

# ***A Consumer's Guide to Real Estate Appraisals***

## **Why you may need an appraisal**

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### **INTRODUCTION**

As urbanization continued, the demand for property information grew what buildings ate on these parcels? How much are they worth? Are they the right buildings for the needs of the population? What public infrastructure and supporting elements are required? Which assets can be used as collateral for new growth?

There are many reasons why you may need a real estate appraisal.

The most common one is to obtain a mortgage on a home. Most lenders are required by Federal and State laws and current banking regulations to obtain an appraisal in conjunction with most loans secured by real estate (mortgages) given by the lender.

Other common reasons for real estate appraisals include appraisals made for insurance purposes, estate valuations, property tax assessments, for buyers, sellers, and relocation companies. More complex appraisals are required for most condemnation proceedings, partial takings, leasehold valuations, various commercial developments, and other related real estate activities. In some states, anyone can make a real estate appraisal as will as in our country there is no such one who is called a professional appraiser. Other states require that appraisers have a license. In 1989 Congress passed the FIRREA Act, which requires that by 1993 all appraisals made for mortgage loans from federally insured lenders and all other federally related transactions be made by a State licensed or state certified appraiser.

## **WHAT IS A REAL ESTATE APPRAISAL**

In non-technical terms, an appraisal is an objective, supported opinion of the value of an adequately described piece of property, made by a person who has sufficient knowledge and experience to accurately estimate its value. Appraisers use comparable sales, as well as rentals and listing data, together with information about the property being appraised (subject property), its neighborhood, community, and region and the local and national economy to support their value estimates.

## **THE VALUATION PROCESS**

The appraisal profession has been organized in the United States for over fifty years. It has developed an accepted standardized method for making a real estate appraisal, which is commonly known as The Valuation Process. This process recognizes that every piece of real estate is unique, and that the type of value to be estimated must be determined by the needs of the client. Most appraisals for mortgage purposes require an estimate of the property's "Market Value", while appraisals for insurance purposes, for example, estimate "Insured Value". These are just a few of the many types of value which are estimated by appraisers.

## **DEFINITION OF THE APPRAISAL PROBLEM**

The first step of every appraisal is to determine what kind of problem the client needs solved and what type of value is to be estimated. To answer these questions fully, the appraiser must identify the property to be appraised, which property rights are involved, the use the client will make of the appraisal, the value to be estimated, together with a definition of this value, the effective date of the appraisal and any underlying assumptions and limiting conditions that apply.

## **DATA COLLECTION AND ANALYSIS**

Next, the appraiser makes a plan to collect and analyze general information about social, economic, governmental and environmental forces that affect the value of the property. This will provide the background against which the specific data will be analyzed. Specific data includes information about the subject property site and improvements (the land and buildings or other structures), and the comparable data on properties which have sold, rented or are listed for sale ("comparable sales", "comparable rentals", and "comparable listings").

The appraiser's analysis of both the general and the specific data includes economic data as well as data about similar properties. This data helps the appraiser to understand the unique competitive position of the subject property in the overall market. The appraiser estimates the present and future demand for the subject property and how this demand affects its value.

## **HIGHEST AND BEST USE ANALYSIS**

What appraisers call "Highest and Best Use" is an important step in the process of estimating the value of any property. Appraisers estimate the Highest and Best Use of a property first assuming the site is unimproved and vacant (even if it is improved and occupied). They identify that use which, in their opinion, would be the best development of the property in terms of its total worth. They do a second Highest and Best Use analysis of the property as actually improved to identify what could be done to the existing improvements to make the property more valuable. For example, the subject property might be improved with a 1,000 square foot, two bedroom, one bath, ranch house. The appraiser may conclude, based on the analysis of the general and specific data, that the Highest and Best Use of the property if the site were vacant is a 1,400 square foot ranch house with three bedrooms and two baths; therefore the property is under-improved. Depending upon the individual site and improvements, it may or may not be possible to (economically) alter the property to its Highest and Best Use. This type of analysis is used by the appraiser as the basis for the site value estimate, sales comparison approach, cost approach, income approach and the remainder of the valuation process.

