.

"Supported and defended" means the appraisal is based on a comparison and evaluation of pertinent data, and the supporting data are either in the appraisal report or in the appraiser's files and that the data support the appraiser's conclusion.

Systematic procedures and logical analyses as presented in the Uniform Standards of Professional Appraisal Practice must be followed. Standards rule 2-3 of the Uniform Standards of Professional Practice (**USPAP**) mandates that each appraisal report contain in the appraiser's certification a statement that the appraiser either has no (or must specify and disclose any) present or prospective interest in the subject property. While the market may determine value, an appraiser only estimates value. An estimate is an approximation of the most likely price expected to be realized if the property being appraised were to be sold.

There are several types of value, and therefore the particular type being estimated must be known by the appraiser. The most common type of value sought in an appraisal is **market value**.

2. Purpose and function

The **Purpose** of an appraisal is to estimate the **type of value sought** by the appraiser. The purpose of an appraisal (*e.g.*, to estimate market value) dictates the type of data and the valuation approaches to be employed. For example, the estimation of market value requires data obtained from the market; the estimation of investment value would also require knowledge of an investor's specific financial situation and objectives. **The purpose of an appraisal must be known by the appraiser doing an appraisal and will be important in determining the value estimate.**

The **function** of an appraisal is the way in which an appraisal is **to be used**. An appraisal may have many uses. Many decisions relating to real estate and its uses can be facilitated by an appraisal. Common uses of appraisals are to (1) aid buyers and sellers in establishing buying and selling prices, (2) deciding whether to lease or buy, (3) making decisions regarding the amount of rent that should be charged or paid, (4) making decisions about the taxable value of a property, (5) making decisions about how much money should be borrowed or loaned on a property, and (6) making decisions relating to the use to which land should be put. **The function of an appraisal does not need to be known by an appraiser, and when known it should not influence the value conclusions.**

3. Identification of property rights to be appraised

An appraiser values the rights involved in the property being appraised. The rights valued may vary from a month-to-month leasehold to full fee simple ownership. Estates for years, life estates, reversionary interests, remainder interests, and undivided interests in concurrent estates are some of the types of interests upon which an appraiser may be asked to estimate value.

Furthermore, the rights may be constrained or limited by one or more other legal rights and obligations such as easements, leaseholds, air rights, tax assessments, zoning restrictions, and building codes. Therefore, an appraiser must carefully identify the rights which are the subject of the appraisal. Also, any rights in personal property (as distinguished from real property) should be specified and separate values assigned to them.

4. Value, cost of production, and price

Value in a general sense is conceptual and means different things to different people. Its use in appraisal implies a more limited concept and certain common characteristics. Economic values are expressed in terms of dollars.

In appraisal, **market value** is **market-determined**, a result of the interaction of supply and demand in a given market. For any good to have economic value there must be a **demand** for it and it must have **utility**, **scarcity**, and be **transferable**. Furthermore, market values are expressed in dollars and represent a consensus of the market participants. Values are the prices that would most likely be paid and may not reflect actual prices paid because forces extraneous to the market may have been involved.

Cost of production is the expenditure of resources necessary to bring an economic good into existence. It is measurable in monetary terms and includes compensation of all factors of production. While cost does not necessarily equal value, it may give an indication of value.

This is the rationale for the cost-depreciation approach. Construction of a new property thus may produce an equal utility substitute for an appraised property. In appraising, "cost" means the cost of production.

Price is simply an amount of money that is paid or received. A price that is paid is quantifiable to the dollar; it is historical and factual. Prices that occur in active, viable markets tend to approximate value. The extent to which markets are imperfect increases the probability for prices and values not to be equal. The important point here is that value, price, and cost **may or may not be equal**. As an example, a person may decide to build a luxury hotel miles from any population center at the cost of $20,000,000. However, the value of the hotel may be only a small percentage of cost. Likewise, a home may be constructed at a cost of $128,000. The selling price may be $130,000, and an appraiser may conclude that the value is only $126,000. While we may not be able to ascertain value with 100 percent certainty, price and cost are ascertainable.

