REBUTTAL

By Max J. Derbes, Jr.

Essentially, if an appraiser is a believer in certain appraisal techniques which have been instilled in him or her, lightning bolts will not remove them. Such is the circumstance with regard to including an entrepreneurial profit in the cost approach at all times.

In order to make this reply to Mr. Mann's points, I have placed the remarks in accordance with his headings:

There is no question that entrepreneurial profit as a potential of a higher value than is represented by true costs must be considered by the appraiser. If there is evidence in either the market or income approaches of a higher value than cost, it may be as a result of market driven entrepreneurial profit.

So, entrepreneurial profit must be considered in the appraisal, but not necessarily in the cost approach.

The Cost Approach Procedure

Point No. 4 indicates: "Estimate entrepreneurial profit, when appropriate, from an analysis of the market." The entire Derbes article centers on "when appropriate."

If entrepreneurial profit is "market-derived," then it should show in market data sales and/or income capitalization—not in some arbitrary percentage added to true cost.

To believe that "no prudent developer or entrepreneur would undertake the risk associated with a project without the expectation of entrepreneurial reward" essentially denies that there are any motivations other than profit in building anything. Is this rational?

Furthermore, in appraising an older building in a depressed market, how can entrepreneurial profit be appropriate? Everyone would agree that no one would construct the building today. Can adding a profit increment in these circumstances possibly be market derived?

Cost Approach or Sales Comparison Approach?

"Specifically, sales data is often used to estimate reproduction or replacement cost of improvements..." states Mr. Mann. While comparable construction data might be valid, sales data would reflect a market data approach rather than a cost approach.

Measuring Entrepreneurial Profit

If "appraisers estimate entrepreneurial profit by analyzing sales of new properties in the same market" what happens when the sales show no entrepreneurial profit? Do we now survey developers and find out they expect a profit? Which is market derived?

If the appraiser finds there is an entrepreneurial profit by analyzing the sales of new properties in the same market, does this mean that the older properties likewise have such an increment? If the estimation of the market value of properties (and the mortgage loans that are to be made thereon) are to be inflated by answers of the survey of market participants, i.e., the builders and developers, there well could be further difficulties in the mortgage loan field.

Why not ask all the sellers what the value of their properties is or the buyers what they think things are worth? If the local developers have built projects and the appraiser studies these as compared with true costs, this is commonly referred to as the market data approach.

The answers to such a survey of expectations by developers in the oil patch area in 1985-1986 would have been at great variance with true market conditions.

Is Entrepreneurial Profit Cost?

The Ninth Edition of *The Appraisal of Real Estate* states that entrepreneurial profit is part of the total cost estimate when appropriate. The premise of the Derbes article is that entrepreneurial profit is not appropriate as a part of the cost approach excepting in speculative building when the market data warrants it.

When Mr. Mann states that such an increment can be found by capitalizing a stabilized income stream including entrepreneurial profit, this is the income approach—not the cost approach.

Entrepreneurial Profit Exists When the Cost Approach is Applicable

Can an appraiser assume that in a depressed market, no prudent person would construct a new office building, or apartment project, or commercial center? If this be the case, then there would be no market derived entrepreneurial profit. Do we then eliminate the cost approach as having no validity?

The justification for developing a cost approach in all circumstances springs from the analysis of the various forms of cost and an analysis of accrued depreciation. (See "Is the Cost Approach Obsolete?," *The Appraisal Journal*, October 1982, pp.581–590.)

Mr. Mann suggests that the only time that you use the cost approach is when there is entrepreneurial profit: "If market conditions show a severely overbuilt market and no projects proposed for development, then what justification is there in developing the cost approach?" If the devotees of entrepreneurial profit all feel this way, they are essentially down to two approaches.

Mr. Mann suggests that "the developer or entrepreneur must be expected to anticipate a reward to undertake the project." The realities of market motivations are vastly broader than a potential for resale immediately upon construction. Their reward can include making cars or refrigerators. Their reward can be the anticipation of an income flow based upon true cost. Their reward can be a hedge against inflation. Their reward can be use and enjoyment plus pride of ownership.

Those who build for profit are called speculative builders. Many others build but not for the same reason.

If we are going to build in the mythical entrepreneurial profit and then immediately deduct same due to functional or external obsolescence, then the original entrepreneurial profit was not market derived (unless from that telephone canvass).

Mr. Mann suggests that "Reproduction or replacement cost of improvements includes all costs despite market conditions." If the "cost" to which he refers includes "an entrepreneurial profit, when appropriate, from an analysis of the market" as in the Ninth Edition of *The Appraisal of Real Estate* and is a "market-derived figure" as defined in the *Dictionary of Real Estate Appraisal*, then, in truth and in fact, it never existed in cases of owner-occupied properties, built-for-income properties, and properties in a depressed market.

Conclusion

If a house has a porch in addition to the house itself, we cost the porch and we add that to value. The porch is tangible. We can see it. We can measure it.

If a speculative house is shown by relevant market data to exhibit an entrepreneurial profit over and above true cost, then there is justification in adding such an increment in the cost approach.

But, if we are going to pay attention to our texts and definitions, we need to heed all the words in the definitions and technique sections, i.e., "when appropriate" and "market driven." And, appraisers should be especially skeptical of canvasses of any kind to derive conclusions of market realities, especially canvasses of those whose answers can be self-serving.