## **SITE VALUATION**

Accepted appraisal methodology requires a separate site value to be developed in every appraisal. When comparable site sales are available, they provide the most reliable basis for making the site value estimate. In the event that there is a lack of sales data, the appraiser may use other procedures. Some of these are the Allocation Method, the Extraction Method, or Subdivision Development, Land Residual and Ground Rent Capitalization methods.

### **THE THREE APPROCHES TO VALUE**

There are three basic approaches to estimating value. Current appraisal standards require appraisers to use all three of these approaches to value for each appraisal, or provide as part of the appraisal adequate reasons why one or more of the approaches was not used. In the following approaches I have chosen restaurant real estate to clarify them.

#### **1. THE COST APPROACH**

The Cost Approach is based upon the assumption that there is a relationship between what it costs to acquire a site which is suitable, build a particular structure on it, and the market value of the improved property. Any difference between the site value plus the cost of the improvements and their combined market value is called depreciation, which is divided into 3 major categories:

- (1) *Physical Deterioration* is the loss of value due to age and condition;
- (2) *Functional Obsolescence* is the loss of value due to poor design, deficiencies and over-improvements;
- (3) *External Obsolescence* is a loss of value caused by something off the site which nevertheless adversely affects it, such as a nearby hazardous waste site.

These categories can be further divided into curable depreciation and incurable depreciation. The use of the Cost Approach is more significant when good comparable sales data is *not* available. It is easier to use on newer properties in good condition, where there is little depreciation. It is not particularly applicable for older properties which may suffer from very significant depreciation which can be difficult to estimate.

New restaurant buildings and the underlying land are often purchased by individual investors at a price that reflects the cost of purchasing a vacant parcel of land and constructing, and equipping, a chain-affiliated restaurant on the site. Investors often prefer chain-affiliated restaurants because chains have a track record of past success and ample financial data upon which the investor can base the decision to purchase. Typically, investors purchase restaurants in order to lease them to operators. These sale/leaseback transactions are considered financing vehicles, as opposed to arm's-length real estate sales transactions. The purchase price is negotiated based on the rate of return required by the investor and the amount of rent the operator of the restaurant business can afford to pay, based on the sales expected to be generated by the restaurant business operation. The price paid is an "investment value" rather than a "market value" because the terms of the purchase are tailored to meet the requirements of an individual investor, and are not necessarily a reflection of what a "willing buyer and willing seller" would agree to in an open market.

The appraiser of restaurant real estate most often will provide the client with an opinion of the "value in use" of the property operating as a specific brand or concept. "Value in use" for a restaurant is based on the premise that the value of restaurant real estate is dependent on the restaurant business producing a revenue stream great enough to cover the return of and return on capital invested in the land and improvements. Until such time as the restaurant operation reaches a stabilized level of revenue, the highest value indication, when a building is new, is often derived using the cost approach, and is identified in the industry as the "full value" of the land and building.

The income approach carries more weight than the cost approach for these properties.

## **2. THE SALES COMPARISON APPROACH**

This method compares the property being appraised to other similar nearby properties that have recently sold or are listed for sale. When good data is available, the results of this approach are most satisfactory and the easiest to understand. Since no two properties are exactly alike, appraisers must make adjustments for significant differences between the comparable sales and the subject property.

There are four major categories of adjustments, which are also known as the "elements of comparison":

- (1) a time adjustment, to reflect market differences between the date of the appraisal and the comparable sales date;
- (2) a location adjustment, to reflect value differences between the location of the subject and the location of each comparable sale;
- (3) Adjustments for differences in physical characteristics between the subject and the comparables;
- (4) Adjustments, if necessary, for any special conditions or special financing that might have influenced the selling price of the comparable.

The accuracy of a sales comparison value estimate decreases if there are many differences between the subject property and the comparable sales.

Whenever possible, appraisers make the necessary adjustments based on data they have extracted from the market. For example, the data may indicate that a swimming pool will add about \$10,000 value to a residence in a specific area.

### **3. THE INCOME APPROACH**

The Income Approach can be useful in estimating the value of single family residences as well as properties owned primarily for their investment value.

