CHAPTER 2. PRINCIPLES OF DWELLING VALUATION

SECTION 1. CHARACTER OF VALUE

2-1. DEFINITION OF MARKET VALUE. Market value is 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.

2-2. SOURCE OF VALUE. The future usefulness of a property is the source of any value it may have. The obvious fact that residential real estate is useful because it provides shelter is significant only when the motives of prospective owners are used as the basis for further examination of the character of the usefulness.

Knowledgeable buyers and sellers in the market examine and view available properties in terms of the probable future benefits to be derived from ownership. Their expectations or their forecasts with respect to the extent, quality and duration of the future benefits are translated into present prices. Buying and selling with these considerations in mind create real estate price levels.

2-3. DEFINITION OF TERMS. The terms used in this section are:

A. Price refers to the total price paid for a property, exclusive of closing costs.

B. Typical buyers refers to buyers who have the needs, and desires and financial capacity most characteristic of the persons who will purchase properties similar to the one under consideration.

C. Appraisal: The act or process of estimating value. In the context of this Handbook, an appraisal shall be taken to mean a written statement independently and impartially prepared by a qualified appraiser setting forth an opinion of defined value of adequately described property as of a specific date, supported by the presentation and analysis of relevant market information.

D. Well informed presumes buyers who have adequate knowledge of the cost of renting and the relative merits of available properties, residential construction costs and lot prices, the prices at which equivalent properties are being sold or can be acquired, and an awareness of the economic factors which cause changes in price levels.

(2-3) E. Acting intelligently presupposes that knowledge of the observed conditions will be used by typical buyers so that determinations as to the wisdom of purchasing, or as to the price to be paid, represent the most advantageous decision.

F. Voluntarily and without necessity assumes freedom for the choice of actions. That is, that a decision to purchase is made solely from recognition of advantages in so doing rather than from necessity due to lack of alternatives. Also, that prospective buyers are in a position to postpone purchasing.

G. Long-term use or investment views the benefits from the usefulness or productivity of the property to an owner occupant or landlord, from the date of appraisal to the end of the remaining useful life of the property, rather than benefits from a resale.

2-4. MARKET VALUE AND MARKET PRICE. A distinction is made between market value as defined above and market price. Market price refers to the amounts that buyers actually pay. Market value refers to the probable prices properties will bring in a competitive open market.

A. Long Term Aspects. Since valuation for mortgage insurance deals with the long term usefulness of a property, the discovery of only the price that may be obtained in the market for the property at the time the valuation is made would be inadequate as the sole conclusion on which to base the "worth" of anticipated benefits. The definition of market value contemplates that HUD's insurance of the loan secured by the property will be in place for up to 30 years. The appraiser's conclusion as to value will be, not what the property can be "sold for," or "bought for," but the price that should be paid for it in view of its long-term productiveness.

B. Market Prices. The level of market prices does not always represent the point of view of buyers who are typical, well informed, acting intelligently, voluntarily, without necessity, interested solely in the future productivity of properties, and acting under conditions of a fairly well balanced relationship between factors of supply and demand.

C. Distinction Between Market Price and Value. Market price levels and value levels may be identical only when there is a fairly well balanced relationship between the supply of and demand for residential properties. The appraiser must ascertain whether or not there is a difference between market price levels and value levels at the time a valuation is made. This determination cannot be based on unsupported assumptions but must be based on substantial data.

2-5. DISTINCTION BETWEEN COST AND MARKET VALUE. A distinction is also made between cost and market value. Value depends on the extent of utility in the future, while cost depends upon outlays for land, labor, and materials which depend upon conditions that do not necessarily deal with factors which create value. Costs are related to value only in that they establish an upper limit of value, since a typical buyer acting intelligently would not be warranted in paying more for a property than the cost of producing an equivalent property. The value of a property may be equal to its cost only in the case of a building which is new and represents the highest and best use for the site when there is a balanced relationship between supply and demand. Since value and replacement cost can be equal, estimates of replacement cost in new construction are used as upper limits for estimates of value, thereby acting as controls on the judgment of the appraiser. However, if there is not more than a three percent differential, the higher estimate of the two may be used. "When market value exceeds replacement cost, the value must be supported by substantial market data. This requires submitting more than three comparable sales typically used on an appraisal report."

2-6. DEPRECIATION. Depreciation is defined as loss in value from any cause whatever. Frequently the term is used in the narrow sense of loss in value caused by physical deterioration, and sometimes it is used to signify deterioration itself. It is essential to understand the nature of the causes of depreciation, not because of any necessity to measure the amount of depreciation which has occurred since the completion of a building, but because of the need to estimate how these forces will probably affect utility or desirability in the future.

