CHAPTER 6. APPROACHES TO VALUE

6-1. GENERAL. The estimate of the market value represents an all-cash price to the seller. This assumes that typical buyers will take advantage of the most favorable mortgage financing available in order to pay the seller all cash. The estimate does not assume that the seller will finance the buyer in part or in whole by accepting a first or second mortgage on the property in lieu of cash. The estimate assumes the property in fee simple unencumbered by special assessments or ground lease. The cost of acquiring a substitute property by outright purchase, like the cost of assembling a duplicate, is an upper limit of value.

Although the Department places more reliance on the market approach, there are instances when the cost and income approaches are required.

A. For a one family dwelling more than one year old only the market approach to value is required.

B. When the subject is a two-unit building, the appraiser should give some consideration to the income approach as well, but it need not be a controlling factor.

C. If the subject is a three- or four-unit building, the income approach must be used in addition to the market approach. While the income approach would be given the most weight, the appraiser must also consider the market value in arriving at the final estimate of value.

D. When there is an unbalanced market of high demand and short supply, and market prices appear to be excessive, the Chief Appraiser should consider requiring the use of the cost approach as well as an upper limit of value.

E. For new and existing properties less than one-year old, both the cost and market approaches must be used; if it is a three- or four-unit building, the income approach must be used as well. When the difference between the estimates of value is 3 percent or less, the best supported estimate may be used for the final estimate of value.

F. For substantial rehabilitation or Section 203(k) applications, replacement cost is to be used, as well as market value.

G. If the property is in an area designated by the Regional Administrator as "investor-dominated", and is subject to

(6-1) modified cost, the modified cost approach, as described in this Chapter must be used.

H. If the site on which the improvement is placed is subject to a leasehold, the leasehold approach to value, as described in this chapter must be used.

All appraisers serving on the fee panel must be knowledgeable about and able to use all approaches to value.

SECTION 1. MARKET APPROACH

6-2. USE OF MARKET PRICE IN VALUATION. Estimates of market price are not necessarily equal to estimates of value for long term use. Market price indicates the price at which a property was currently bought or sold, and that value may exist in an equivalent amount. The relationship of value to estimated market price must be determined through analysis of all circumstances affecting the property and the transaction.

In a reasonably balanced market, with comparatively stable economic conditions prevailing and sufficient relevant sales and listings available, the market approach is the most reliable method of estimating value. Like all other estimates, it must be considered and weighed with good judgment and compared with conclusions of value arrived at through other methods of estimation. The importance and reliability of sales, listings, and offers as indicators of value decrease in periods of rapidly changing price levels, or in periods when housing supply and demand are clearly not in balance. During such abnormal periods adjustment must be made not only for the differences in the properties, but also to reflect the amount attributable to the unusual conditions existing in the market.

6-3. EXCLUSION OF NON-REALTY ITEMS. The selling or contract price is the total amount received by the seller from the buyer. Closing costs and items of prepaid expenses are not included in the Estimated Market Value. It is the practice in some instances as an inducement to buyers, to offer and to sell properties at a price which includes items in addition to the real estate such as personal property items not acceptable as mortgage security. Therefore market data used in estimating the market value must be studied to determine that they do not include amounts for items of this nature which are typically paid by the buyer in addition to the contract price.

In some areas of the country, items such as stoves and refrigerators are considered part of the real estate. In other areas, these items are considered personal property and are not included in the sales

(6-3) price. Therefore, the appraiser should view these items in accordance with local custom. If such items are included in the contract in an area where they are not customarily included, the appraiser must estimate the value of the items, deduct their total value from the total reconciled value, and explain in comments section of the URAR.

6-4. USE OF MARKET DATA CONCERNING BUYDOWNS AND INCENTIVES TO BUY. The sales price of properties which offer the purchaser a cash refund by means of a monthly payment reduction plan (buydown or similar arrangement) is not to be used as comparable sales data unless the worth of the total refund is deducted from the sales price to reflect the true all cash payment to the seller. Appraisers must make a dollar for dollar adjustment to comparables where the seller's contribution exceeds limits established by HUD, currently six percent.

A. Seller buydowns are payments for discount points, any type of interest payments, or seller payment of closing costs normally (under local market practice) paid by the buyer (including the one percent loan origination fee). The sales price of the comparable is selected as the base for making the adjustment in order to simplify the process. To provide an abbreviated example:

Sales Price of Comparable			$75,000
Dollar Amount of Seller Buydowns:	$8,750		
Less: six percent of sales price	4,500	(excess)	4,250
Adjusted Value of Comparable Property			$70,750

To the extent possible appraisers should select comparable sales from properties which sold without the benefit of various seller buydowns in excess of six percent. When comparables are not available without these types of incentives, adjustments must be made to the sales price of the comparable to better reflect the cash equivalent value of the property.

B. The instructions above, particularly the six percent allowance, relate to seller buydowns as defined. Where sellers use other known incentives such as trips, non-realty items, monthly payments to principal, homeowner association or condominium association fees, and similar gifts as inducements to purchase, reductions in the sales price of the comparable must be made on a dollar-for-dollar basis from the first dollar, without regard to the six percent allowance. These instructions apply both to new construction and sales of existing properties.

The appraiser will he responsible for making appropriate notations on the URAR explaining all adjustments made.

6-5. MARKET COMPARISONS. In order to make the estimate of market value it is necessary to thoroughly explore the market to determine the price at which competitive properties are being offered and sold. It is necessary to consider data from competing neighborhoods within the area as well as data from the neighborhood. This data will serve to indicate a range within which the market price of an equivalent property will fall.

6-6. SELECTION OF COMPARABLE PROPERTIES (Bracketing). In the selection of properties for comparison it is desirable to choose some that are equivalent and some that are nearly equivalent to the subject property. For properties to be equivalent they must provide equal accommodations, approximately the same number of square feet, the same total number of rooms and the same number of bedrooms, bathrooms, and so forth, and must be equally desirable to the same group of occupants. Nearly equivalent properties should include some better than the subject property and some not as good, to establish a market price bracket for an equivalent property, in order that comparisons can be made within the bracket. The properties selected for comparison should furnish accommodations, livability, and amenities within a range of similarity to the subject property and within a price range that would be acceptable to typical purchasers. For instance, a prospective purchaser may desire a 3-bedroom, 2-bath ranch-type house in an outlying neighborhood readily available to rapid transportation to the downtown area. This purchaser may be willing to accept a 3-bedroom, 1-bath house in a similar location, or he/she may accept a 2-story, 3 or 4-bedroom house in a relatively close-in location. He/she will ultimately purchase the property containing the greatest number of elements desired, for the lowest price, limited of course by ability to pay. In selecting the comparative properties utility is the initial basis for selecting comparables; price is secondary.

6-7. USE OF CONVENTIONAL SALES DATA. When using conventional sales data, the appraiser must be aware of the terms of the sale and adjust the conventional sales price to reflect any unusually favorable terms. In the case of a property sold with two or three mortgages or trusts, the going rate of discount must be determined for the second and/or third and the sales price reduced by the amount of the discount. It is better to avoid such transactions if single mortgages, trust, or all cash conventional sales are available. Sales made by contracts for deed (land contracts) shall not be used as conventional data due to the difficulty of determining discount rates and unusual term arrangements.

A. When using sales data in appraising inner-city properties, the appraiser must exercise extreme care to ensure that the property selected for comparison is as nearly like the subject property as possible. The appraiser should examine the comparable

(6-7) information carefully to determine the terms of sale and the condition of the comparable, visually verify the description of the property, and note any advantages or disadvantages found in the neighborhood. The appraiser should carefully adjust the sale to reflect conditions found.

6-8. EVALUATION AND USE OF MARKET DATA. In evaluating market data, the appraiser determines:

A. If a sale, whether the price resulted from a normal transaction under free and competitive conditions where the buyer and seller acted intelligently and without duress, and were not motivated by unusual or capricious desires; or,

B. If a listing, whether the price quoted is at or near the price at which the property may be expected to sell rather than a price to "test the market" or a price that would induce the owner to sell although he has no particular desire to sell; or

C. That the data are factual and reflect the current market reaction to pertinent factors of supply and demand. Generally speaking, however, listings are not acceptable as comparables since they represent the highest price for which a property is likely to sell. Listings may be shown on an addendum to indicate the asking prices in a neighborhood, but only in extremely unusual circumstances, such as an area in which there has been virtually no activity for some time may they be used. In those cases, the appraiser must verify all information and discount as necessary to make a judgement as to the amount for which the property is anticipated to sell. When a listing or listings are used, the Reviewer must check data to verify that there have been no sales in that area for some time.

