When a developer seeks to build a new property, there are certainly a variety of costs associated with completing the project. Unfortunately, it can come both as a surprise and a problem when the market value appraisal comes in below the project costs. There are many contributing factors that
can impact this gap. Here are but a few:

As defined, Cost is – “The dollar expenditure to develop an improvement; applies to either reproduction of an identical improvement or replacement with a functional equivalent, not exchange (price).” Any given project will have some level of cost associated with it, such as acquiring land, indirect (soft) and direct (hard) costs. However, depending upon the characteristics of the property being built, and market conditions at the time of development, a certain level of impact from obsolescence can be present at the outset. Such impact is often attributable to either External or Functional Obsolescence, or both. External Obsolescence is associated with negative economic conditions outside the property itself such as an imbalance of competing supply and demand, or the inability to command a sufficient level of rental income to feasibly finance the debt and equity components to support project costs. The higher the costs, the larger this impact can be. Functional Obsolescence is associated more with the characteristics of the property itself, such as design, size, finishes, mechanicals, etc. in relation to what more “typical” market tastes and standards would require. Building 16' ceilings into a property when the market is made up mostly of 12' ceilings, for example. Building in a 30% level of finished area, when most other like properties only have 10% finished area. The more unique or special purpose the property, the higher the likely costs, yet the smaller pool of potential users or buyers for it. Such special purpose or limited market properties may get developed more on a Value-in-Use premise for an owner-user, which is worthy of a whole separate discussion and future article.

Market Value however is what banks seek for lending purposes, and is generally defined as: “The most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.” So when an appraiser is commissioned to develop an independent opinion of Market Value, analyses have to be conducted that take into consideration what is “typical” of the market for the subject property and what the majority of potential buyers/users would be justified in paying for the property at that point in time. This usually entails finding competitive listings and recent sales of like properties in the Sales Comparison Approach, as well as analyzing market rents, expenses, and current financial rates and ratios in the Income Capitalization Approach. While the Cost Approach is one of the three traditional methods appraisers consider in every appraisal assignment, the results may not be supported by the other methods due largely to obsolescence impacts in the marketplace. Such obsolescence is the difference between cost new, and what competitive sales and rental income would otherwise support in terms of market value.

In closing, a cost basis can be thought of as the price to create the product, but one that a very few potential purchasers/users would be willing to pay. An owner-user may have specific needs or wants in a property that exceed the norm, and may be willing to pay the price. A Market Value basis, however, considers what other participants are actually paying or seeking for a substitute property of equivalent utility. Not unlike shopping for any product, the real estate market often penalizes superadequacies and/or inadequacies in a given property. It will discount the frills, and over-estimate the cost-to-cure problems. The more atypical the property, the larger the potential cost-market value gap may be. These are just some of the reasons why it should not be surprising that Cost simply does not equal Market Value in many cases.

2. The Dictionary of Real Estate Appraisal, 6th edition, page 142
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