



JACKSON & ASSOCIATES

REAL ESTATE APPRAISERS & CONSULTANTS

Understanding the Appraisal



VALUE IS MORE THAN A NUMBER

Understanding the Appraisal

Much of the private, corporate and public wealth of the world consists of real estate. The magnitude of this fundamental resource creates a need for informed appraisals to support decisions pertaining to the use and disposition of real estate and the rights inherent in ownership. An appraisal answers one or more specific questions about a real estate parcel's value, marketability, usefulness or suitability.

The Appraisal Defined

Professional real estate appraisers perform a useful function in society and offer a variety of services to their clients. They develop opinions of several types of property value and assist in various decisions about real estate. In Canada, standards for the appraisal profession are set forth in the Canadian Standards of Professional Appraisal Practice (CUSPAP) developed by the Appraisal Institute of Canada. CUSPAP or 'the Standards' specifies the procedures to be followed in developing and communicating an appraisal and the ethical rules for appraisal practice. An appraisal is defined as the act or process of developing an opinion of value. The valuation process is a systematic procedure the appraiser follows to answer a client's question about real property value.

The most common type of appraisal assignment is the development of an opinion of market value. However, because of their specialized training and experience, appraisers can provide a wide range of additional appraisal services—from investment consultation to advice on various business as well as personal financial decisions.

The Intended Use of an Appraisal

An appraisal may be requested or required for many reasons.

- *To facilitate the transfer of ownership of real property*
- *To help would be sellers determine acceptable selling prices or prospective buyers decide on offering prices*

Many appraisal assignments relate to financing and credit (loan underwriting).

- *To assist the underwriter in establishing a value of security for a mortgage loan*

- *To provide an investor with a sound basis for the purchase of real estate mortgages, bonds or other types of securities.*

Other appraisals are requested to help resolve legal or tax issues.

- *To estimate the market value of a property in expropriation proceedings*
- *To estimate the market value of a property in contract disputes or as part of a portfolio*
- *To estimate the market value of partnership interests*
- *To estimate damages created by environmental contamination*
- *To estimate assessed value for taxation purposes*
- *To determine gift or inheritance taxes; donations, ecological gifts and conservation covenants*
- *To estimate the value of the real property component of an estate*

Appraisals are also used in investment counseling and decision-making.

- *To set rent schedules and lease provisions*
- *To determine the feasibility of a construction project or renovation program*
- *To aid in corporate mergers, issuance of stock or revision of book value*
- *To counsel a client on investment matters, including goals, alternatives, resources, constraints and timing*
- *To advise municipal zoning boards, provincial and national bodies, courts and planners, among others, regarding the probable effects of proposed actions*
- *To arbitrate between adversaries*

Value Influences

The analysis of social, economic, governmental and environmental forces provides an understanding of the dynamics of change and helps identify value trends. Against this background, the appraiser investigates the characteristics of the subject property that might impact the property's value. The appraiser also investigates the nature of the market for that property, competitive properties, and the buyers and sellers who constitute the market for that property type. The principles of supply and demand, substitution, balance and externalities help explain shifts in value. Four independent economic factors—utility, scarcity, desire, and effective purchasing power—must be present to create value in a

particular item or collection of items. Professional appraisal standards specifically require the study of all value influences.

Approaches to Value

Participants in the real estate market commonly think of value in three ways:

- *The current cost of reproducing or replacing a building, minus an estimate for depreciation, plus the value of the land (and entrepreneurial profit, if applicable)*
- *The value indicated by recent sales of comparable properties in the market*
- *The value that the property's net income generation will support*

These different viewpoints form the basis of the three approaches that appraisers use to value property—the cost, direct comparison and income capitalization approaches. One or more of these approaches may not be applicable to a given assignment or may be less significant because of the nature of the property, the appraisal problem or the data available. The approaches to value are applied within the context of the valuation process.

The Valuation Process

Although characteristics of properties differ widely, all appraisal problems can be solved through the systematic application of the valuation process. In the valuation process the problem is defined, the work necessary to solve the problem is planned and relevant data are collected, verified and analyzed to form an opinion of value.



The valuation process is accomplished by following specific steps, the number of which depends on the nature of the appraisal assignment and the data available to complete it. In all cases, however, the valuation process provides the model to be followed in performing market research and data analysis, in applying appraisal techniques and in integrating the results of these analytic activities into an opinion of value.

Definition of the Problem

The first step in the valuation process is to develop a concise statement of the problem. This sets the parameters of the assignment and eliminates any ambiguity about the nature of the assignment. In this step the appraiser identifies the client or intended user of the appraisal, the real estate to be appraised, the intended use of the appraisal, the type and definition of value, the date of the value opinion, the property characteristics (including location and property rights to be valued) and any extraordinary assumptions or hypothetical conditions affecting the assignment.

Scope of Work

The scope of work is the amount and type of information researched and the analysis applied in an assignment. After the problem to be solved is clearly defined, the appraiser must next determine the appropriate scope of work to solve the problem. The scope of work must be clearly disclosed in the appraisal report.