6-9. QUANTITY OF DATA. There must be a sufficient number of transactions used for comparison to firmly establish the present market attitude toward the subject property. A limited number of sales or listings may be sufficient when appraising a property of a design that is typically constructed in comparative neighborhoods. A property of unusual design will present a more difficult appraisal problem and may require an extensive list of comparisons.

6-10. MARKET PRICE COMPARISONS. The existence of rapidly rising or declining prices of residential properties, as indicated by data, must be recognized in the appraisal. The appraiser will analyze the data and determine the rate of increase or decrease in residential prices. The rate of increase or decrease from the date of the sale of the comparable to the date of the appraisal will have an effect on the value of a property and must be considered. The appraiser will

(6-10) adjust the sales price of the comparables by the rate of increase or decrease for the appropriate time, (three months or more) to determine a range of indicated value that is relevant to the current market. It is not appropriate to adjust listings for any applicable rate of increase.

A. Market Price Comparison. Market price comparisons are made using sales and listings of competitive properties as guides in estimating the amount likely to be paid for the property under appraisal. Experienced appraisers familiar with the market in the community rely on their experience and comprehensive knowledge of current sales and listings to make a preliminary estimate of the price range in which the property under appraisal is likely to fall. Thus, sales and listing data should cover the broad range of the market including FHA, VA, and conventional transactions.

B. Preliminary Price Comparison. Each appraisal report will contain at least one conventional comparable, if available, and be so designated on the appraisal form. The data should include comparable sales in competing neighborhoods and should not necessarily be limited to the subject neighborhood or subdivision or block. Sizes, accommodations, locations and date of sale are considered in this preliminary process of establishing a price range.

C. Specific Estimate. A more specific estimate of the market price must be made somewhere between the upper and lower limits of the preliminary price range. This is done by a more detailed comparison of the subject property with those selected as comparable. This refining or pin-pointing process includes making lump sum allowances for plus or minus features.

6-11. ADJUSTMENTS. In making adjustments to equalize the comparable properties to the subject property, the appraiser should adjust only where the reason for the adjustment has a substantial effect on value. "Site/view" for example is not usually adjusted in an urban or suburban area because there is not usually much difference between size of sites or the view. In most neighborhoods sites are of typical size and may range from 50 by 100 feet to 60 by 100 feet, or 50 feet by 100 feet to 50 feet by 120 feet. Size alone is not necessarily a reason for adjustment. Topography is of far greater importance. If a lot is much larger than others, it may be far less desirable if it has a steep slope rather than a gentle slope or is of unusual shape, such as a triangle.

(6-11) With respect to "view," most urban and suburban dwellers see only the streets and homes surrounding them, so it is difficult to justify a difference in "view." One instance in which an adjustment for "view" is justified is if within a neighborhood, one side of a street may overlook a city or picturesque valley and is sufficiently pleasing to warrant more desirability, thereby increasing its value.

A. "Location" adjustments are also very seldom justified. If the comparable is within a reasonable distance from the subject, as it should be, and is in the same typical surroundings and environment, there should be no reason for an adjustment.

In summary, if the appraiser has selected similar properties within a reasonable distance from the subject property, there should be only a minimal number of adjustments to equalize the comparables to the subject property.

6-12. RELIABILITY OF SALES DATA. Consideration must be given to factors surrounding the sale of a comparable property such as date and terms of the sales transaction. In some instances the price paid may have resulted from necessity or nontypical points of view of an individual purchaser. The bargaining process between a buyer and seller or their representatives may affect the amount paid resulting in a sales price above or below the general market level for such a property.

A. Sales data are reliable to the degree that they embrace information which accounts for the prices paid including:

1) The motives of the buyer and the seller.

2) Relative skill and intelligence of the buyer and seller in negotiating the sale.

SECTION 2. REPLACEMENT COST

6-13. USE OF REPLACEMENT COST OF PROPERTY IN VALUATION. In accordance with the principle of substitution the upper limit of value is the cost of replacement of the property assuming the building improvements to be in new condition. Therefore, the replacement cost of property is estimated to make possible the application of the substitution principle. Estimates of replacement cost of property are not estimates of value, although they indicate the possibility that value in an equivalent amount may exist. Value depends entirely upon usefulness, not upon the cost of replacement. Value tends to conform to cost, but this is not to imply that it is always equivalent to cost.

A. Typical Replacement Cost. The replacement cost estimate must reflect the costs typically found in an area and not necessarily the costs of a particular builder or owner.

B. Unusual and Non-Typical Costs. Some of the items or allowances in the cost estimate may not represent equivalent value in a particular case. An owner might erect a house which would cost more than the houses which generally characterize the neighborhood, but the value of the home to the typical prospective owner in that neighborhood might be less than the replacement cost of the property. Cost of construction also may be in excess of value at a given time because under some circumstances a reduction in cost may be in prospect. If construction costs decline, value may also decline if it was originally equal to cost.

6-14. CONDITIONS UNDER WHICH VALUE EQUALS REPLACEMENT COST. The value of a dwelling property may be equivalent to its replacement cost only if:

A. No decline in the level of construction costs is in prospect;

B. The building improvements are in as good condition as new;

C. The building improvements represent the highest and best use for the land;

D. The replacement cost and the expense of maintenance and operation of the mechanical equipment and accessories are not excessive when related to the income group which comprises the market for the property.

(6-14) E. The replacement cost of the property does not exceed the price at which equivalent completed properties may be purchased; and

F. There is evidence of continued demand for such residential property at a price equivalent to its replacement cost.

6-15. PRINCIPLE OF SUBSTITUTION. In accordance with the principle of substitution, the estimate of replacement cost of a property must include all items of expense which a typical prospective owner would meet in acquiring a property and duplicating its improvements upon an equivalent site. Such an estimate would include:

A. Estimated replacement cost of on-site improvements in new condition.

B. Estimated market price of an equivalent site.

C. Miscellaneous allowable costs.

It would not include costs incurred in the transfer and acquisition of title which must be paid in addition to the contract price of the property. These are included under Closing Costs.

As a practical matter, it is generally found that most construction cost data are obtained from builders building for sale rather than from contractors bidding competitively. For this reason only, a fourth category of costs is included in the estimate of replacement costs, i.e., marketing expense. The inclusion of this item along with operative builder construction costs is considered justified on the assumption that the operative builder costs, including overhead and profit and marketing expense, will not exceed the cost to an individual who employs a contractor to construct a dwelling on his/her own site.

6-16. REPLACEMENT COST OF ON-SITE IMPROVEMENTS. The Marshall and Swift square foot method will be used for all proposed and existing properties under one year of age.

A. Since the square foot method is a simplified procedure, all appraisers must have the knowledge and skill to prepare the Marshall and Swift Form #1007 when necessary except for the exceptional case involving custom built homes or unique building types requiring the segregated method.

B. Construction with which HUD is involved should most probably be "fair," "average," or "good" quality. Basically, mass produced, tract-built homes are either "fair" or "average," meeting only

(6-16) the minimum construction requirements of lending institutions, mortgage insuring agencies and building codes. Appraisers must be sure to review the basic description of each quality type.

C. The appraiser will prepare the Marshall and Swift Form #1007 (or #1008, as appropriate) for each proposed construction case in accordance with the construction quality of the property as shown in the Marshall and Swift Cost Handbook. The pages from which the appraiser obtained the figures (usually two pages) are to be xeroxed on an 8-1/2 x 11 sheet of plain paper, with the cost figures encircled, and attached to the Form #1007 (or #1008), as shown in the sample on page 6-13a and b. This procedure will simplify the desk review since the desk reviewer need only check the quality type and compare the figures used by the appraiser with the attachment and the accuracy of the mathematical calculations.

D. Marketing expense is calculated on the total amount obtained from addition of the replacement cost of improvements and the current cost multiplier (line 28) divided by the complement of the marketing expense.

