<u>The Real Estate Appraisal</u>

By Scott Kroepel, State Certified Residential Appraiser

A real estate **appraisal** is a professional opinion of value, provided by a State Licensed or State Certified Appraiser, upon the reconciliation of up to three supported valuation methods. *Not to be confused with a market analysis performed by a real estate agent to establish a listing price, or an assessment performed by a local municipality for taxation purposes.*

Appraisal reports are typically ordered by banks, mortgage lenders, and other investors when a home buyer has applied for a new mortgage, or when a home owner wants to refinance their current home or property. The purpose of an appraisal is for the lender's security and to satisfy their due diligence, since they will only make their mortgage loans based on a percentage of the appraised value. In the unfortunate event that the borrower stops making their mortgage payments and the lender has to foreclose on the property, they want to make sure they aren't loaning more money than the property is worth.

The appraiser is a non-biased, independent outside-party, who is not related to, nor affiliated with anyone involved in the transaction. They follow the Uniform Standards of Professional Appraisal Practice, and many are also accredited or hold certifications with other state and national organizations, beyond the minimum licensing requirements.

An appraisal cannot be ordered based on a predetermined value or any specific outcome. Nor can an appraiser accept an assignment based on any value or outcome contingencies. In fact, as a result of the mortgage crisis of the late 2000's, there are new laws that prohibit specific activity by those parties affiliated with the transaction. For example, trying to intimidate an appraiser or influence an appraiser's decision (such as an agent threatening to turn an appraiser in to the state for not using their pre-chosen comps, a mortgage broker threatening to withhold additional orders from an appraiser who doesn't hit a target value, or a borrower threatening an appraiser). An appraiser is not an advocate for the client, but does have a confidentiality and fiduciary responsibility with the client who ordered the appraisal. As such, an appraiser may not discuss the appraisal report or the results with anyone other than the client (including the borrower or any of the other parties involved in the transaction), without the prior written consent of the client.

When an appraisal request is accepted by the appraiser (based on the client's Letter of Engagement outlining the Scope of Work, assignment information, and appraiser's fee), the appraiser will schedule an appointment with the home owner, borrower, agent, or other contact provided to inspect the property. At the inspection, the appraiser will take measurements, interior & exterior photos, and notes about the home, outbuildings, and amenities. Any information pertinent to the home or property that can be provided to the appraiser may be helpful, and may save the appraiser some time at the appointment and/or allow for a quicker completion time for the report. (Such as a copy of the survey, recent property tax records, floor plans, etc.) The appraisal inspection can take between 15 minutes to an hour on average, depending on the size and complexity of the property and the assignment. The appraiser will then gather all of the information back at the office, research & verify comps, verify tax & assessment information, and gather & verify additional relevant information for the property to complete the appraisal report.

It's important to understand that the appraiser is only inspecting the property in the most general sense, to determine the facts and condition of the property, for valuation purposes only. The appraiser is not a licensed contractor, home inspector, pest inspector, surveyor, environmental expert, or any other type of inspector unless specifically noted. Experts in those fields should be hired by the client, if they have any questions or concerns.

There are three common methods, or approaches, to determining a final value estimate in a standard residential appraisal report: The **Sales Comparison Approach**, the **Cost Approach**, and the **Income Approach**.

The **Sales Comparison Approach** is the most common method of determining real property value, due to the proven market support of the sales data. The appraiser will research at least 3 comparable sales in the neighborhood that have sold within the past 3-12 months (or more, depending on the location and availability of local market data), and will make monetary adjustments for the differences in each of those comparable properties.

For example, if the home being appraised (also known as *the **subject***) has 3 bedrooms, while one of the comparable sales in the neighborhood had 2 bedrooms when it sold, the appraiser will then add value to the 2 bedroom comp, effectively bringing up the value of that sale as compared to the subject. Similarly, if the subject had a crawl space foundation and one of the comps had a fully finished basement, then the appraiser would subtract value from the comp with the basement, effectively lowering the value of that sale as compared to the subject. The monetary adjustments are based on the appraiser's market research, and may vary by neighborhood, market, or by other supporting factors.

The adjustments added or subtracted from the comparables in the appraisal report may not represent the actual cost of the item (especially in the amenities section). Rather, adjustments are given based on the additional value that buyers in the market are willing to pay for the added item, based on what other properties with those similar items are selling for in the market.

For example, say all of the homes located in a certain neighborhood are exactly alike in every way, and all of the homes in that neighborhood that have sold within the past six months all closed for around $150,000. However, two of the homes in the neighborhood that had in-ground swimming pools sold for around $155,000. Since most in-ground pools cost well over $5,000 to install, those property owners likely over-improved for the neighborhood (also known as superadequacy). Therefore, an appraiser would only add $5,000 for the value of a pool if appraising a home in that neighborhood. Similarly, if an appraiser was using a property with a pool as a comparable sale in that neighborhood, the value of the pool would only be reduced by $5,000 in this example.

If the comparables and the value adjustments are accurate for the market, the bottom line figures of the adjusted comps should all be within a close value range. The appraiser will decide which comparable (or comparables) is most similar to the subject, and will select a price within that range to determine the estimated value for the Sales Comparison Approach.

