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## **Three approaches to appraisal theory - by Bill Pastuszek**

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Bill Pastuszek

Three Approaches. Appraisal Theory gives real estate appraisers and users of appraiser services three approaches with which to arrive at value opinions. Let's review the approaches.

**Cost Approach: Old School.** The steps in the cost approach are as follows:  $\text{Cost New} - \text{Depreciation} + \text{Land Value} = \text{Property Value}$ . The cost approach is a summation approach where separate values of the vacant site, site improvements, and the improvements are developed. The value of the improvements and site improvements are developed by arriving at an opinion of cost new – including both direct and indirect costs - and then deducting accrued depreciation, which is the loss in value from physical, functional, and external factors.

In theory, the cost approach seems like a reasonable way to look at properties, particularly properties just built and to be built. It considers the four agents of production and segregates out the components. In practice, the cost approach often is not considered applicable by appraisers where typical market participants do not rely on the approach's technique in arriving at value indications, even for relatively new properties. Appraisers often note that depreciation is subjective, hard to prove, and that costs are better estimated by construction professionals and not by appraisers using cost services.

Generally, appraisers often tend to avoid the cost approach except when absolutely necessary. As a consequence, many appraisers lack the constant practice that they have with the other two approaches. Appraisers have not been trained well in developing the cost approach.

**Income Approach: Quantifying the market .** The income capitalization process converts the anticipated flow of future benefits (income) to a present value indication. The approach relies on the principle of anticipation. This principle is based on the premise that an investor would base a purchase decision for a property on the present value of income benefits expected to be derived from the ownership of the property.

There are two typical capitalization techniques in this approach, direct and yield capitalization. The nature of the income stream guides the choice.

This approach is foundational. For an income property, adequately developing the approach is essential to model the behavior of investors for a property.

For many years, the approach relied on mechanistic, formula-based techniques that did not directly reflect investor behavior. More recently, greater emphasis has been placed on deriving and support the components of the approach through observing and quantifying investor behavior.

**Sales Comparison Approach: Old Reliable.** This approach is preferred by residential appraisers and has an important place in the process for income property appraisal. The approach attempts to simulate the process by which informed buyers and sellers proceed in deciding upon a price. When reasonable, market-supported adjustments for differences between the subject and comparables

are appropriately applied and when historical comparable data is interpreted in the context of the current market, a credible result is obtained.

The principle of substitution is the foundation for the approach. This fundamental concept holds that a well-informed buyer would not pay more for a property than it would cost to acquire a comparable substitute property.

The principle of contribution forms the basis for making adjustments to comparable data to make sales, listings, etc. as similar to the subject property as possible. The key to credible results is to provide adequate support in making adjustment to the comparables. This is not always done; many appraisers rely on past experience and some intuition to develop adjustment.

Fourth Approach: Is that even possible? An encouraging trend since the Great Real Estate Recession is the trend toward more quantitatively based market analysis. There are vastly more data resources out there for appraisers to rely upon and far less reliance on assertions and unsupported assumptions.

This is a good trend. For many years, appraisers found it too difficult, time consuming, and costly to undertake the type of quantitatively based market analysis that is possible today. As both clients and appraisers have access to these resources, a more collaborative atmosphere has evolved with greater transparency into the appraisal process.

Appraisal is gradually, perhaps too late to prevent the solutions from being imposed from without, rather than being developed from within, adopting more broad-based data sets and analytical techniques. Quantitative methods, such as multiple regression, statistical analysis, and advanced investment analysis, are working their way into appraisers' toolboxes. As strange as it may seem but crowd sourcing and social media have had an effect on appraiser's perceptions of market activity.

More Approaches – Is it even conceivable? There may be more good news/bad news out there. There are tools out there that can enhance the appraiser's practice by allowing appraisals to be done faster and better. In the hands of well-trained, skilled practitioners, these tools can do much to enhance the three approaches.

Appraisers have been challenged recently in residential markets and small inventories have been bid up by eager (if not desperate) buyers. (Everybody wonders if this is a permanent condition. It remains to be seen.) The current market has shown some limits to comparable analysis and suggests that there might be better ways – not yet fully formed – for appraisers to develop values.

The appraisal profession has always been slow to change. This is a good time for the profession to adapt and adopt some fresh ways of looking at real estate markets.

Bill Pastuszek, MAI, ASA, MRA, heads Shepherd Associates, Newton, Mass.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540