For example: Assuming local market expense is 6%. The complement of 6% is .94; therefore, if the sum of the items mentioned above is $42,356, the marketing expense will be $2,704, indicating a total replacement cost of $45,060. ($42,356 : 94% = $45,060 minus $42,356 = $2,704.)

E. This calculation is then entered on the Marshall and Swift Form by crossing out line 30 and entering Marketing Expense as shown in the example which follows. To this amount is then added the estimated value of an equivalent finished lot (line 33). (See page 6-13B)

F. Upon completion, the Marshall and Swift form and the attached page of encircled cost figures are to be attached to the URAR.

G. Field Offices and Direct Endorsement Mortgagee Underwriters, as well as appraisers, must ensure that their Marshall and Swift handbooks are kept current at all times.

6-17. ESTIMATED MARKET VALUE OF AN EQUIVALENT SITE. To determine the market value of an equivalent site, it may be necessary to use one or more of the three different methods of analysis. The three methods are: (1) Market Comparison, (2) Land Residual, and (3) Production Cost Method.

(6-17) A. Market Comparison. Where available sites are in supply sufficient to result in free sales transactions, the estimate found by comparison will carry the greatest weight. As this supply diminishes, the estimation processes will progress through the Land Residual and Production Cost methods. These methods are used in those instances when the factual data for Market Comparison are found to he inadequate or inconclusive.

They can, however, produce amounts which may serve to bracket and prove the range within which the estimated market price of an equivalent site will be plausible and acceptable.

1) The market comparison method should be used whenever possible. A price currently being paid in the market for sites offering similar utility and amenities establishes a solid basis for a defensible conclusion.

2) Consideration will be given to those factors, both favorable and unfavorable, recognized by the typical purchaser (i.e., neighborhood desirability, topography, trees, size and utility of site, adequacy of utilities and street improvements, etc.). In making a market price comparison, consideration should include vacant sites having utilities, etc., installed and ready for improvement with dwellings. Transactions involving single or small group purchases in newly improved areas offer a better comparison than large group purchases. They will also provide better comparison than the prices paid for isolated remaining sites in built up neighborhoods. In the use of comparative data, the Appraiser will consider the circumstances surrounding each sale or offering.

B. Land Residual. Most localities provide a sufficient number of comparisons where the replacement costs and prices of newly constructed homes recently sold would approximate those in any proposed case. By breaking down the total sales price, it is possible to discover the maximum sum attributable to land. Thus, if in the subject or competing neighborhoods the typical homes are selling at $75,000 and the cost of all buildings and on-site improvements including marketing expense is estimated at $60,000, obviously the land represents no more than $15,000 of the total. This is the Land Residual approach in which the sum of $15,000 will represent the maximum and probable amount attributable to land.

C. Production Cost. The production costs currently required to be expended by a developer to produce sites in an active sales

(6-17) market are often indicative and useful. Any analysis of the separate cost items, however, demands comprehensive study to determine their reasonableness and reliability.

1) Included in this list of items will be:

a. Supportable raw land costs.

b. Typical costs encountered in the installation of utilities and improvements, including the cost of underground utility wiring wherever required.

c. Engineering and legal expense: title and legal expenses incidental to acquisition; engineering and recordation of subdivision and dedication plats.

d. An overhead and Profit allowance that is logical, based on local custom rather than a fixed amount or percentage.

e. Carrying charges for a comparatively brief period.

f. Additional cost to retain mature and attractive trees or to substitute with new planting.

2) Raw acreage land costs are developed in the market by comparison. In the comparative process, consideration is given the area and dimensions of compared parcels especially as such factors may have a bearing upon the platting of the land, the availability of utilities or cost of extension, convenience to urban centers, etc. Current market data in the form of sales and asking prices will be studied, and any unusual circumstances surrounding each transaction or proposal will be given proper consideration. In considering parcels offered for sale, consideration will be given the absorptive capacity of the community, inasmuch as available land may over supply the need for building sites and list prices may not be firm.

D. Correlation and Final Estimate. The estimate of the market value of a site is made by considering all pertinent information. If market data are adequate in amount and quality, this approach will be the control since it is the most reliable. If Land Residual and Production Cost Methods are also used, correlation of the three approaches should be indicative of market price. The accuracy of the final estimate will depend upon the proper assembling, analysis and judgment of the data by the appraiser.

(6-17) 1) When estimates of market values are being made simultaneously for a number of sites within a subdivision, differences in characteristics, if any, must be taken into account and reflected in the estimates.

2) Indiscriminate assignment of the same market value to every site in a subdivision without regard to differences

in characteristics is illogical and contrary to sound appraising.

E. Value of Trees. Among other neighborhood amenities, the presence of suitable mature trees in the neighborhood will add to its attractiveness and improve the general level of marketability. Land suitable for subdivision development will be made desirable by the presence of mature trees which can be retained as a part of the finished property. Developers should therefore be encouraged to retain those trees which will increase the amenities of residential properties. This added attractiveness will be reflected in the individual lot prices which will usually be higher when compared to lots in neighborhoods without trees. The attitude of the typical purchaser as expressed by market prices paid for properties will determine the price increase which should be reflected due to the presence of trees of established growth. The physical condition, type, and location of the trees with respect to each site are also important considerations.

6-18. SITES SOLD BY A PUBLIC BODY. Where sites are sold by a municipality or other public body to a developer for specific reuse purposes, the market value of an equivalent site estimate will be the lesser of (1) the amount found by comparison with other sites having the amenities and improvements that the subject site will have upon completion, and (2) the dollar amount paid by the purchaser as set forth under the terms of the purchase contract with the public body, plus an estimate of those costs required by the contract or the cost to fully improve the site, i.e., the production cost but excluding profit. This policy is applicable to all Sections of the National Housing Act.

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SQUARE FOOT APPRAISAL FORM

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SECTION 3. CAPITALIZATION OF INCOME

6-19. GENERAL. Classic appraisal practice offers two methods of appraising two to four unit residential structures. Both methods consider the type of neighborhood in which the properties are located. If the property is located in an area of typically non-occupant owners, then the property is considered to be owned for its rental income and thus is capitalized using the rental returns as the basis for value. When the property is located in an area that is predominantly owner-occupied, or one in which the owner lives in the property and is primarily interested in the amenity returns of the property, the market comparison approach is used. Appraisals will be performed in accordance with the subsequent instructions.

A. When one side of a two unit property is owner-occupied, the Department requires only the market approach. If a two unit property is located in a predominantly rental neighborhood and is not owner occupied, the income approach as well as the market approach should be used.

B. All three and four unit existing properties must be appraised using both the income and market approaches. Values should be ascertained using gross rent multipliers as a guide in addition to using direct market comparisons.

C. Proposed construction or new properties less than one year old must be processed using the cost approach as well as the income and market approaches for income properties.

6-20. VALUE OF RENTAL INCOME PROPERTIES. In appraising rental income properties, the value indicated by the capitalization of rental income arises out of the primary appeal of the property as an investment. In usual circumstances, such value by capitalization will approximate or equal the cost of acquiring an equivalent property. In rental income cases, the Estimate of Value (excluding closing costs) will not exceed the lower of the Value of the Capitalized Income, or the Estimate of Market Price.

6-21. DETERMINATION OF RENTAL VALUE. Rental value refers to the amount which prospective typical tenants are justified in paying for the use of a property. The monthly rent which typical year-round tenants would pay for the use of the subject property is its rental value. This concept presupposes that tenants have knowledge of the rentals paid and asked in the community and that they will pay no more than the lowest rental at which competitive accommodation are available.

6-22. BASIS OF THE ESTIMATE. The estimate of monthly rental value assumes that the dwelling is unfurnished. Dwellings are considered to be unfurnished even though equipped with ranges, refrigerators, or other items of equipment if the equipment is customarily included in similar properties offered for rental. The estimate of monthly rental value also assumes that the landlord will furnish those services (electricity, gas, water, heat) that are customarily furnished by owners offering dwellings of similar type for rent.

6-23. SEASONAL RENTAL. Monthly rentals obtainable from seasonal occupants in areas in which there are wide seasonal fluctuations in rents, as in summer or winter resorts, shall not be used to estimate the monthly rental value. The estimate of monthly rental value must be based upon that amount which a typical tenant would be warranted in paying for the right to occupy the premises on a year-round basis.