2-7. OBSOLESCENCE. Obsolescence refers to those changes in usefulness of structures in certain neighborhoods which cause them to become less desirable or less useful. It operates to terminate the economic life of a building. Obsolescence does not affect physical life as it does not cause deterioration. It has greater significance in valuation than does deterioration. It is caused by:

A. FUNCTIONAL

1) New inventions and discoveries;

2) Changes in the preferences and tastes of the public, with regard to styles of architecture, geographical locations as places of residence, sizes of rooms, heights of ceilings, the extent of mechanical equipment, such as plumbing and heating, etc.;

B. ECONOMIC

1) The infiltration of inharmonious land uses, as when commercial and industrial uses are introduced into residential neighborhoods,

(2-7) 2) The failure of substantial numbers of property owners in the neighborhood to maintain their properties in good condition; and

3) Changes in land values which result from changes in the highest and best uses for which land is suited.

2-8. DETERIORATION. Deterioration is the decay and disintegration which takes place in structures with the passage of time. Deterioration is caused by natural forces, by the elements, and by use. Deterioration operates to terminate the physical life of a building. Both deterioration and obsolescence cause a lessening of utility and thereby result in depreciation, that is, loss in value. The forces which cause deterioration and obsolescence operate continuously. Even though they may or may not operate in the future in the same manner as in the past, greater accuracy in estimating how they may operate in the future is attained by studying the manner in which they have operated in the past.

SECTION 2 - BASIC PRINCIPLES OF VALUATION

2-9. VALUATION PRINCIPLES. There are certain principles used in the appraisal of residential properties. These include:

A. Principle of Supply and Demand. The demand for a commodity is created by scarcity. The greater the supply of a commodity available, the lower will be its value.

B. Principle of Change. Nothing remains static. Value of a property is derived from its future, not its past. The appraiser must be aware of change, and any of the indications of change. The appraiser must be aware of the stage a particular neighborhood is in, and be able to define its position in its life cycle.

C. Principle of Competition. In an active real estate area, high profits to one or more builders attract competition.

D. Principle of Conformity. To obtain its maximum value, the property must conform in general terms to its existing surroundings in size, age, condition and style, and should attract an occupant of similar economic status.

E. Principle of Increasing and Decreasing Returns. The value of the property is governed by the contribution made by the tour agents of production: labor or wages, management (coordination), capital investment in building and equipment, and the land. This principle affirms that larger amounts of the agents of production will produce greater net income up to a certain point. At this point, the maximum value will have been developed. Any additional expenditures will not produce a return commensurate with the additional investments.

F. Principle of Contribution. The principle of contribution is actually the principle of increasing and decreasing returns applied to a portion or portions of a real property. According to the principle of contribution, the value of an item of production is measured by its contribution to the net return of the enterprise. Enterprise in this sense means the combination of all items of production such as land, buildings, and all other improvements.

G. Principle of Substitution. A buyer, in any case, is not warranted in paying any more than substitute properties would currently cost to acquire.

(2-9) A substitute property is one which affords advantages equal to the one under examination and is also subject to equal disadvantages. The substitute may be an existing property or it may be a duplicate which may be had by acquiring a site and constructing upon it new building improvements.

H. Principle of Highest and Best Use. The highest and best use of a real estate site is that use or succession of uses which makes the land most productive. In determining highest and best use, the test is to discover which program of future use is capable of developing the highest return on the land over a substantial period of time. Highest and best use does not refer to a building of the greatest size that someone could be induced to erect. The concept of highest and best use is without meaning unless building improvements having different functional designs are included in the comparison of available uses.

2-10. BASIC VALUATION PROCESS. The purpose of valuation, definition of value, valuation principles, and the practical limitations of appraisal data dictate the basic valuation process. The process embraces:

A. A study of the future use of the property and of the motives of possible prospective owners;

B. A forecast representing the most probable series of expected future returns to be derived from continuous ownership of the property; and

C. An analysis which converts the expected returns into a present price, that is, an estimate of value.

2-11. DETERMINATION OF RIGHTS INCLUDED IN PROPERTY. The word property refers to rights which are possessed through acquisition of title, that is of ownership. The concept of ownership embraces the rights of possession, control, enjoyment, and disposition. It is these rights in relation to a specific property that must be valued. The rights must be known before they can be valued. The extent of the rights depends upon the nature of the title that will be held by the party whose rights are being valued.