The **Cost Approach** to value considers the costs associated with replacing the home new, less depreciation, then adds the estimated land value and current site improvements. Cost figures are obtained from valuation service subscriptions which cover the subject's region, local contractors, or from other reliable sources. The appraiser then calculates the square footage of the home and multiplies it by the appropriate cost figures, along with other individual items and their associated costs such as a basement, garage, and other amenities to obtain the Total Estimated Cost New. The appraiser then factors in the various types of current depreciation along with the estimated land value and the site improvements on the property to reconcile the estimated value for the Cost Approach. It should be noted that physical depreciation (such as normal or excessive wear, lack of modernization, or physical deterioration) isn't the only type of depreciation. There is also Functional, such as a poor floor plan layout (for example, needing to walk through a bedroom to get to the only bathroom, steep & narrow staircases, etc.) and External, such as uncontrollable off-site factors (for example, a garbage dump or a known contaminated facility located next door, etc.)

The **Income Approach** to value is considered when the subject property is a duplex, multi-unit complex, or other type of income producing property. Or it might be completed if the subject is located in an area of primarily income-producing properties. The appraiser will search for properties in the subject neighborhood that were rented at the time of sale, then divide the sale prices by the gross rental incomes to determine an appropriate Gross Rent Multiplier. That GRM is then multiplied by the current rent (or the estimated market rent) that the subject property is producing, or could be producing, to determine the estimated value for the Income Approach. This method is often difficult to complete when there is a lack of market rental data to complete a credible report.

Now the appraiser will review and consider all of the approaches to value that were completed in the report. The bottom line value estimates of each method should be within a close range of each other. The appraiser is not supposed to simply average the figures to determine the estimated value, but determine which of the approaches is the most accurate for the subject property in reconciling a final value for the appraisal report.

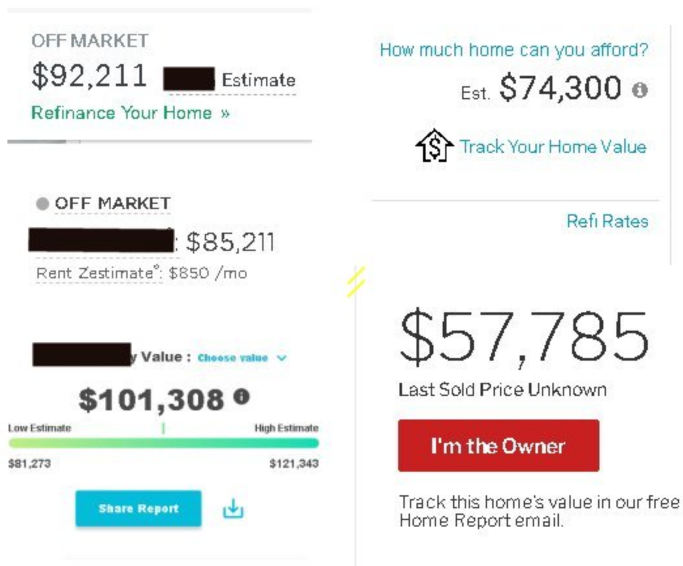
Along with the three most common approaches to value, the appraiser will also consider the zoning, highest & best use of the property, and other factors in the final reconciliation.

The report can take up to a week or longer to complete, depending on the assignment, market, verification of information with all of the different sources, and the appraiser's schedule.

Besides new mortgages & home equity loans, some other uses for professional appraisal reports include: home sellers, as a tool to help them or their real estate agent competitively price & sell their property*; home buyers who aren't required to obtain an appraisal (such as cash buyers, purchasers of seller-financed properties, or even when an appraisal isn't required by the lender), estate settlements, property tax disputes, divorce settlements, bankruptcy, eminent domain, etc. The type of report that the appraisal is completed on will depend on the client, type of property, and the intended use of the report.

**Real estate agents typically offer a market analysis to home sellers by researching comparable sales, similar to the Sales Comparison Approach in an appraisal.*
Most experienced agents familiar with the neighborhood will provide a reasonably accurate listing price for the property. Unfortunately, there are some agents who will choose comps that are superior, to try and justify a higher price, just to get the listing. Sellers should be careful not to list their property too high or they will risk actually selling for below market value. Whether it's because the property sets on the market too long, being passed up by buyers for those accurately priced properties; or if it does get an accepted offer, but the appraisal comes in lower than the contract price. The seller then has to lower the price to complete the transaction or lose the deal.

Beware of free online value estimates. They rely on computerized algorithms, based on averages of all properties in the neighborhood and can be very unreliable. In most cases, they are only there to capture your personal information to try and sell to local real estate agents, or to promote their own products and services.



The image above shows the online value estimates from 5 different sources that were estimated on the same property located in a small rural town, on the same day. As you can see, they are all different and vary considerably. It's best to hire a professional appraiser to physically inspect the property to determine the most accurate value.

Finally, many lenders now require appraisers to include original photos of the comps that were included in the appraisal report. This practice is controversial, as many will argue that due to buyer's changes & updates after the closing, the comparable property is most closely represented at the time of sale by the MLS photos. Additionally, some homeowners are not fond of strangers driving up and taking photos of their home.
It's always good to be safe and skeptical, but if you recently purchased a home within the past year (or sometimes longer in rural areas) and see someone taking a photo of your home, that could be the reason. However, an appraiser is not likely to get any closer than the street or end of the driveway for the photo.

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Scott has been in the real estate business since 1990, and has been appraising since 1994. He actively works in the West Michigan real estate market, and is a Past President of his local real estate association.