6-24. GROSS RENTAL ESTIMATE. The Gross Rental estimate is the gross monthly rental value of the property without loss of rent from any cause. The rental value estimate is the sum of the rental values of the individual units.

6-25. BASIS OF COMPARISON. All rental estimates must be on a comparative basis. In determining monthly rental value, competitive rents asked for or paid for equally located accommodations must be ascertained. Rentals for inferior or superior accommodations also may be used for purposes of comparison by making adjustments for differences in rental values.

A. In estimating monthly rental value essentially the same methods of comparison are used as when estimating available market prices of properties. In comparing rentals for different properties, the conditions of tenancy must be taken into consideration. Comparisons must be made with rental prices for dwelling units which include the same services and equipment as those assumed in the subject dwelling units or necessary adjustments must be made before rentals may be used for purposes of comparison.

B. In estimating rents, concessions, if any, must be ascertained. For example, one month's free rent for each 12-month lease is equivalent to reducing the monthly rental by 1/12.

6-26. RENT MULTIPLIERS. Monthly gross rent multipliers are factors which express the relationship between the estimate of market rent and the estimate of value by the income approach. The appropriate rent multiplier is found by dividing the sales price of a number of comparable properties by their actual monthly rents at the time of their sale before expenses or vacancy and collection losses are deducted.

(6-26) A. The monthly gross multiplier is affected by the location, condition, remaining economic life, price or rental range.

B. "Backing" into the rent multiplier is not a valid approach to value.

6-27. VARIABLES IN RENT MULTIPLIERS. Since differences usually exist between the relationship of estimated monthly returns to typical buyers and the capitalized income according to rental ranges, rent multipliers will vary with rental ranges. Furthermore, rent multipliers vary within the same rental ranges.

Rent multipliers selected for use in making a capitalization estimate in a given case must he based upon comparison with rent multipliers applicable to other cases having approximately the same rental appeal and economic life.

A. Remaining Economic Life. Rent multipliers vary with the remaining economic life of properties. Two properties producing identical returns and having the same owner-occupancy appeal will not capitalize at identical amounts if there is a difference in their remaining economic life. Higher rent multipliers apply when properties have long remaining economic life and successively lower rent multipliers apply as remaining economic life decreases.

B. Rental Ranges. Experience demonstrates that rents do not increase proportionately with increase in value of income dwellings. For example, dwellings valued at $40,000 may have a range of rental value of $350 to $400 per month; dwellings valued at $45,000 may have a range of rental value of $425 to $500 per month, while dwellings valued at $80,000 may have a rental range of $550 to $650 per month.

6-28. ACCURACY OF ESTIMATES. Because of the importance which an estimate of rental value for the subject property has in the determination of values, great care must be taken in this endeavor. The estimate must not be an offhand opinion, but the result of thorough investigation and comparison. Small inaccuracies have an important effect on capitalized income. For example, a difference of $15.00 in the Estimate of monthly rental value when used with a rent multiplier of, say, 110 will result in a difference of $1,650 in the estimate of capitalized value.

SECTION 4. MODIFIED COST

6-29. SPECULATIVE SALES AND MODIFIED COST APPROACH. The purpose of this section is to describe procedures relating to the identification of ownership of existing dwellings and to distinguish between those applications which will he subject to standard appraisal instructions and those subject to the modified approach.

The use of the modified cost approach and the procedures described herein shall be at the option and discretion of the Regional Administrator. The option to eliminate this procedure is not, however, applicable in those areas identified by the Field Office as being speculator-dominated. (Speculator-dominated areas are those areas where speculators are the primary purchasers and sellers of the properties.)

While the Cost approach recognizes the cost of constructing a new home and sets an upper limit of value (because a buyer is not warranted in paying more for a property than it would cost to construct a similar property), the Modified Cost approach involves the acquisition cost of an existing property and includes attendant costs such as expense of purchase, interim financing, holding costs, real estate broker's commission and discount points. In this instance, a purchaser is not warranted in paying more for an existing property than the acquisition cost plus repairs and a fair, reasonable profit to an investor.

Therefore, in an area where speculators are purchasing, rehabilitating and selling properties, and such an area has been declared by the Regional Administrator to be "speculator-dominated", it is important that the appraiser use the modified cost approach as well as the market approach to value to ensure against inflated sales prices caused by unreasonable speculator profits.

The Field Office is to provide fee appraisers, mortgagees and Direct Endorsement staff appraisers with a list of areas, if any, subject to the modified cost approach and update when appropriate.

The Valuation Branch will obtain overhead and profit data and furnish appraisers and Direct Endorsement Mortgages Underwriters with a reasonable "overhead and profit percentage." A reasonable profit is one which is required in order to attract legitimate sponsors to engage in the purchase, repair or rehabilitation, and resale of older properties in the locality. The profit allowance must be such that it will discourage the "speculator" thereby excluding from HUD insured mortgages the possibility of exorbitant profits at the purchaser's expense.

(6-29) A. Application Requirements. The following information will be required with every home mortgage application for existing properties including those to be rehabilitated: (Format Provided as Figure 1, Page 6-23a).

1) Every application must be accompanied by the name and address of the present owner, the date the property was acquired (year only, if over two years), and the present status of the property with respect to any option or contract to sell and the amount involved.

2) In cases where the property was acquired by a non-occupant owner who has owned the property less than two years from the date of application or if the owner (irrespective of term of ownership) has optioned or contracted for sale of the property to a purchaser who intends to resell as soon as possible (speculator, investor, or rehabber), the mortgages must submit the last arms-length purchase price of the property.

3) If the application falls within category 2) above, a list of improvements to the property (excluding maintenance repairs) and the cost of same must also be provided, but only if the property was acquired by the seller within the last two years. When an application is submitted on a property owned by a non-occupant owner who has held title to the property for over two years, the Modified Cost Approach will not be used in the determination of value.

4) If the property was purchased more than once within the last two year period and the transactions were to non-occupant owners, the aforementioned information will be required on such transactions.

5) The following language will be furnished by the mortgagee with the application for conditional commitment in HUD-processed cases:

"In submitting this application for a conditional commitment for mortgage insurance, it is agreed and understood by the parties involved in the transaction, that if at the time of application for a Firm Commitment the identity of the seller has changed, the application for a Firm Commitment will be rejected, and the application for a Conditional Commitment will be processed upon request by the mortgagee.

"It is further understood and agreed that in submitting the request for a Firm Commitment for mortgage insurance the seller, the purchaser, and the broker involved in the

(6-29) transaction shall each certify that the terms of the contract for purchase are true to his/her best knowledge and belief and that any other agreement entered into by any of these parties in connection with this transaction is attached to the sales agreement."

6) When discount points are to be paid for by the seller who has an arms-length relationship with the mortgages, a mortgagee's certification of the amount of discount that will be charged will be submitted at firm commitment. A request for reconsideration and revision of the mortgage amount may be required.

B. Use of Standard Appraisal Procedures. Standard appraisal procedures will he followed in all cases not covered by the guidelines for the application of the modified cost approach described below. This means all cases not involving a speculator or other person trading in properties are exempt from the modified cost approach.

C. Use of the Modified Cost Approach. If the date of purchase of the property is less than two years prior to the date of application and the owner is not the last permanent occupant of the property or the last permanent owner (irrespective of length of ownership) has optioned the property to a purchaser who intends to resell as soon as possible, the estimated value of the property for mortgage loan purposes (irrespective of the home mortgage insurance program to be used) shall not exceed the lesser of:

1) The value found by market comparison in accordance with applicable instructions, or

2) the sum of the following:

a. The last arms-length purchase price and expense of purchase plus cost of improvements already made, or present option or contract price, whichever is applicable.

b. Interim financing expense.

c. Holding costs.

d. The HUD estimated cost of required repairs.

e. A reasonable overhead and profit allowance on the above.

(6-29) f. A typical broker's commission on the sum of the above.

g. Discounts paid by the seller (only where there is an arms-length relationship between the seller and the lender).

D. Conditional Commitments or Statements of Appraised Value Containing Repair Requirements.
If the HUD Estimate of Value is limited by the modified cost approach as described above, the following commitment condition will be included.