B. Types of value

There are many types of value. In practice, however, only a few value concepts are commonly used or are relevant in real estate.

1. Market value

Market value is the most common objective of real estate appraising. The USPAP defines market value as the most probable price which a property should bring in a competitive and open market under all conditions requisite a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in the 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. both buyer and seller are typically motivated;

2. both parties are well informed or well advised, and acting in what they consider their best interests;

3. a reasonable time is allowed for exposure in the open market;

4. payment is made in terms of cash in United States 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.

2. Investment value

Investment value is the value of property to an individual investor, based on his or her standards. It is subjective, and represents the maximum a given buyer would pay, or the minimum a given seller would accept, for a given property.

3. Other types of value that are less frequently estimated by real estate brokers are discussed below.

a. **Assessed value** is the value assigned to a property for ad valorem tax purposes.

b. **Liquidation value** is the amount a property is most likely to sell at a forced or hurried sale. It is sometimes used in valuing foreclosed properties and properties having tax liens.

c. **Salvage value** is the amount that part or all of a property's improvements can be sold for at the end of its economic life, taking into consideration the cost of removing those improvements from the land.

d. **Insurable value** is often estimated for insurance coverage purposes, and is based on replacement value taking into consideration insurance exclusions.

C. Steps in the appraisal process

The appraisal process may be defined as the systematic procedure that must be followed in any appraisal, regardless of the type of property being appraised, how large the property may be, or how much the appraiser is being paid to do the appraisal. In other words, it is a general procedure that can be likened to the scientific method in the physical sciences.

Step 1--Definition of the Problem. The first step in the appraisal process requires appraisers to identify the real estate and property rights involved. For example, whether they are fee simple title or some other partial interest in the real estate such as a leasehold or life estate. Next, appraisers must determine whether the type of value to be estimated is market value (as is the case in the vast majority of appraisals) or some other type of value. Appraisers should also establish the date of the appraisal; that is when the value estimate will be effective.

The type of report to be used will be determined by the needs and desires of the client for whom the appraisal is being performed. For example, if an owner needs an appraisal only to help set a listing price, a letter report may be sufficient. However, if the appraisal will be used to support a loan or used in a court proceeding, a form report or a narrative report will probably be required. Each type of value must be adequately defined. Finally, the limiting conditions should be identified.

Step 2--Preliminary Analysis and Data Selection and Collection. This step requires appraisers to collect data and analyze the general environment and market trends affecting the property being appraised, and to collect data and analyze the characteristics of the subject property and comparable properties. This can be the most time consuming step in the appraisal process because the types of data needed may not be readily available. If the appraisal is carefully planned and the needed data identified and collected, however, the rest of the appraisal should go relatively smoothly and quickly.

Step 3--Highest and Best Use Analysis. The procedures for highest and best use analysis are discussed in Chapter 6. For residential appraisals of one-to four-family properties, highest and best analysis is not usually a difficult step. If, however, the improvements are old and the site is zoned for a more intensive use, this step might be more important and difficult. The appraiser would then have to determine whether the existing improvements should be demolished or modified. If it were economically feasible to demolish the building, the appraiser would have to suggest what type of improvements would maximize the land and total property values.

Step 4--Land Value Estimate. Most appraisals (not all) require a separate estimate of the value of the land. A land value estimate is always required when the cost-depreciation approach is used and in some applications of the income capitalization approach. In single family residential appraisals land value is usually estimated by comparison with similar sites that have sold recently.

Step 5--Application of the Three Approaches. The three approaches are discussed in the following section. Generally, appraisers should use all three of the approaches unless there is some compelling reason to not use them all. Having used all three (or those that are appropriate) the appraiser then determines the relevancy of each one and determines the weight to give each in a process called **reconciliation**.

