Entrepreneurial Profit
Should Be Considered in
ALL MARKETS
By George R. Mann

George R. Mann, SRPA, is an independent fee appraiser recently relocated to Williamsburg, Virginia. He earned a B.S. degree in Business Administration at the University of Florida and has been a practicing appraiser since 1986.

This article addresses both the consideration of entrepreneurial profit in all market conditions and the criticism of entrepreneurial profit presented in “Entrepreneurial Profit Is Not Cost” by Max J. Derbes, Jr. Derbes rejected the theory that entrepreneurial profit must be added to all reproduction costs in the cost approach because of either some moral economies or due to a cost accounting theory. It is unrealistic in terms of market perceptions, excepting in speculative/builder markets. But even in speculative markets, entrepreneurial profit, if any, may not be appropriate to a cost approach exercise; rather, it can be handled in the sales comparison approach and in the correlation process. This article will attempt to justify that entrepreneurial profit should be considered despite market conditions.

The Cost Approach Procedure

The Ninth Edition of The Appraisal of Real Estate lists eleven steps in developing the cost approach. The first five steps are stated below:

1. Estimate the value of the land as though vacant and available to be developed to its highest and best use.
2. Estimate the reproduction or replacement cost of the improvements on the effective date of the appraisal. This includes direct (hard) and indirect (soft) costs.
3. Estimate other costs (indirect costs) incurred after construction to bring the new, vacant building up to market conditions and occupancy levels.
4. Estimate entrepreneurial profit, when appropriate, from an analysis of the market.
5. Add estimated replacement or reproduction cost, indirect costs, and entrepreneurial profit, often expressed as a percentage of total direct and indirect costs and sometimes land value, to arrive at the total replacement or reproduction cost of the primary structure(s).

The fifth step specifically suggests that entrepreneurial profit is part of total replacement or reproduction cost. The Second Edition of The Dictionary of Real Estate Appraisal defines entrepreneurial profit as:

A market-derived figure that represents the amount an entrepreneur expects to receive in addition to costs; the difference between total cost and market value. Also called entrepreneurial reward.

Recognition of entrepreneurial profit is essential as no prudent developer or entrepreneur would undertake the risk associated with a project without the expectation of entrepreneurial reward. Entrepreneurial profit is essentially a market-derived figure that reflects the amount a developer or entrepreneur expects to receive in addition to costs.

Objections to Entrepreneurial Profit

Mr. Derbes presented the following four objections to the above definition in his article: 6

1. If entrepreneurial profit is "market-derived," then it truly belongs in the market data approach rather that the cost approach.

2. If the appraiser is to research and obtain such a figure, how is such research to be undertaken? Is the research to be entirely what "an entrepreneur expects to receive"? If so, what entrepreneur or which entrepreneurs? Can subjective profit expectations be a valid criteria of cost?

3. If the factor is "in addition to costs" then entrepreneurial profit is not cost.

4. If the amount of the factor is "the difference between total cost and market value," then entrepreneurial profit is over and above total cost. Yet, the basic tenant of the cost approach is total cost.

The objections above represent valid questions and misconceptions of the entrepreneurial profit theory. The following discussion addresses each of the above points.

Cost Approach or Sales Comparison Approach?

Some appraisers suggest that in those cases where entrepreneurial profit is evidenced by sales data, the indicated increment more properly belongs in the sales comparison approach. This logic does not hold as most of the information used in the cost and income approaches is derived from sales data. Specifically, sales data is often used to estimate reproduction or replacement cost of improvements, accrued depreciation, and economic life. As with entrepreneurial profit, these latter items are derived from sales data, but used in the cost approach.