"This Conditional Commitment/D.E. Statement of Appraised Value is issued upon the condition that the specified repairs or alterations will have been made prior to issuance of the firm commitment as evidenced by a clear final inspection report. The estimated total cost of the foregoing repairs is $_______________.

It is understood and agreed that in the event the mortgage fails to submit satisfactory evidence that the actual cost of required repairs or alterations equals or exceeds the estimate herein, the estimate of value stated above will be reduced by the amount of the difference between the estimated cost of repairs required and the actual cost of required repairs performed."

Furthermore, for HUD processed cases, the mortgagee is required to certify as to the amount of discount to be charged. This is to be submitted with the firm commitment application. A request for reconsideration should then be submitted to the Valuation and Mortgage Credit staffs for revision of the conditional and firm commitments if appropriate. This processing should be accomplished within a two-day period. For cases processed under Direct Endorsement, the mortgagee need only to provide the certification when submitting the case for endorsement.

E. Firm Commitment Processing. Processing will be completed in accordance with HUD Handbook 4155.1.

F. Optional Firm Commitment Processing. In instances where vandalism of vacant properties is evident and repaired homes are vandalized before occupancy, an alternative procedure may be adopted by the Field Office. This procedure will permit the non-occupant owner to complete needed or required repairs to the property prior to submitting his/her certified statement of costs which is typically required at the time of firm commitment:

(6-29) 1) When accompanied by a written statement from the owner concerning conditions of vandalism, a mortgagee may be permitted to submit a firm application when the Modified Cost Approach is applicable without the certified statement of costs.

2) Firm commitment processing will be based upon the value as estimated at the time of Conditional Commitment/Statement of Appraised Value.

G. Discount Points.

1) Discount points actually paid by the seller may be included, provided the seller has an arms-length relationship with the mortgagee charging the discount and provided further that the discount is not in excess of typical discounts being charged by mortgagees in similar transactions.

2) The validity of the arms-length relationship will be determined by requiring a statement from the mortgages attested to by the seller's signature, that the mortgagee has no interest, past or prospective, in the identified property, or in the business affairs of the seller.

3) Where discount points are claimed by the seller and the modified cost approach governs the value, the amount of the discount allowed will be added to the total after computation of the overhead and profit and broker's commission. (No overhead and profit or commission will be applied to the discount.)

H. Veterans Administration Conversions, Certificate of Reasonable Value (CRV). Applications for a conditional commitment based on CRV estimates of value which must be processed using the modified cost approach will be rejected and the mortgagee notified that a HUD conditional commitment based upon a HUD appraisal will be required.

I. Implementing the Modified Cost Approach. The directives in this paragraph supplement the outstanding appraisal instructions in this Handbook. It must be emphasized that in appraising amenity income properties, the market approach is the most reliable indicator of value and must be used as the principal approach. The Modified Cost Approach to value will be used to prevent unreasonable disparities between net sellers' prices plus typical cost and HUD values with the attendant implication of excessive profits. The information concerning ownership, acquisition prices, repairs, and other costs should be an invaluable source of data to implement this approach.

(6-29) 1) Purchase and Option Prices. The last arms-length purchase price paid by the seller or the present option or contract price (to the speculator) and the cost of repairs already made must be verified by evidence in the form of contracts or other bona fide information (copies of deeds with stamps, if applicable, certified statements from a principal or broker involved, etc.) furnished by the principals through the mortgagee and shall become a part of the file.

2) Data Requirements. Data are required relating to the five items described below. Verification and comparison of substantial amounts of these data are necessary to assure their validity. The following data will be assembled and provided to appraisers. The data must he updated as needed to assure reliability.

a. Expenses incurred in connection with the purchase from the original owner (recording charges, transfer taxes and any other expenses of purchase).

b. Interim Financing Expense (interest on borrowed money necessary to carry the property until resale) expressed as a percentage which will be applied to the purchase or option price.

c. Expenses incurred in connection with holding the property awaiting sale and closing (such as taxes, insurance, water and heating costs, grass-cutting, etc.). These may or may not be elements of expense, particularly if in the typical transaction the sale is consummated early or the speculator rents the property during the sale period.

d. The Chief Appraiser or designee will obtain overhead and profit data and furnish the Valuation staff and fee appraisers with a reasonable overhead and profit percentage. A reasonable profit is one required to attract legitimate sponsors to engage in the purchase, repair or rehabilitation, and resale of older properties in the locality. The purpose is to exclude from HUD insured mortgages the possibility of exorbitant profits at the purchaser's expense.

e. Typical broker's commission charges (percentage) on properties of this type.

3) Repairs. The HUD Estimated cost of repairs, proposed or required to make the subject property acceptable, must be determined by the best judgement of the appraiser.

(6-29) 4) Appraisal Instructions Using the Modified Cost Approach. The appraiser will perform the appraisal using the market approach to value as in any ordinary case. In addition, he/she will complete the method of arriving at a value by the modified cost approach, as shown in the following example, on a separate sheet of paper which is to he attached to the URAR. This value is then entered on the back of the URAR in the cost approach box where the words "indicated value by cost approach" is shown and inserting the word "modified" above the word "cost."

EXAMPLE

a.	Purchase or Option Price (Includes cost of improvements already made)	$ 6,200
b.	Expense of Purchase	75
c.	Interim Financing Expense (9%, 3 months on $6,200)	140
d.	Holding Costs	(NONE)
e.	Repairs	1,800
f.	TOTAL	$ 8,215
g.	Overhead and Profit	$ 8,215
	20% of $8,215 = $1643	1,643
		$ 9,858
h.	Broker's Commission 5% = $9,858 = $10,376 / 95%	518
		$10,376
i.	Discount Points	200
j.	Modified Cost Approach =	$10,576

When the amount calculated above and entered in the cost section of the URAR limits the value of the property, this amount will he entered on the line marked "Final Reconciliation" with the words "Modified cost is the lesser of the two approaches to value." On the line below where the final estimate of value is shown, the word "Market" is to be lined out so that it reads: "I estimate the value, as defined . . . . "

NOTE: Where discount points are allowed, the discount will be added to the total after computation of the overhead and profit and broker's commission.

Figure 1

Appraisal Method
Speculative Sales :
Modified Cost Approach

Click Here for Graphic

SECTION 5. LEASEHOLDS

In the event the mortgage is secured by a leasehold estate rather than a fee simple estate, the value or replacement cost of the property described in the mortgage shall be the value or replacement cost of the leasehold estate (as determined by the commissioner) which shall in all cases be less than the value or replacement cost of the property in fee simple. The Leasehold Estate may consist of both the improvement and the land, although in most cases the improvement is purchased in fee simple, subject to ground rent.

6-30. DEFINITIONS:

A. LEASED FEE: An ownership interest held by a landlord with the right of use and occupancy conveyed by lease to others; usually consists of the right to receive rent and the right to repossession at the termination of lease.

B. LEASEHOLD ESTATE: The right to use and occupy real estate for a stated term and under certain conditions which have been conveyed by a lease.

C. GROUND RENT: Rent paid for the right to use and occupy land; the portion of the total rent allocated to the underlying land.

D. CAPITALIZATION: The conversion of income into value.

6-31. TENANT-OCCUPIED PROPERTY: (LAND AND IMPROVEMENT)

When an application is received for the purchase of a property which is encumbered by a lease, other than for ground rent, i.e., tenant-occupied under a lease previously given by the seller, it is valued subject to the effects of the encumbrance.

A. Short-Term Leases. Single-family dwellings that are encumbered by a short-term lease (23 months or less) will be processed as if in fee simple. The value will be found in fee simple with a notation that the property is encumbered by a lease. The Mortgage Credit Examiner will base his calculations of debt service on the estimate of typical net income. The terms and contract amount of the lease will be noted on the URAR along with the rent typically found in the market.

B. Long-Term Leases. Single-family dwellings that are encumbered by long-term (24 months or more) leases may suffer a lesser value depending on the terms of the lease and conditions concerning periodic rent adjustments, if any.

6-32. ELIGIBILITY OF LEASEHOLD ESTATES (GROUND LEASES).

A. When a site upon which a building is constructed is subject to a lease, the value of the property lies in the value of the building and the leasehold estate. Leaseholds are acceptable when they contain the following conditions. (There is no requirement that evidence be provided that leaseholds are marketable in the community.)