A. Fee Simple Title. Fee simple absolute may be defined as "the largest possible estate in real property." There are other forms of holding title to real property, such as fee determinable and conditional. There are also various ways of holding title such as life estates and remainders, joint tenancy, and tenancy by the entirety. Regardless of the nature of title, the rights of an owner even though exclusive, are never absolute for they are always subject to the rights of the sovereign authority, such as the right to tax, to regulate and control as by zoning ordinances or other legislative enactments, and the right of eminent domain.

(2-11) B. Easements and Other Restrictions to Rights. If a title is encumbered the rights are correspondingly restricted and may be less valuable, depending upon the nature of the encumbrances. Examples are encumbrances in the nature of easements, reservations, restrictions, and rights-of-way.

C. Lessee, Lessor Rights. The term "property" may refer only to the rights established by a lease. A lease is an agreement under which the tenant (Lessee) acquires certain rights in a real property for a designated period of time from the Landlord (Lessor). The Lessor is usually, but not always, the owner of a property. The terms and conditions of a lease must be ascertained before the lessee's or lessor's "property" can be valued.

D. Delineation of Rights as a Prerequisite to the Value Estimate. Property rights generally include the right to use and occupy, the right to lease to others, and the right to encumber or sell. The exercise of these various rights results in the realization of benefits. The extent and nature of the rights determine the extent and nature of the benefits which, when compared to other properties that contain the same rights and benefits, indicate the value to be ascribed to the property or rights to the property. The benefits cannot be valued except in consideration of certain assumed characteristics and motives for ownership, such as the right to occupy, or to lease, or to mortgage or sell that vests in any owner holding title in fee simple unencumbered. An owner might occupy the property and value it because of its desirability as a place of residence for his/her family, or an owner might value the property because of the net rental he/she can realize from it. After delineating the property, or rights to be appraised, appraisers are required to value them from the point of view of typical buyers to whom the property exerts its strongest appeal.

2-12. ESTIMATION OF RETURNS FROM PROPERTY. Returns from property relate to either future direct services or the amenities which will be enjoyed by an owner-occupant, or to dollar incomes which are the source of value to an investor. The forecast must embrace the entire future. It is incomplete if it includes only a forecast of services or returns which are expected to accrue during the next year, a typical early year, or "on the average" in early years. Future services of properties are best conceived if they are visualized as being in the form of a flow of returns. The returns will be periodic services which include shelter, enjoyment and pride of ownership, or net dollar income. All forms of returns should be considered as a flow of benefits, whether they take the form of direct satisfactions or dollars.

A. Trend and Flow of Returns. In urban residential real estate, the flow of returns is present only when the site is occupied by useful buildings or other programs of use. Undeveloped vacant land is presumed to become productive shortly after the completion of

(2-12) construction. Typically, the flow of returns will rise rapidly to a maximum rate in the early life of the improvements and gradually decline during midlife and late life until the improvements have finally lost profitable usefulness and the flow of returns is only large enough to justify purchase of the property as vacant land. (However, see Gentrification, page 4-6.)

B. Net Return. The difference between the value of total services or total revenues of a property, and the expenses and taxes, is the net return. As the value of a property arises from its capacity to produce net returns, the characteristics of the future net income stream must be forecast in valuation.

1) The future net income stream has three characteristics:

a. Quantity, or the size of the income stream at the time of appraisal and thereafter;

b. Quality, or the possible fluctuation in size of the income stream; and

c. Duration, or the period of time during which the income stream in any size will endure.

2) Physical deterioration and obsolescence will decrease the average amount of net returns in the future, thereby decreasing the margin between amounts of net returns and the periodic amounts which represent a fair return on the value of the land. The services of buildings are limited to duration owing to the fact that buildings will eventually become useless due to the action of forces which cause deterioration, disintegration, and obsolescence. Therefore, the portion of the net income attributable to the building, whether measured in services or dollars, is not only of limited duration but subject to decline during the period of its continuance. Gradually, the value of improved property may decline until eventually only land value remains. At that time, the building has reached the end of its economic life.

2-13. OVERIMPROVEMENT AND UNDERIMPROVEMENT. An overimprovement is an improvement so costly or so large as to produce land returns lower than those which could have been produced on the same site by a smaller or less costly improvement. An underimprovement is an improvement which, because of its size or cost, produces a land return less than could have been produced on the same site by some larger or more costly improvement. Both overimprovement and underimprovement fail to develop fully the potential capacity of the site. The estimated market price of the site is not modified or changed in instances of over or underimprovement, but the total value of a property may be adversely affected. (Principle of Highest and Best Use.)