For newer one-to four-family residential properties, the sales comparison approach or cost-depreciation approach may be most relevant and therefore assigned the most weight. For an older residential property the most weight might be assigned to the sales comparison or income approach. For income producing properties including residential income producing properties the most relevant approach would usually be the income approach. If it were a vacant or nearly vacant income producing property the most weight might be assigned to the cost-depreciation approach. For small rental properties, a variation of the income capitalization approach, gross rent multiplier analysis, may be appropriate.

Step 6--Reconciliation of Value Indications and Final Value Estimate. Reconciliation is the process of using judgement to evaluate and weigh the value indications obtained by the approaches used. An appraisal report will usually contain three different value indications (one from each of the three approaches) and the appraiser must **reconcile** these into one final value estimate. The appraiser decides how much weight to give each in order to arrive at a final estimate of value.

Step 7--Report of Value. The last step in the appraisal process is to prepare the appraisal report. It could be a letter report (although a letter report is usually not appropriate), a form report (such as the standard FNMA form), or a narrative report. The type of report to be provided is usually dictated by the circumstances and should be agreed to by the appraiser and the client at the time the appraiser accepts the appraisal assignment.

D. Applicability of the appraisal process to brokers

Although most brokers do not prepare formal appraisal reports, they do employ a valuation procedure in helping sellers establish listing prices and in counseling buyers about offering prices. The analysis performed by such brokers may not be as detailed as the professional appraiser's analysis; however, the procedure should be just as logical and relevant.

The failure to consider any major element, implicitly or explicitly, may result in listing prices and offers that may not result in the best results for the broker's client. It should also be pointed out that a broker's license legally entitles the broker to perform appraisals for clients <u>unless the function of the appraisal is to support a federally related transaction</u>. Real estate brokers may not represent themselves as state certified or licensed unless they are, in fact, also certified or licensed appraisers.

Many brokers become professional appraisers or engage in some appraisal work, in addition to their sales activities. As central participants in market activity, brokers should be able to perform their function more competently and efficiently by an understanding of the appraisal process. Before attempting to perform professional appraisals for a fee, however, brokers would be wise to obtain additional training and education in the field.

II. Types of Appraisal Reports

The type of report provided by the broker will vary with the needs of the client. However, regardless of the type of report used, it should be thorough and complete and should stand on its own without reference to other reports or analyses. The four types of reports are discussed below:

A. Letter report

The **letter report** is occasionally a satisfactory way of presenting an appraiser's value conclusion. The letter report should be used only for simple, straightforward appraisals or when a more complete report is not needed by the client. In addition, the client should be aware that this is the type of report that will be received.

Although the letter may be brief, the appraiser must identify the property and legal interest appraised; the objective of the appraisal report; procedures, approaches, and methods employed; the types of data used; and the value conclusion. Also, all major assumptions and limiting conditions should be stated. Finally, the letter should specify the "as of" date for which the appraisal is relevant.

Even when a letter report is used, the appraiser goes through the same process and uses the same data as in one of the more detailed reports. The same supporting data must be used and must be available in the appraiser's file to defend the value conclusion should such a defense later be required.

B. Form report

Financial institutions typically require **form reports**. A standard form provides an institution's appraisers with a quick and efficient process for doing their work. Review appraisers and loan officers can easily follow and verify the information in a form appraisal. Additionally, purchasers of mortgages in the secondary market such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) specify the form to be used. While it may appear that it can be filled out quickly and easily by an appraiser, it requires the same supporting data as would be included in a narrative report.

C. Narrative report

A **narrative report** is a complete explanation of the appraisal process and literally "walks" the reader through the data and logic such that the reader should be led to the same conclusion as the appraiser. One important fact to remember is that an appraisal report should be able to stand alone. This means that the appraiser should include all the data and analyses performed so that readers can follow the reasoning by which the conclusions are made.

Most appraisal textbooks provide an outline that includes the major elements (and an explanation of the supporting information) that must be included in the narrative report. While some flexibility is allowable using such outlines, appraisers and users of appraisals should be certain that if a major section is omitted, justification is given. This alerts readers to the omission and indicates that it has been considered by the appraiser.