When it is applied to small residential properties, the Income Approach is based on comparing monthly rentals of similar properties which have sold, and estimating a monthly market rental for the subject property. The ratio between rent and the sales price is used to estimate the value of the subject property.

When it is used in the appraisal of investment properties, this approach begins with an estimate of the market rent for the subject property, deducting all fixed and operating expenses to yield what appraisers call the Net Operating Income (NOI); not included are deductions for depreciation or mortgage interest and amortization. The last step in applying the Income Approach converts NOI into value by using an appropriate capitalization rate or factor. This conversion process can be complex and is the subject of many books and articles. The accuracy of estimates made by using this technique is dependent upon the availability of good data and the skill of the appraiser applying this methodology.

When the income approach is used to value the land and improvements of a proposed restaurant, the value derived depends heavily on the projection of the restaurant's stabilized gross revenue estimated by the appraiser. Because the real estate's "value in use" is directly related to the potential revenue generated by the restaurant, the indication of value is only as reliable as the projected restaurant food and beverage sales. The projection of stabilized gross sales can be estimated with relative confidence in the case of a chain-affiliated restaurant with a past operating history in multiple locations. However, projecting revenue for a new restaurant concept requires experience in the restaurant business supported by market research in the area where the restaurant is to be built.

The combined “value in use” of the land and restaurant building can be approximated by capitalizing the net income stream that would flow to a hypothetical landlord, after the deduction of vacancy and credit loss, and management expense, assuming the building and land is leased to the restaurant operator at market rent. The key determinant in calculating the value of the subject property is the selection of an appropriate capitalization rate. For example:

<b>Annual food and beverage sales</b>	<b>\$3,200,000</b>
<b>Multiplied by rent percentage</b>	<b><u>7.0%</u></b>
<b>Annual (Potential Gross Income)</b>	<b>rent \$ 224,000</b>
<b>Less: Vacancy &amp; Credit Loss @ 3%</b>	<b><u>- \$6,720</u></b>
<b>Effective Gross Income</b>	<b>\$ 217,280</b>
<b>Less: Management Expense @ 2%</b>	<b><u>\$ 4,346</u></b>
<b>Net Rental Income</b>	<b>\$ 212,934</b>

<b>Net Rental Income ÷ Capitalization Rate</b>	
<b>=Value of the Land &amp; Building</b>	
<b>\$212,934 ÷ 9.5% =</b>	<b>\$2,241,410</b>
<b>\$212,934 ÷ 10.0% =</b>	<b>\$2,129,340</b>
<b>\$212,934 ÷ 0.5% =</b>	<b>\$2,027,943</b>

As shown in this example, a one-percentage point difference in the capitalization rate results in an approximately \$213,000 difference in value. This emphasizes the importance of choosing a capitalization rate that is derived from the market by analyzing comparable sales and interviewing buyers and sellers who are actively involved in the market for restaurant real estate investments.

Another Income Approach technique is known as Discounted Cash Flow Analysis, which converts the estimated future income of a property into present value.

## CONCLUSIONS

All through the valuation process, the appraiser analyzes and reconciles the collected data to arrive at conclusions regarding the final value estimate. In the final reconciliation, the appraiser considers all the available data and uses his or her knowledge, experience and professional judgment to estimate a final value for the subject property.

After each of the three approaches to value has been considered, the appraiser reconciles the three indications of value, or range of values, to reach a conclusion of value for the subject property. The weight given to each approach to value may vary depending on many factors including the age of the improvements, whether the property is vacant or occupied, the length of time the investment has been in operation, the credit worthiness of the operator, and the availability of comparable sales of similar properties. In conclusion, the valuation of real estate and business value is complex and dependent on many variables. In this report, I have attempted to explain, in simple terms, the methodology used by an appraiser experienced in valuing restaurant real estate and the business value.

To this end, international data standards and systems of data sharing must be developed so real property markets can become more efficient and transparent. To have a future the valuation profession must build on the heritage of professionals who have long protected the risks of capital investors and step up to help the world's economy avoid the turmoil of the last century. To do so does not require a wholesale retooling of the valuer's skill set, but it does require that valuers change the scope and perspective of their analyses. Healthy real property markets can be the catalyst of a bright future for every region of the world.

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