2-14. DWELLINGS ON HIGHER-USE SITES. There are cases in which a property to be appraised consists of a single-family dwelling upon a lot suitable at the time for commercial or multifamily residential use.

A. If a site used for a residence is found to be zoned for business use or if it fronts upon a street, portions of which are being devoted to commercial purposes, the estimated market price assigned to the lot should not be equal to the estimated market price of another nearby site which actually is being profitably used for commercial purposes even though at the time the highest and best use of the subject lot is for commercial use. The lot value assigned shall be for residential use, not commercial use.

2-15. MECHANICAL EQUIPMENT AND ACCESSORIES. Equipment which is part of the real estate is included in value if the equipment is appropriate for the dwelling. If, however, the equipment is too elaborate in relation to the property, or if the typical buyer cannot afford the cost of operating the equipment, it will not enhance the value of the property to the full extent of its cost. Examples might be such things as swimming pools, saunas, etc. The appraiser must determine to what extent, if at all, the value of the property is enhanced by the equipment. In cases involving rental properties, special mechanical equipment enhances value only to the extent that it increases net income. This applies to existing equipment as well as to new equipment proposed to be added.

SECTION 3 - ACCURACY IN VALUATION

2-16. ACCURACY IN VALUATION. Accuracy in valuation is dependent on the quality and adequacy of the supporting data and the degree of proficiency with which the data items are analyzed. Incorrectness or inaccuracy of valuations result from various causes, such as:

A. Misconception of the objective and purpose for which the valuation estimate is made.

B. Lack of judgment and experience.

C. Haste and carelessness.

D. Inadequate data or data of poor quality.

E. Incorrect interpretation of data

F. Incorrect method of valuation.

G. Faulty application of correct method.

H. Influence on appraiser.

The valuation process requires gathering, analyzing and interpreting a great volume and variety of data. One must avoid merely corroborating a predetermined unsupported conclusion. Also, because the necessary data are gathered piecemeal, one is in danger of assigning greater importance to some of the data than they are rightly entitled to receive, thus reaching a conclusion which is premature and unsound. Opinions with respect to values should take form during the process of the appraisal by direct and simultaneous comprehension of all factors as much as by the detailed method itself.

2-17. PLAUSIBILITY. Accuracy is derived only when the integral and final estimates are characterized by plausibility. Estimates should always be set at the most reasonable, most fair, and most likely amounts, as opposed to placing them at possible extremes.

2-18. BRACKETING. In establishing criteria to determine plausibility and probability, they are tested in terms of possible upper and possible lower limits of items, thereby "bracketing" the zone within which the final estimate should lie. Next, the limits are narrowed as much as

(2-18) possible, and a figure between the narrowed limits is selected as the estimate. It may not always be precisely midway between the limits, but in general the bracketing process does conclude with a strong presumption of correctness attaching to some one level of estimate.

For example, the comparable sales selected should be within the value range of the neighborhood. This is the first step in "bracketing." Next, each comparable must be adjusted to the subject which further narrows down the differences between the comparables and provides another bracket within which the market value falls.

2-19. FINAL CONCLUSION. The estimate of value is the price which a well-informed typical buyer would pay for the property appraised rather than the maximum price which could be obtained if the property were offered for sale. Consideration will be given the prices at which other equally desirable properties of like characteristics can be obtained from well informed sellers who, when selling, would be acting intelligently, voluntarily, and without necessity. The advantages of renting will be contrasted with the advantages of buying, as indicated by comparison of the cost of renting and cost of buying, and many other items will be considered to which attention is drawn in this handbook. The buyer will not be especially interested in or greatly influenced by what the property has cost someone else in times past, although the buyer will desire such information. The buyer will be vitally interested in the ability of the property to produce a stream of future benefits for him/her if, being a typical prospective owner, he/she were to purchase it. The characteristics of this stream of benefits - its present size, the extent of any probable diminution in its size in the future, the certainty of the continuation of the flowing stream, and the length of the period during which the flow may be expected to continue - will determine the price which the buyer is warranted in paying and, hence, the value of the property.

A. Undervaluation and Overvaluation. Unduly liberal or conservative attitudes should not be allowed to influence the quality of an estimate used in valuation. Undervaluation and overvaluation must be avoided. There is no virtue in undervaluation of properties, and great risk of loss to all concerned is introduced by overvaluation.

B. Speculative Elements. Speculative elements cannot be considered as enhancing the security of residential loans. These elements not only contribute to wide fluctuations in market prices, but increase the risk of loss to mortgagees who permit them to creep into the valuations of properties upon which they make loans.