Measuring Entrepreneurial Profit

Appraisers estimate entrepreneurial profit by analyzing sales of new properties in the same market or surveying developers and entrepreneurs. The profit increment may be measured as a percentage of (1) direct costs, (2) direct and indirect costs, (3) direct and indirect costs plus land value, or (4) the value of the completed project. 7

The difference between the sale price and the sum of direct costs, indirect costs, and current market land value is entrepreneurial profit. The weakness in this approach is that the indication is historical and might not reflect current market expectations. Deriving internal rates of return from historical sales in the income approach presents the same problem. Unless market conditions are coincidentally similar at date of sale and date of appraisal, the indications from sales data are not reliable. Choosing more recent sales should improve reliability.

A survey of market participants is more accurate as it reflects current market expectations. The survey method is very useful in determining current investment criteria and therefore can be used in establish current ranges of entrepreneurial profit expectations. Although surveying is not an exact science, a somewhat representative sampling can be obtained to provide a reasonable range of assurance to the appraiser. 8

6. Derbes, Jr., pp. 18–19.

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Entrepreneurial Profit Exists When the Cost Approach Is Applicable

Some appraisers argue that entrepreneurial profit should not be used in all markets. They believe that developers cannot anticipate profit in an over-supplied or depressed market. Mr. Derbes states, "It is absurd to include entrepreneurial profit in constructing the cost to create an improvement in an over-supplied market." I contend that it is absurd not to include an entrepreneurial profit increment.

The cost approach to value assumes a prudent investor would weigh the price they pay for an existing building against the cost to replace it. The primary assumption in developing the cost approach is that an investor would construct improvements similar to the subject property at the date of appraisal. If market conditions do not justify the development, then the cost approach is not applicable.

Appraisers apparently have a problem with entrepreneurial profit: it is not truly realized until a sale occurs. The assumption is that the developer will realize the anticipated profit on a sale of an existing building. A value estimate is based on the anticipated profit in the future market.

Entrepreneurial profit exists when the cost approach is applicable. Some appraisers argue that entrepreneurial profit is not cost as it is an anticipated reward to the developer above land, direct and indirect costs. The assumption that entrepreneurial profit is not realized until a sale occurs is not accurate and should not be a deterrent to using the increment in the cost approach.

Market value is a reflection of anticipated future market conditions. After finding the appropriate market participants, the survey can be conducted by mail or telephone. A sample survey questionnaire appears in the article "Criteria for Use of the Cost Approach in Appraising Real Estate" in the April 1990 issue of The Appraisal Journal.

Entrepreneurial Profit Cost?

Some appraisers argue that finding similar types of facilities is impossible. This task is far from impossible as many sources exist. Developers and entrepreneurs often develop projects similar to the subject on the sites considered as comparable land sales. Appraisers also should be familiar with local developers who build projects similar to the subject property. The local telephone book, construction magazines, and real estate magazines list the names of local developers.

The cost approach to value assumes a prudent investor would weigh the price they pay for an existing building against the cost to replace it, less depreciation. The primary assumption is that the developer would construct improvements similar to the subject property at the date of appraisal. If market conditions do not justify the development, then the cost approach is not applicable.

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Therefore, assuming the cost approach is appropriate and similar improvements are under construction, the developer or entrepreneur must be expected to anticipate a reward to undertake the project. Market conditions dictate whether the cost approach should be developed, not if entrepreneurial profit should be considered. As stated earlier, total reproduction or replacement cost includes anticipated entrepreneurial profit.

The estimate of accrued depreciation considers whether the anticipated entrepreneurial reward is or is not realized. The Ninth Edition of *The Appraisal of Real Estate* states that "like direct and indirect costs, part or all of this profit may be deducted as functional or external obsolescence if the market indicates that the market value of the improvements is less than their current reproduction or replacement cost minus physical depreciation." The estimate of accrued depreciation reflects a deduction in value from reproduction or replacement cost due to any causes.

