



CHAPTER 3

COST, VALUE AND PRICE

This chapter focuses on cost, value and price and their differences. Approaches to value are discussed such as the cost approach, income approach and comparable market approach. Special attention is given to capitalization rates and rates of return for investors and how these affect the value of property.

CHAPTER LEARNING OBJECTIVES

Upon completion of this chapter, the learner will be able to:

- Explain why the subject property list price does not match other “opinions” of value such as the assessor’s valuation, and your client’s expectation of price based upon what others have paid in the neighborhood.

COST, VALUE AND PRICE

Cost

The amount of funds needed to build a structure added to the value of the land is defined as the cost value. This includes all building costs such as materials, the shipping, labor, administrative costs and the costs involved in acquiring the land.

Value

Value is the amount that a property commands with a willing buyer and a willing seller. Also known as Fair Market Value.

Fair market value is the price a buyer will pay and a seller will accept for a property under reasonable and ordinary conditions. Neither the buyer nor seller is under any pressure to complete the transaction.

Fair market value is important in real estate for the following reasons:

- A home is being priced for sale
- A property may be involved in a divorce settlement
- The home may be tied up in an estate
- Eminent domain is being exercised by the government
- A home is being re-financed
- Why A home is being foreclosed upon
- A home is being offered for sale as a short sale

The two most effective ways to determine fair market value are a comparative market analysis and a real estate appraisal.

Price

Price is the actual asking (list) price of the home. It may be priced under or over fair market value.

Role of the appraiser - an appraiser can value property using three methods:

The cost approach- usually used for commercial and industrial appraisals. The cost approach takes into consideration the cost to build a similar structure (including building materials, labor, administrative and permit fees) plus the cost of the land.

The income approach- usually used for income producing properties. Takes into consideration the income produced, fixed and variable expenses and the future value of the income using a capitalization rate.

NOTE: *The capitalization rate is the rate of return an investor receives on their investment.*

Capitalization Formulas

Formula

$$I(\text{Income}) = V(\text{Value}) \times C(\text{Capitalization Rate})$$

The value in this equation is a property value an investor would be willing to pay for a property to obtain a specified rate of return. The rate of return is the capitalization rate and is a percentage of the return the investor desires on investment. The higher the desired rate of return equates to a higher capitalization rate and a lower value for the property.

The income in this equation is the annual income from the property.

EXAMPLE #1

A property's net annual income is \$67,000 and the capitalization rate is 10%. What is the value?

$I = V \times C$, so knowing the income and capitalization rate you would use the following calculation to find the value.

$$\$67,000 \text{ divided by } .10 = \$670,000$$

EXAMPLE #2

The property's annual net income is \$48,333 and the investor desires a rate of return of 11%. What is the value?

Same as in example #1, you would divide the income by rate of return to find the value.

$$\$48,333 \text{ divided by } .11 = \$439,391$$

The investor can pay up to \$439,391 to realize their investment return of 11%.

The higher the risk, the higher the capitalization rate which will lower the property's value.

EXAMPLE #3

A property with low risk produced an annual income of \$55,000. The cap rate was 9%.

$$\$55,000 \text{ divided by } .09 = \$611,111. \text{ So the property was worth } \$611,111$$

EXAMPLE #4

Another property which was considered high risk produced the same income of \$55,000, but the capitalization rate was 12.9%

\$55,000 divided by .129 = \$426,356 property value. The higher capitalization rate (due to the high risk) substantially reduced the property value.

EXAMPLE #5

In some problems, one must deduct the bad debt or vacancy factor and operating expenses from gross income to calculate the net income.

A 20 unit apartment building has 6 units that rent for \$900 per month and 14 units that rent for \$850. Allow 6% for vacancy factor and uncollected rent as bad debt. Operating expenses include: annual property taxes of \$8,200, annual utilities of \$24,000, and maintenance expenses of \$11,600 per year. The mortgage balance is \$ 350,000 at 8% interest. The monthly payments are \$2,900. If an investor requires a 7.5% rate of return, how much should they offer for the property?

$$I = V \times C$$

Step # 1

Calculate the annual gross income.

\$900 x 12 = \$10,800 a year x 6 units =	\$64,800
\$850 x 12 = \$10,200 a year x 14 units =	<u>\$142,800</u>
	\$207,600

Step # 2

Calculate the bad debt and vacancy factor and deduct it from the gross income to find the effective gross income.

$$\begin{aligned} \$207,600 \times .06 &= \$12,456 \text{ (bad debts and vacancy)} \\ \$207,600 - \$12,456 &= \$195,144 \text{ (effective gross income)} \end{aligned}$$

Step #3

Operating expenses must be deducted from the effective gross income to arrive at net income. Since we are trying to calculate annual net income, all expenses must be in an annual form.

Property taxes	\$8,200
Utilities (\$2,000 x 12 = \$24,000)	\$24,000
Maintenance	<u>\$11,600</u>
	\$43,800

\$43,800 is the total operating expense (mortgage payments are not treated as operating expenses). The operating expenses are deducted from the effective gross income.

$\$195,144 - \$43,800 = \$151,344$ (annual net income)

Step #4

Substitute the capitalization rate into the formula $I = V \times C$

$\$151,344 = .075 \times V$

$\$151,344$ divided by $.075 = \$2,017,920$

The investor would be willing to pay \$2,017,920

EXAMPLE #6

If we continue with the previous example, if the investor paid \$750,000 for the apartment building, what capitalization rate was used?

$I = V \times C$

$\$151,344$ (annual net income) = $\$750,000 \times C$

$\$151,344$ divided by $\$750,000 = .202$ or 20.2%

The capitalization rate = 20.2%

Sales Comparison approach – usually used for residential property and also used to value the land portion only, when using the cost approach. Similar properties are compared to the site property. Additions and subtractions are made to the site property for greater or less amenities.

An appraiser typically uses only those properties that are sold. Whereas a real estate licensee will usually take into consideration properties sold, pending sale, expired listings and active listings.

The role of the real estate licensee – a residential real estate licensee typically uses only the sales comparison approach when valuing properties for a Comparative Market Analysis (CMA). However, the real estate licensee uses data from properties that are sold, sale pending, expired and currently on the market to derive a value. As with the appraiser, similar properties are compared to the site property and additions and subtractions are made to the site property for greater or less amenities.

NOTE: Pending refers to a property that is under contract, but has not yet closed.

The opinion of value from the appraiser may not match that of a value derived from a market analysis performed by a real estate licensee. And those two values may not meet the expectations that the seller has, based on the prices that were paid in the neighborhood. Sellers may have very different expectations of the value of their property.

Summary

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Check your understanding

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