1) Term. A term extending at least ten years beyond the mortgage maturity.

2) Rental. Ground rentals are established in the local market place, but in no case may the annual rental exceed the lesser of 12 percent of the site value, or the mortgage interest rate at the time of underwriting, less two percent, times the site value.

Example:

Value of Leasehold	$51,000
Value of comparable site	9,000
Ultimate maximum annual rental (yield rate 12 percent)	1,080
Maximum annual rental if mortgage interest rate is 12 percent (yield rate 10 percent)	900

These provisions represent a maximum limitation, and are not intended to he used as standards in the establishment of rentals.

(3) Rental Increases. Ground rentals may increase periodically, subject to the following:

a. Rental amounts may not be increased for the first three years of the lease term. Subsequent rental increases may occur no more frequently than once every 12 months.

b. Increases must be stated in the lease document in exact dollar amounts.

c. Establishment of future rentals by negotiation or by formula is not permitted.

d. Increases in any 12-month period may equal no more than 2 percent of HUD's original site valuation, but at no time may annual ground rental exceed 12 percent of HUD's original site valuation.

(6-32) Example:

Value of leasehold	$57,000
Value of comparable site	9,000
Annual rental (yield rate 6 percent)	540
Maximum permissible Rental resulting from first increase (yield rate 8 percent)	720
Maximum annual rent (12%)	1,080

4) Assignability. Leases may not contain restrictions of assignability such as assignment by way of mortgage or assignment to or by the Federal Housing Administration or

Department of Veterans Affairs or upon foreclosure, nor withhold consent for assignment because of the assignee's national origin, race, color or creed so long as the leasehold is covered by an insured mortgage or a mortgage held by the Secretary or so long as the Secretary owns the leasehold.

5) Option to Purchase. Subject to the exceptions listed below the lease must permit lessee or assigns to purchase fee simple title from lessor or assigns with 30 days written notice. The option price of the fee simple title is intended to reflect HUD's recognition of value ascribed to the stream of income produced by the lease. Thus underwriting instructions require the lease to permit purchase at a price not to exceed HUD's original valuation of the leased fee. Buyer and seller may agree that this right shall not be exercised during the first five years of the lease term.

6) Exception to Option to Purchase. The Requirement of an Option to Purchase may be waived in any transaction covering the leasehold interest of the mortgagor under a lease where:

a. A state, including any political subdivision thereof, of the United States, an Indian Tribe, or an Indian, or a charitable institution, a church, a university or

(6-32) similar public purpose institution, is the lessor and an option to purchase would not he permitted under existing laws or regulation;

b. Where the property is located in an area which the Commissioner has determined that the option to purchase is not economically feasible or acceptable because of the custom and practices relating to land ownership and its use.

7) Default. Mortgagee must have the right to correct lessee's defaults within 120 days from receipt of notice of intent to terminate lease because of such default, or such further time as may be necessary to complete foreclosure.

8) Merger. The lease must provide that ownership of both the fee simple title and the leasehold estate by the same owner will not effect a merger of such estates while either estate is encumbered by a mortgage, without the written consent of the mortgagee.

Example: When a home situated on leased land is purchased, the security for the mortgage includes not only the improvement but the leasehold estate as well. If the purchaser subsequently buys the land from the lessor, the purchaser then acquires fee simple title to the land. Since the mortgagee holds no interest in the fee simple title to the land, this destroys the mortgagee's security of the leasehold estate. Therefore, the homeowner must contact the mortgagee and obtain permission before buying the land and effecting such a merger.

9) Conflict. The terms of the lease must not conflict with the terms of the mortgage.

B. Rights of Parties to the Lease. A long-term lease upon real property creates two distinct properties:

1) The lessor still holds title in fee simple, but since it is encumbered by the lease which he/she has given, the lessor's interest is designated the leased fee.

2) The lessee acquires the rights to the benefits which the use of the property will produce during the term of the lease, if he/she does not default in the performance of required acts of the lease. The lessee's interest is designated the leasehold estate. In exchange for the

(6-32) rights, the lessee is obligated to pay a rental to the owner of the fee and to discharge the other obligations imposed by the lease.

6-33. APPROACH TO VALUE OF THE LEASEHOLD ESTATE. The value of the property is established as though it were owned in fee simple and unencumbered by a lease. The value of the leased fee is then determined and deducted from the estimated value of the unencumbered property. The resulting difference is accepted as the value of the leasehold estate.

A. The Elements of Value in the lessor's rights (leased fee) are:

1) The present value of the net rentals specified in the lease.

2) The value of the reversion. The reversionary right is the right to repossess full and sole use of the property which commences at a stated time: i.e., such as at the end of

the lease.

B. For the leasehold estate to be eligible for mortgage loan insurance, it must involve a lease for a term of at least ten years beyond the mortgage maturity.

1) Commonly, long term leases provide for flat or level rental rates which are not subject to change. However, a lease may stipulate successive rate changes, (e.g., one fixed rental rate for the initial 25 years, a second rental rate for the second 25 years, etc.). This is acceptable if rate changes appear reasonable and if they are stipulated, fixed dollar amounts of rental for a minimum number of years equal to the estimated remaining mortgage life of the structure(s).

2) Leases involving future rentals to be determined by arbitration or negotiation, or to be related to a future value of the land, or to its earnings are generally difficult to appraise accurately. The indefinite amount of the future obligation makes uncertain the continuing value of the leasehold. Such leases are generally unacceptable if provisions for such uncertain rentals become operative during the remaining mortgage life of the structure.

C. Capitalization of Ground Rents. Long term leases, such as those for 99 years, renewable, are often termed perpetual leases. Usually renewable for a like term or successive terms, the effect is a renewal forever, and any reversion to the fee owner is not only improbable but so remote in time as to be of

(6-33) infinitesimal value. Ground rents accruing from such leases are therefore treated as perpetual annuities. To evaluate the leased fee, the ground rental is capitalized at the going market for such investments. Ground rents under substantial buildings having ground utility or rental value are generally well secured, since they are primary liens, prior even to subsequent first mortgages. Nevertheless, their use and acceptance in residential property is limited to but a few housing market areas. Commercial ground rents, including apartment houses are more common although not universally used or acceptable. The liquidity (ready marketability) of the leased fee is therefore somewhat below that of a prime first mortgage or of the unencumbered fee.

1) Capitalization Rates for Ground Leases. Capitalization rates for ground rents are usually found to vary only between narrow limits and are not likely to be found to

deviate far from a six percent rate, net. The lessee pays all real property taxes and assessments levied against both land and structures. The value of the leased fee and therefore the capitalization rate applicable will also tend to be fixed by any rights of purchase or "redemption" of the leased land granted to the lessee, either under the terms and conditions of the lease contract, or by statute. Thus if the lessee is granted the right to purchase the leased fee at a fixed price in dollars or at a price derived by capitalizing the ground rent at a stated rate, such capital sum may well be the maximum obtainable for the leased fee in the market from any other purchaser. Exceptions may occur, however, as in a lease that produces an excessive return in relation to the value of the land in which the right of the lessee to purchase at a fixed price is deferred by agreement or by state law.

2) Capitalization Process. The process of capitalization of a net rental in perpetuity merely involves division of the yearly rental by the capitalization rate. For example, if the ground rent is $1,350 per year net to the lessor and it is found that the proper capitalization rate is five percent, the value by capitalization of the ground rent in perpetuity is $1,350 divided by .05, which is $27,000. If it is determined that the rate should be six percent, the capitalization of the ground rent in perpetuity is $1,350 divided by .06 which is $22,500. Under these conditions, there will be no reversion to the lessor; that is, the property presumably will never revert to the lessor since the lessee has the right to renew his lease forever. Therefore, the total value of the leased fee in the example quoted would be $27,000 or $22,500 depending upon the rate of capitalization.

(6-33) 3) Data Files. Valuation data should he analyzed to determine proper rates of capitalization. This will take into account the effect upon such rates of purchase rights granted to the lessee by the lease contract or by statute, and the effect of deferral of such rights. If deferred for a number of years, the effect of such rights may he lessened.

D. APPRAISAL PROCEDURE.

1) In appraising a property which is situated on leased land the appraiser must first arrive at an estimate of value for the subject property in fee simple.

