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Over improvements in a sluggish real estate market

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By Rey Archambault

One of the most uncomfortable encounters a residential real estate appraiser faces involves responding to questions by homeowners looking to sell or refinance who are shocked to learn their property is worth far less than they thought, or hoped. After all, this is their home, their pride and joy, their dreams and all too often, their nest egg. It's personal. Residential equity has become easier to tap over the past 15-20 years and is often used to fund college educations, home improvements, travel, caring for sick or elderly relatives and, in some cases, just make ends meet. Declining values erode buying power, not unlike an unauthorized ATM withdrawal.

Statewide, residential property values peaked in 2005 in most markets, held their own until mid-2007, then receded through 2009. Some areas have shown a degree of stability over the past year while some softer markets continue to creep downward, with urban areas hardest hit. Owners who bought high obviously had the most to loose, while established owners rode a cushion of market built equity that conventional wisdom tells us will return. Timing is everything, and property owners had little control over the percentage of worth lost on initial investment, once their choice was made. What buyers can control is where they purchase (location) and their decisions regarding the property after purchase, particularly over-improvement.

One of the axioms of residential real estate deals with issues regarding location and the consensus that, to paraphrase "...it is better to have the smallest house within a neighborhood of larger homes than have the palace among the peasants". The same goes for what you put inside the house or on the site, or the site itself for that matter. A standard, level site with minimal natural barriers to development is less expensive to develop than a sloping site with outcroppings of ledge, watercourses, etc. Tens of thousands of dollars can be expended just to ready a site for development, which a resale buyer may not fully appreciate, were an alternative site available for similar development. Costs for retaining walls, drainage, elaborate landscapes, serpentine driveways, sewage injection pumps, etc., all add cost without necessarily improving utility vs. a cheaper alternative where such infrastructure was not needed in new construction projects. Is that hillside view or that added privacy worth that much? The Principle of Substitution says no.

Of greater concern is the home itself. Buyers will often take a home in average or better condition at time of purchase and set about completing a wish list of renovations that, while improving overall appeal and livability, may not be supported in terms of recapture value upon resale. Taking the example of a median priced home within a neighborhood of residences otherwise compatible in appeal, size and age, sensible improvements would include needed cosmetic updates, upgrades of mechanical systems and major dwelling components including roof structures, siding, windows and doors and repairs to rectify defects such as wet basements. Expanding the footprint of the dwelling to add a family room, master bedroom, bath, enlarge a small kitchen, etc., may be a wise expenditure, but the key is to not over-improve. Will the size of the house after completion still appeal to the average buyer within this neighborhood? Will the materials used be consistent with what is expected and customary for the area? Will the curb appeal after completion be enhanced? If the answer is no to one or more of these questions, the improvement project is likely ill advised from an investment standpoint.

Putting on a consultant's hat, it is important to balance the owner's wants and comforts with the dollars. If the owner intends to stay in the home for five years or more, the decision to improve can be more flexible. After all, it is first and foremost a home and personal enjoyment and physical needs (special fit-up for disabilities, in-law unit, etc.) enter the equation. However, if the owner is likely to relocate within a short period of time, either due to job change or imminent retirement, upgrades should be kept to those deemed necessary to return the dwelling to a marketable condition and include amenities expected within the market for resale. In this case, the addition may not make sense. The Brazilian cherry wood or marble tiled floors, high end appliances, home theater systems, etc., for the median home probably does not make economic sense, unless the majority of homes have been similarly upgraded. Much like buying a used car "loaded" with options selected by the original owner, selling an over-improved home can be a financial disappointment to the seller and a boon to the buyer who purchases the best house on the block for an "otherwise at market" price. In a down market, these results are magnified.

Some of the items least likely to return a near dollar for dollar investment include elaborate finish to a below grade basement, elaborate kitchens/bath updates, expensive custom built-ins, home theater systems, elaborate landscape schemes, oversized garages, expensive perimeter fences and in-ground pools in entry and median value market areas. Such amenities may be more standard in upper bracket markets, in which case they are likely to return greater value or be expected by prospective buyers, otherwise putting the home at a competitive disadvantage from a marketing standpoint. Adding total dollar expenditures to original purchase price, losses in value from the recent declining market has left many owners with sticker shock, which could have been minimized by prioritizing home improvement projects and exercising restraint in decisions to over-improve. The guy next door with the more "market typical" improved home is probably not feeling quite the burn the owner of the elaborately improved home is feeling these days. But, cheer up. The tax assessor may be more willing to validate your decisions to over-improve, even if the next buyer probably won't.

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