Data Collection and Property Description

In this step the appraiser gathers general data on the market area and specific data on the subject and comparable properties. The appraiser collects general data related to property values in an area to understand the economic climate in which property competes and the interacting forces that cause values to increase, decrease or remain stable. Specific data are details about the property being appraised (the subject property) and comparable properties that have been sold or leased in the local market. Land and building descriptions are specific data that help an appraiser to select comparable sales and rentals.

Data Analysis

In the analysis of general data, national, provincial and local trends are emphasized. Supply and demand data are studied to understand the competitive position of the property in its market. In an analysis of specific data, a set of properties most like the subject property is studied. The analysis of comparable properties helps an appraiser extract specific sale prices, rental terms, incomes and expenses, rates of return on investments, construction costs, economic life estimates and rates of depreciation. These figures are used in the calculations that result in indications of value for the subject property. Highest and best use is a critical step in the development of a market value opinion. In highest and best use analysis, the appraiser considers the use of the land as though it were vacant and the use of the property as it is improved. To qualify as the highest and best use, a use must satisfy four criteria: it must be legally permissible, physically possible, financially feasible and maximally productive.

Market analysis provides the basis for an appraiser's conclusions about the highest and best use of a subject property, and the remainder of the valuation process follows from these conclusions.

Land Value Opinion

A land value opinion is formed through the application of a variety of methods that are derived in varying degrees from the three approaches to value. The most reliable procedure for arriving at a land value estimate is sales comparison. Sales of similar vacant parcels are analyzed, compared and related to the land being appraised. If sufficient sales are not available for comparison or the value opinion indicated by

sales comparison needs substantiation, the appraiser may use another procedure such as extraction, allocation, the land residual technique, ground rent capitalization, or subdivision development analysis.

Application of the Approaches to Value

The appraiser begins to derive an opinion of property value using one or more of the three approaches to value. The approaches employed depend on the type of property, the use of the appraisal and the quality and quantity of the data available for analysis.

Cost Approach

The cost approach is based on the understanding that market participants relate value to cost. In the cost approach, the value of a property is derived by adding the estimated value of the land to the current cost of constructing a reproduction or replacement for the improvements and then subtracting the amount of depreciation in the structures from all causes. Entrepreneurial profit may be included in the value indication. The current cost to construct the improvements can be obtained from published costing manuals or through direct interaction and surveys of builders, developers and contractors. Depreciation is of three different types (physical deterioration, functional obsolescence and external obsolescence) and is measured through market research and the application of specific procedures. Land value is estimated separately in the cost approach. This approach is particularly useful in valuing new or nearly new improvements and properties that are not frequently exchanged in the market. Cost approach techniques can also be employed to derive information needed in the sales comparison and income capitalization approaches to value, such as an adjustment for the cost to cure items of deferred maintenance.

Sales Comparison Approach

The sales comparison approach is most useful when a number of similar properties have recently been sold or are currently for sale in the subject property's market. Using this approach, an appraiser develops a value indication by comparing the subject property with similar properties, called comparable sales. The sale prices of the properties that are judged to be most comparable tend to indicate a range in which the value indication for the subject property will fall. The appraiser estimates the

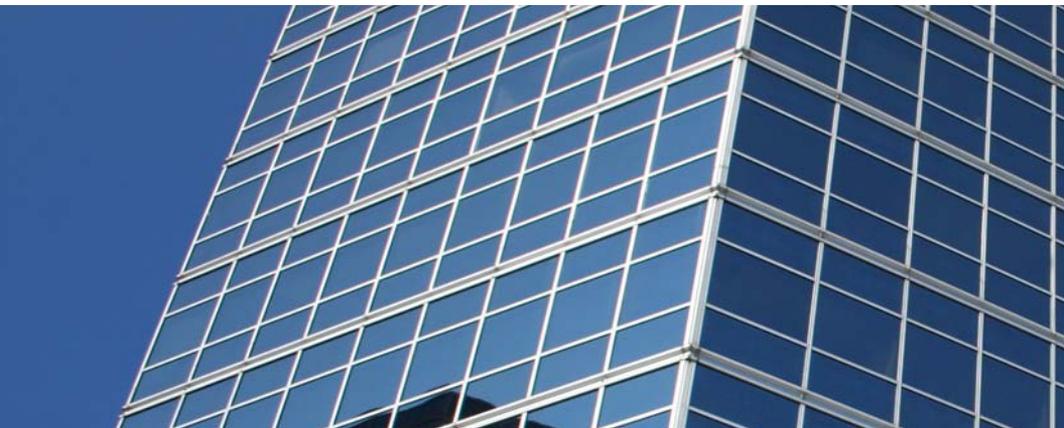
degree of similarity or difference between the subject property and the comparable sales by considering various elements of comparison such as:

- *Real property rights conveyed*
- *Financing terms*
- *Conditions of sale*
- *Expenditures made immediately after purchase*
- *Market conditions*
- *Location*
- *Physical characteristics*
- *Economic characteristics*
- *Use/zoning*
- *Non-realty components of value*

Dollar, percentage or qualitative adjustments may be applied to the known sale price of each comparable property to derive a range of value indications for the subject property. Through this comparative procedure, the appraiser ultimately arrives at an opinion of value. Income multipliers and capitalization rates may also be extracted through analysis of comparable sales, though these factors are not regarded as elements of comparison in the sales comparison approach. Instead, they are usually applied in the income capitalization approach.