To say that entrepreneurial profit should not be added because market conditions suggest it will not be recognized fails to consider the cost approach theory. Reproduction or replacement cost of improvements includes all costs despite market conditions. Accrued depreciation accounts for all deductions in value attributable to market conditions. Not including entrepreneurial profit due to market conditions results in an incomplete and inaccurate analysis of reproduction/replacement cost and accrued depreciation. Developing the cost approach without entrepreneurial profit makes it difficult to estimate functional and/or external obsolescence accurately. Therefore, it is impossible to decide how much anticipated entrepreneurial profit that the market recognizes. Tables 17.22, 17.23, and 17.24 in the Ninth Edition of *The Appraisal of Real Estate* summarize cost approaches that include entrepreneurial profit and any resulting accrued depreciation.

Some appraisers believe proponents of entrepreneurial profit demand that every cost estimate includes such a profit. This is far from the truth. Entrepreneurial profit is an expectation derived from market analysis through sales data or surveying. Sales of recently constructed special purpose or user occupant properties will show if the market recognizes entrepreneurial profit. Of course, such sales are rare as owners do not typically construct these properties for immediate sale. The alternate method of determining anticipated entrepreneurial profit is by surveying developers and entrepreneurs. The survey probably will show that profit was not a motivating factor in developing special purpose properties.

Therefore, if entrepreneurial profit is not warranted, the appraiser has reached this conclusion through market analysis fulfilling the definition of entrepreneurial profit as an expectation of the developer. Here the expectation might be zero.

When estimating entrepreneurial profit, the appraiser must be sure not to include other costs. Entrepreneurial profit is different from the standard direct and indirect costs and "does not include lease-up costs or lost revenues from the time of completion of the physical buildings until the property reaches stabilized occupancy."10

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Entrepreneurial profit is essentially an anticipated award over above all other measurable costs. The appraiser must be careful when deriving the increment from market analysis. Surveying developers for anticipated entrepreneurial profit requires a distinct segregation between contractor’s overhead and profit and the expected entrepreneurial profit.

Mr. Derbes states in his article that “the result [of adding entrepreneurial profit] is an automatic increase in the value indicated in the cost approach for every property, old and new.” An increase in total reproduction or replacement cost of improvements occurs, but not necessarily an increase in value.

As discussed earlier, accrued depreciation reflects market reductions from total reproduction or replacement cost now for any causes. By analyzing market conditions, the appraiser can decide if part, all, or an amount greater than the estimated entrepreneurial profit should be deducted as functional or external obsolescence.

Entrepreneurial profit does not inflate values. The value might be lower if the appraiser correctly estimated entrepreneurial profit, and functional and external obsolescence. Without using entrepreneurial profit, an appraiser incorrectly assumes that functional or external obsolescence negates exactly 100 percent of the anticipated profit. Obviously, this precise percentage would be the exception instead of the rule.

The initial steps in developing the cost approach are estimating land value and reproduction or replacement cost of improvements. Total reproduction or replacement cost consists of direct costs, indirect costs, and entrepreneurial profit. Entrepreneurial profit is an anticipated or expected increment in addition to direct and indirect costs.

Appraisers estimate entrepreneurial profit by analyzing sales of new properties or surveying developers and entrepreneurs. Either method results in a market-derived figure. The appraisal of special purpose or user occupant buildings might show no entrepreneurial reward.

Market conditions dictate the pertinence of developing the cost approach, not the appropriateness of using entrepreneurial profit. The cost approach theory requires a market derived entrepreneurial reward in estimating total reproduction or replacement cost. The estimate of accrued depreciation reflects the amount of anticipated entrepreneurial profit not recognized by the market. Correct application of the cost approach requires the use of entrepreneurial profit in developing the cost approach. Because of market supported data and research, the use of entrepreneurial profit also results in a more accurate value indication by the cost approach.

In the interest of furthering discussion on the topic of entrepreneurial profit and where in the appraisal it should be addressed, members of the Editorial Review Board suggested that Mr. Derbes be invited to respond to the Mann article. His rebuttal follows.

12. Ibid., p. 27.