CHAPTER 3 - FOUNDATIONS OF APPRAISAL

INTRODUCTION

- Real property is the focus of real estate appraisal theory as perceived by society to be a good investment.
- The level of participation depends on one’s needs and wants.
- The production of goods, services, and income depends on the combined effects of four essential economic ingredients called the agents of production.

AGENTS OF PRODUCTION

Combining the four agents of production (land, labour, capital, and entrepreneurial coordination) creates a finished real estate product.

- **Land** is the basis for any development and its cost must be considered in relation to the overall development.
- **Labour** comprises all of the direct and indirect costs to construct and market the product, including wages, materials, and financing.
- **Capital** is the cost of financing and the return on both borrowed capital and equity capital invested in the project.
- **Entrepreneurial Coordination** is the anticipation of receiving a profit in addition to the return of the equity investment. That is, the consideration of the time and expertise required by the developer to create and market the project.

ANTICIPATION AND CHANGE

- **Anticipation** of future benefits creates value. Residential housing provides a place to live and to raise a family. Commercial properties generate future income. Education for future work advancement.
- **Change** is the brought about by the nature of the social, economic, governmental, and environmental forces interacting on a daily basis which in turn affect the public’s attitudes towards real estate.
- **Depreciation and obsolescence** impact real estate by lessening those future benefits, hence value.

SUPPLY AND DEMAND, SUBSTITUTION, BALANCE, AND EXTERNALITIES

- Economic theory states the price of a commodity varies directly but not necessarily in proportion with demand and inversely but not necessarily in proportion, with supply. With an increase in demand relative to supply, the price will rise. An increase in supply relative to demand will have the opposite effect and the price will fall. The supply and demand for commodities tend toward equilibrium or a balanced market. At this theoretical point, market value, price and cost are equal.
The supply of real estate depends on the four agents of production. Supply refers to the amount of service or space available. Quality of space is also important. Quantity of space changes slowly, while quality can change quicker by remodelling or making additions.

The demand is the desire and ability of market participants to buy or lease goods and is affected by the quantity and quality of supply. Demand supported by purchasing power results in an effective demand. Appraisers must be aware of the supply and demand for the real estate they are appraising.

Competition is fundamental to the equation because it affects both the supply and demand which in turn affects the value of the commodity. Existing subdivisions compete with new subdivisions for buyers. Shopping malls are either newly constructed or remodelled to compete for and attract new shoppers.

Substitution assumes rational, prudent purchasers, with no undue delay in obtaining that commodity and that they will be attracted to that equally desirable commodity with the lowest price. This principle is fundamental to the three approaches to value: direct comparison, cost, and income. In other words you can satisfy your needs by BUYING, BUILDING or INVESTING in a similar property.

Balance states that property values are created and sustained when contracting, opposing, or interacting elements are in a state of equilibrium. It is achieved when the combination of land and improvements is optimal with no added benefit or utility achieved by adding another unit of capital. Following this principle are those of diminishing returns, contribution, surplus productivity and conformity. The principle of diminishing returns states that adding more units of production will produce greater net income up to a certain point and at this point further expenditures result in diminishing returns. For example, building a four bedroom house where three is standard may not return any extra value in relation to the cost incurred.

Contribution is the value of a particular component measured in terms of its contribution to or its absence from, thus adding to or detracting from the value of the whole property. For example, a residential swimming pool may or may not return its cost when the property is sold on the market. In some cases, homes are purchased and the pool is filled in as a giant planter. The pool does not add value and, in fact, detracts from it.

Surplus Productivity is the net income to the land remaining after the costs of the other agents of production have been paid. It tends to set the value of the land when the income is capitalized at an appropriate rate of return.

Conformity holds that value is maintained when properties conform to those market expectations/standards. The principle of regression states a higher-priced property in a lower-priced neighbourhood will be worth less than that in a comparable neighbourhood. Likewise, the principle of progression states that a lower-priced property in higher-priced area will command a higher price.

Externalities state that factors outside the property can affect its value, either in a positive or negative manner. Externalities occur on a macro/international to a micro/neighbourhood level. Since real estate is immobile, this principle is very important and appraisers should be aware of external events at all levels as they impact property values. International/national externalities include proximity of provinces to their trading partners, the regions geography and available resources encouraging growth in certain industries. Community/neighbourhood externalities include local laws and policies, an example would be the policy of the local authority allowing the expansion of an airport in
the neighbourhood adversely affecting property values of those proximally located properties. Other examples include property taxes and social attitudes.

- An appraiser needs to be aware to those externalities impacting the subject property.

**FORCES THAT INFLUENCE REAL PROPERTY VALUES**

- The four basic forces that affect real property values are social trends, economic circumstances, governmental controls and regulations, and environmental conditions. Their interaction affect all parcels of land.

1. **Social Forces** are related to population characteristics. A study of demographic trends will reveal the potential demand for real estate. Social forces reflect attitudes towards education, law and order, and lifestyle options.

2. **Economic Forces** refer to factors such as employment, wage levels, price levels, cost of money, new developments, supply of existing properties, rental rates, and construction costs, to name some. The appraiser needs to keep abreast of any economic trends that may affect the market they are appraising.

3. **Governmental Forces** refers to the effect government policies can have on real estate values. Policies regarding public services (police and fire protection), transportation networks (roads, rapid mass transit, bridges, etc.), local zoning and building bylaws, environmental protection of lands, fisheries legislation, control over mortgage loans and policies regarding banks, or credit unions, etc.

4. **Environmental Forces** refer to such factors as climate, topography, toxic contaminants, natural barriers to development (rivers, mountains, wetlands, etc.), primary transportation systems, and nature of surrounding property. Other areas to investigate are public transportation, schools, stores, parks, recreation facilities, places of worship, processors of raw materials, etc.

- The appraiser needs to be aware of these forces and this is best done by reading the local and national newspapers and trade publications, and by attending appraisal organizations’ meetings, seminars, and annual conferences. This is an ongoing learning experience and does not occur in one or two days, but over a lifetime. Appraisers interpret the market for clients and therefore need to be familiar with market trends and local activity.