Income Capitalization Approach

Income-producing real estate is typically purchased as an investment, and from an investor's point of view earning power is the critical element affecting property value. In the income capitalization approach,



value is measured as the present value of the future benefits of property ownership. There are two methods of income capitalization: direct capitalization and yield capitalization. In direct capitalization, the relationship between one year's income and value is reflected in either a capitalization rate or an income multiplier. In yield capitalization, the relationship between several years' stabilized income and a reversionary value at the end of a designated period is reflected in a yield rate. The most common application of yield capitalization is discounted cash flow analysis. Given the significant differences in how and when properties generate income, there are many variations in both direct and yield capitalization procedures. The specific data that an appraiser investigates in the income capitalization approach might include the property's gross income expectancy (assuming either market rent or contract rent), the expected reduction in gross income caused by vacancy and collection loss, the anticipated annual operating expenses, the pattern and duration of the property's income stream and the anticipated reversionary value. After income and expenses are estimated, the income streams are capitalized by applying an appropriate rate or factor or converted into present value through discounting. In discounted cash flow analysis, the quantity, variability, timing and duration of a set of periodic incomes and the quantity and timing of the reversion are specified and discounted to a present value at a specified yield rate. The rates used for capitalization or discounting are derived from acceptable rates of return for similar properties.

Reconciliation of Value Indications and Final Opinion of Value

In reconciliation the appraiser analyzes alternative conclusions and selects a final opinion of value from among two or more indications of



value. A thorough review of the entire valuation process may precede reconciliation. In reconciliation an appraiser draws upon his or her experience, expertise and professional judgment to resolve differences among the value indications derived from the application of the approaches. The appraiser weighs the relative significance, applicability and defensibility of each approach and relies most heavily on those most appropriate to the intended use of the appraisal. The conclusion drawn is based on the appropriateness, accuracy and quantity of all the evidence in the appraisal. When a final opinion of value has been derived, the immediate objective of the valuation process has been accomplished. However, an appraisal assignment is not completed until the conclusions and findings have been stated in a report and communicated to the client.

Report of Defined Value

The type, format, length and contents of a written appraisal report may vary depending on the requirements of the client and the scope of work criteria. The purpose and function of the report will to a large degree dictate the content of the appraisal and the CUSPAP standards dictate the reporting requirements and standards. In general, a written, narrative style report describes the data and analyses used in the assignment. It provides coverage of appropriate information contained within the report itself with minimal reference to files outside the report. With residential properties, a form report is most commonly utilized which summarizes the findings of the appraisal process. An appraisal may also be communicated by means of an oral report when circumstances do not permit or warrant the preparation of a written report.

Certification

The certification states that the appraiser has personally conducted the appraisal in an unbiased, objective manner in accordance with AIC Standards. It may follow the final opinion of value or be combined with it. The certification must be signed by the appraiser. Certification is important because it clearly states the role of the appraiser, thereby clarifying that the assignment was performed by an individual who is impartial, objective and unbiased. All appraisal reports will specify the following items:

- *the identity of the client and any other intended users*
- *the intended use of the report*
- *the type and definition of the value to be estimated*
- *the effective date of the appraisal*
- *the real estate being appraised*
- *the real property interest being valued*
- *any extraordinary assumptions and hypothetical conditions affecting the appraisal*
- *the scope of work—i.e., the extent of the process of collecting, confirming and reporting data*
- *any usual valuation approaches that may have been excluded*
- *the highest and best use of the real estate when such an opinion is necessary and appropriate*
- *the information considered, appraisal procedures followed and reasoning applied*
- *a signed certification*

In every field of business and professional endeavor, there are experts who are recognized for their skill and superior abilities. In the real estate appraisal profession, these are generally appraisers who have extensive training and experience, subscribe to a code of professional ethics and standards of professional practice and have received professional recognition for their abilities. Designated members of the Appraisal Institute of Canada, holding the AACI or CRA designation, are such appraisers. AIC professional membership designations are conferred on individuals who have met stringent education requirements and have demonstrated appraisal experience. Currently, the AIC confers one general designation, the AACI, and one residential designation, the CRA. Once designated, these members participate in a program of continuing education. Training in up-to-date valuation techniques, coupled with experience and integrity, make Appraisal Institute designated members the preferred source of high-quality appraisal services.



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REAL ESTATE APPRAISERS & CONSULTANTS

331A - Sixth Street
Courtenay, BC V9N 1M2
Tel: (250) 338-7323 Fax: (250) 338-8779
www.comoxvalleyappraisers.com