2) To accomplish this, each comparable must either be a fee simple sale or an adjusted leasehold estate. If any of the comparables are leasehold estates, an adjustment must be made to each leasehold comparable by adding back the leased fee to the sales price to arrive at the fee simple value. This will require the appraiser to check the annual ground rent for each leasehold comparable.

3) When all comparables have been adjusted to reflect their value in fee simple, the reconciled value in fee simple is made for the subject. Then the leased fee is determined in accordance with the annual rent divided by the capitalization rate, and deducted from the fee simple value to arrive at the value of the leasehold estate of the subject property.

4) The appraiser enters the value of the leased fee on the back of the URAR in the COST section by lining out the words "ESTIMATED SITE VALUE" and writing in "LEASED FEE." The value in fee simple is still shown below on the line for "INDICATED VALUE BY SALES APPROACH," and just below, on the line for "Final Reconciliation of Appraisal." the appraiser should write in "SUBJECT ON LEASED LAND WITH ANNUAL RENT OF $ ___________capitalized at ____% = $________ Leased Fee." Under "Reconciliation," on the line for final estimate, the word "Market" should be lined out and replaced with the word "leasehold" so it reads, "I estimate the value of the Leasehold Estate, as defined, of the subject property. . . ," and the value of the Leasehold Estate shown at the end of that line.

(6-33) E. Long Term Lease with Fixed Rent for full term of the lease.

If a lease is long-term (over 50 years) with a fixed rent for the full term of the lease, the annual rent may be divided by the appropriate capitalization rate to determine the value of the leased fee. The leased fee is then deducted from the fee simple value of the property (building and land) to arrive at the value of the leasehold estate. The value of the leasehold estate is HUD's value for mortgage insurance. Example: $400.00 divided by 8% = 5,000.00. Fee simple $60,000 - 5,000 = $55,000 (value of leasehold estate).

F. Lease with Term of Less than Fifty Years with Fixed Rent.

1) When a lease is written for a term of 50 years or less, the possibility of the land reverting to the lessor becomes less remote and therefore the value of the reversion must

be included in value.

2) In this approach to value of the leased fee, the present value Inwood Tables II, "What $1.00 payable periodically is worth today" are used. Appraisers who use computers can easily program them to facilitate the calculations. (See tables at pages 6-34 and 6-35).

3) If the lease term is less than 50 years with fixed rent for the full term of the lease, the annual rent should be multiplied by the appropriate Inwood factors to arrive at the leased fee. If the term is 40 years and your cap rate is 8%, the Inwood factor is 11.925. Multiply the annual rent by this factor. In addition to this figure, you must add the reversionary factor which is obtained by isolating the fortieth year from the previous 39 years - i.e. the Inwood factor for 40 years at 8% is 11.925. From this factor is subtracted the factor for 39 years at 8% (11.879). The result is 11.925 - 11.879 = .046. The present market value of the site is then multiplied by this factor of .046 and the result added to the previous calculation to arrive at the value of the LEASED FEE.

Example: (8%/40 years)
Rent $450 X 11.925 = $5,366

Site $10,000 X .046 (reversion) = $460

Value of leased fee ($5,366 + 460) = $5,826

Fee simple value of property $50,000 - $5,826 (leased fee) = $44,174 (value of leasehold estate)

(6-33) G. Valuation of the Leasehold Estate with a Term of 50 Years or Less with One or More Fixed Rent Periods.

1) Example: The lease is for 40 years with two fixed rent periods. For the first 20 years the rent is scheduled at $360 per year. For the second 20-year fixed period, the rent is scheduled at $450 per year. The site has been appraised by the appraiser at $10,000.

2) According to Table #2, the factor for 20 years at 6% is 11.470. The annual rent of $360 is then multiplied by this factor.

$360 x 11.470 = $4,129.00

3) For the next 20-year fixed rent period, the factor for 40 years is taken from the Table (15.046). Since this calculation is for the second 20 years (21 - 40), the factor used for the first 20 years must be subtracted from it (15.046 - 11.470) which results in a factor of 3.576. The rent of $450 for this fixed period is then multiplied by this factor.

$450 x 3.576 = $1,609.00

4) The value of the reversion is then calculated by taking the factor from the Table for 40 years (15.046) and subtracting from it the factor shown for 39 years so as to isolate only the 40th year value which is the reversionary factor representing the recapture of the land by the lessor at the end of the lease term.

$15.046 - 14.949 = .097

5) The present day estimated market value of the land is then multiplied by this factor to show the value of the reversion.

$10,000 x .097 = $970.00

6) The three calculations are then added together and represent the value of the leased fee.

$4,129 + $1,609 + $970 = $6,708.00

7) The leased fee is then subtracted from the fee simple value of land and building which results as the value of the leasehold estate which is the lessee's interest in the property.

(6-33) H. Format for Calculation of Leased Fee.

(first period 20 years) $360 x 11.470 = $4,129.00
(present worth of $1 per period)

(40-Year PW of $1 per period = 15.046 - 11.470
First Period) = 3.576

(Second period 20 years) $450 x 3.576
(PW of $1 per period) = $1,609.00

(Reversionary Value to Lessor = 40-year Present
worth of $1 = .097)

$10,000 (Fee Simple Value) x .097 (R. Value)	= $ 970.00
Value of Leased Fee	=$ 6,708.00
Fee simple value of property	=$65,000.00
Less Value of Leased Fee	=$ 6,708.00
Value of Leasehold Estate	=$58,292.00

I. Subleasehold Estates. Because a subleasehold mortgage is inherently riskier for a mortgagee and mortgage insurer than an ordinary leasehold mortgage, the Department prohibits the acceptance of subleasehold estates for mortgage insurance. In an assignment, the lessee conveys its entire interest under the lease with respect to all or a portion of the leased property, whereas in a sublease the lessee retains some interest as against the sublessee. Subleasehold estates exist when the mortgagor holds an interest in the property only through a sublease from a lessee, rather than through a lease or deed from a fee owner or an assignment of lease from a lessee. If the lessee's rights in the property are terminated, such as for the breach of the lease convenants, all of the sublessee's rights are also terminated absent a separate agreement between the fee owner and the sublessee. That would leave a mortgagee without any security under the mortgage.

K. Lease Forms and their Approval.

Any ground lease form which does not meet the foregoing standards, should not be accepted without Headquarters approval.

TABLE II: PRESENT WORTH OF ONE PER PERIOD

What $1 payable periodically is worth today.

Years	Speculative Interest Rates			
	3%	4%	4-1/2%	5%
1	0.971	0.961	0.957	0.952
2	1.913	1.886	1.873	1.859
3	2.829	2.775	2.749	2.723

4	3.717	3.630	3.587	3.546
5	4.580	4.452	4.390	4.329
6	5.417	5.242	5.158	5.076
7	6.230	6.002	5.893	5.786
8	7.020	6.733	6.596	6.463
9	7.786	7.435	7.269	7.108
10	8.530	8.111	7.913	7.722
11	9.253	8.760	8.529	8.306
12	9.954	9.385	9.118	8.863
13	10.635	9.986	9.683	9.394
14	11.296	10.563	10.223	9.899
15	11.938	11.118	10.739	10.380
16	12.561	11.652	11.234	10.838
17	13.166	12.166	11.707	11.274
18	13.753	12.659	12.160	11.690
19	14.324	13.134	12.593	12.085
20	14.877	13.590	13.008	12.462
21	15.415	14.029	13.405	12.821
22	15.937	14.451	13.784	13.163
23	16.444	14.857	14.148	13.489
24	16.935	15.247	14.495	13.799
25	17.413	15.622	14.828	14.094
26	17.877	15.983	15.147	14.375
27	18.327	16.330	15.451	14.643
28	18.764	16.663	15.743	14.898
29	19.188	16.984	16.022	15.141
30	19.600	17.292	16.289	15.372
31	20.000	17.588	16.544	15.593
32	20.389	17.874	16.789	15.803
33	20.766	18.148	17.023	16.002
34	21.132	18.411	17.247	16.193
35	21.487	18.665	17.461	16.374

TABLE II: PRESENT WORTH OF ONE PER PERIOD

What $1 payable periodically is worth today.