D. Oral Report

Occasionally a client will request an **oral report**. Some appraisers refuse to make such reports and if they do would not accept compensation. When an appraisal report is given orally the same data and analysis process must be used, and the appraiser's files must contain the same support information that would be required for a letter or form report.

Appraisals involving federally related transactions must be in written form. To the extent that it is possible, an oral real property appraisal report must address the substantive matters that are contained in a written report. That is, the appraiser would state the purpose of the appraisal, the type of value estimated, the effective date of the appraisal, etc.

III. Approaches to value

A. Sales Comparison

The **sales comparison** approach to value is sometimes called the **comparable sales** approach or the **direct sales comparison** approach. All three approaches use market data; however, this approach is more direct than the other two.

The sales comparison approach compares the **subject property** (the property being appraised) to **comparable properties** (similar properties that have recently sold). Adjustments are made to the sale price of the comparable property to reflect differences between the subject and the comparable and the manner in which the market tends to react to those differences. For example, if the comparable had a swimming pool and swimming pools tended to increase the value of properties in that market by $20,000 then the sale price of the comparable would be adjusted downward by $20,000. This adjusted price of the comparable would then be an indication of the value of the subject if everything else about the properties were the same. This approach is covered in detail in Chapter 3.

B. Cost-Depreciation

The **cost-depreciation** approach to value is sometimes simply referred to as the **cost** approach. This approach also uses data obtained from the marketplace although it is not as direct as the sales comparison approach.

In this approach the appraiser estimates the cost to construct a reproduction of the subject property, estimates and subtracts accrued (accumulated) depreciation and adds the estimated value of the land or site upon which the improvements are built. The cost-depreciation approach is covered in detail in Chapter 4.

C. Income Capitalization

The **income capitalization** approach to value is based on the stream of income that a property is producing or could produce and what a prudent investor would typically pay for that stream of income. The income is then capitalized (valued based on a rate that the market seems to be demanding on similar properties in the market). The most common method of applying this approach is by using the **IRV** formula (dividing the **net operating income** by the selected capitalization rate to arrive at an indication of value). This approach is covered in detail in Chapters 5 and 6.

IV. Selecting an Appraiser

A. Relationship between selling brokers and professional appraisers

Typically, an appraiser is employed by a person or persons having an interest in a property or someone who needs to make a decision about the property. Because of their relationship with both buyers and sellers, brokers may be called upon to assist in the selection of an appraiser. Brokers who are not involved directly in appraising should know the appraisers in their communities and their qualifications and areas of specialization. Appraisers are registered, licensed, or certified by the state and may belong to one or more of the several professional appraisal organizations.

B. State certification

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) required states to establish appraisal licensing and certification programs for appraisers who may be involved in performing appraisals which support a federally related transaction. Each federal financial institution regulatory agency and the Resolution Trust Corporation are required to set standards that meet the minimum requirements of the Appraisal Foundation, a private entity comprised of the major professional appraiser organizations.

Licensing as a real estate salesperson or broker in Florida legally qualifies one to appraise real estate or businesses. The federal law referred to above, however, limits this qualification to the appraisal of properties not involved in a federally related transaction. Since the vast majority of appraisals are performed to support federally related loans, most professional appraisers are licensed or certified as appraisers. In Florida registered, licensed and certified appraisers are regulated by the Florida Real Estate Appraisal Board.

Florida law provides for four classes of state regulated appraisers:

1. <u>Registered Appraiser</u>: This category is for beginning appraisers who work under and are supervised by a licensed or certified appraiser. The applicant need not have any appraisal experience, and a state exam is not required. However, an applicant must have completed 75 classroom hours, inclusive of school examination(s), of Board approved academic courses in subjects related to real estate appraisal, which must include coverage of the Uniform Standards of Professional Appraisal Practice.