Years	Speculative Interest Rates			
	3%	4%	4-1/2%	5%

36	21.832	18.908	17.666	16.547
37	22.167	19.143	17.862	16.711
38	22.492	19.368	18.050	16.868
39	22.808	19.584	18.230	17.017
40	23.115	19.793	18.401	17.159
41	23.412	19.993	18.566	17.294
42	23.701	20.186	18.724	17.423
43	23.982	20.371	18.874	17.546
44	24.254	20.549	19.018	17.663
45	24.519	20.720	19.156	17.774
46	24.775	20.885	19.288	17.880
47	25.025	21.043	19.415	17.981
48	25.267	21.195	19.536	18.077
49	25.502	21.341	19.651	18.169
50	25.730	21.482	19.762	18.256

Equal annual amounts; payable at end of year.

TABLE II: PRESENT WORTH OF ONE PER PERIOD

What $1 payable periodically is worth today.

Years	Speculative Interest Rates			
	5-1/2%	6%	6-1/2%	7%
1	0.948	0.943	0.939	0.935
2	1.846	1.833	1.821	1.808
3	2.698	2.673	2.648	2.624
4	3.505	3.465	3.426	3.387
5	4.270	4.212	4.156	4.100
6	4.996	4.917	4.841	4.766
7	5.683	5.582	5.485	5.389
8	6.334	6.210	6.089	5.971
9	6.952	6.802	6.656	6.515
10	7.538	7.360	7.189	7.024
11	8.093	7.887	7.689	7.499

12	8.618	8.384	8.159	7.943
13	9.117	8.853	8.600	8.358
14	9.590	9.295	9.014	8.745
15	10.038	9.712	9.403	9.108
16	10.462	10.106	9.768	9.447
17	10.865	10.477	10.110	9.763
18	11.246	10.828	10.432	10.059
19	11.608	11.158	10.735	10.306
20	11.950	11.470	11.019	10.594
21	12.275	11.764	11.285	10.835
22	12.583	12.042	11.535	11.061
23	12.875	12.303	11.770	11.272
24	13.152	12.550	11.991	11.469
25	13.414	12.783	12.198	11.654
26	13.662	13.003	12.392	11.826
27	13.898	13.210	12.575	11.987
28	14.121	13.406	12.746	12.137
29	14.333	13.591	12.907	12.278
30	14.534	13.765	13.059	12.409
31	14.724	13.929	13.201	12.532
32	14.904	14.084	13.334	12.647
33	15.075	14.230	13.459	12.754
34	15.237	14.368	13.577	12.854
35	15.390	14.498	13.687	12.948

TABLE II: PRESENT WORTH OF ONE PER PERIOD

What $1 payable periodically is worth today.

Years	Speculative Interest Rates			
	5-1/2%	6%	6-1/2%	7%
36	15.536	14.621	13.791	13.035
37	15.674	14.737	13.888	13.117
38	15.805	14.846	13.979	13.193
39	15.929	14.949	14.065	13.265
40	16.046	15.046	14.145	13.332
41	16.157	15.138	14.221	13.394
42	16.263	15.224	14.292	13.452
43	16.363	15.306	14.359	13.507

44	16.458	15.383	14.421	13.558
45	16.548	15.456	14.480	13.605
46	16.633	15.524	14.535	13.650
47	16.714	15.589	14.587	13.692
48	16.790	15.650	14.636	13.730
49	16.863	15.708	14.682	13.767
50	16.931	15.762	14.724	13.801

Equal annual amounts; payable at end of year.

TABLE II (continued)

Years	Speculative Interest Rates			
	7-1/2%	8%	9%	10%
1	0.930	0.926	0.917	0.909
2	1.796	1.783	1.759	1.736
3	2.600	2.577	2.531	2.487
4	3.349	3.312	3.240	3.170
5	4.046	3.993	3.890	3.791
6	4.694	4.623	4.486	4.355
7	5.297	5.206	5.033	4.868
8	5.857	5.747	5.535	5.335
9	6.379	6.247	5.995	5.759
10	6.864	6.710	6.418	6.145
11	7.315	7.139	6.805	6.495
12	7.735	7.536	7.161	6.814
13	8.126	7.904	7.487	7.103
14	8.489	8.244	7.786	7.367
15	8.827	8.559	8.061	7.606
16	9.142	8.851	8.313	7.824
17	9.434	9.122	8.544	8.022
18	9.706	9.372	8.756	8.201
19	9.959	9.604	8.950	8.365
20	10.194	9.818	9.128	8.514
21	10.413	10.017	9.292	8.649
22	10.617	10.201	9.442	8.772

23	10.807	10.371	9.580	8.883
24	10.983	10.529	9.707	8.985
25	11.147	10.675	9.823	9.077
26	11.299	10.810	9.929	9.161
27	11.441	10.935	10.026	9.237
28	11.573	11.051	10.116	9.307
29	11.696	11.158	10.198	9.370
30	11.810	11.258	10.274	9.427
31	11.917	11.350	10.343	9.479
32	12.015	11.435	10.406	9.526
33	12.107	11.514	10.464	9.569
34	12.193	11.587	10.518	9.609
35	12.272	11.655	10.567	9.644

TABLE II (continued)

Years	Speculative Interest Rates			
	7-1/2%	8%	9%	10%
36	12.347	11.717	10.612	9.676
37	12.415	11.775	10.653	9.706
38	12.479	11.829	10.691	9.733
39	12.539	11.879	10.726	9.757
40	12.594	11.925	10.757	9.779
41	12.646	11.967	10.786	9.799
42	12.694	12.007	10.813	9.817
43	12.738	12.043	10.838	9.834
44	12.780	12.077	10.861	9.849
45	12.819	12.108	10.881	9.863
46	12.855	12.137	10.900	9.875
47	12.888	12.164	10.918	9.887
48	12.919	12.189	10.933	9.897
49	12.948	12.212	10.948	9.906
50	12.975	12.233	10.962	9.915

Equal annual amounts; payable at end of year.

TABLE II (continued)

Years	Speculative Interest Rates			
	11%	12%	13%	14%
1	0.901	0.893	0.885	0.877
2	1.713	1.690	1.668	1.647
3	2.444	2.402	2.361	2.322
4	3.102	3.037	2.974	2.914
5	3.696	3.605	3.517	3.433
6	4.231	4.111	3.998	3.889
7	4.712	4.564	4.423	4.288
8	5.146	4.968	4.799	4.639
9	5.537	5.328	5.132	4.946
10	5.889	5.650	5.426	5.216
11	6.206	5.938	5.687	5.453
12	6.492	6.194	5.918	5.660
13	6.750	6.424	6.122	5.842
14	6.982	6.628	6.302	6.002
15	7.191	6.811	6.462	6.142
16	7.379	6.974	6.604	6.265
17	7.549	7.120	6.729	6.373
18	7.702	7.250	6.840	6.467
19	7.839	7.366	6.938	6.550
20	7.963	7.469	7.025	6.623
21	8.075	7.562	7.102	6.687
22	8.176	7.645	7.170	6.743
23	8.266	7.718	7.230	6.792
24	8.348	7.784	7.283	6.835
25	8.422	7.843	7.330	6.873
26	8.488	7.896	7.372	6.906
27	8.548	7.943	7.409	6.935
28	8.602	7.984	7.441	6.961
29	8.650	8.022	7.470	6.983
30	8.694	8.055	7.496	7.003
31	8.733	8.085	7.518	7.020
32	8.769	8.112	7.538	7.035
33	8.801	8.135	7.556	7.048
34	8.829	8.157	7.572	7.060
35	8.855	8.176	7.586	7.070

TABLE II (continued)

Years	Speculative Interest Rates			
	11%	12%	13%	14%
36	8.879	8.193	7.598	7.079
37	8.900	8.207	7.609	7.087
38	8.919	8.221	7.618	7.094
39	8.936	8.233	7.627	7.100
40	8.951	8.244	7.634	7.105
41	8.965	8.253	7.641	7.110
42	8.977	8.262	7.647	7.114
43	8.989	8.270	7.652	7.117
44	8.999	8.276	7.657	7.120
45	9.008	8.283	7.661	7.123
46	9.016	8.288	7.664	7.126
47	9.024	8.293	7.668	7.128
48	9.030	8.297	7.670	7.130
49	9.036	8.301	7.673	7.131
50	9.042	8.305	7.675	7.133

Equal annual amounts; payable at end of year.