

3 Types of Value

■ LEARNING OBJECTIVES

Students will be able to

1. understand that there are objective and subjective views of value and know which applies to real estate valuation.
2. understand and differentiate between price and value.
3. understand and differentiate between the types of value with special consideration accorded the definition of market value.
4. cover in detail and understand the various fundamental conditions in the standard market value definition.

■ KEY TERMS

assessed value
going concern value
insurable value
investment value

liquidation value
market value
objective value
price

subjective value
value in use

■ INTRODUCTION

In order to perform competently, the appraiser must constantly observe and analyze influences that affect the value of land and/or improvements. Following are the two major philosophical views of value:

- a. Objective
- b. Subjective

Objective Value

The **objective value** view holds that value is inherent in the object itself. Because something is, it has value. This school of philosophical thought emphasizes the cost to produce a commodity as the primary value determinant.

Subjective Value

The **subjective value** philosophical position holds that value is in the eyes of the beholder, not in the object itself. It is often said that *the worth of a thing is what it will bring*. The subjective value concept represents the more modern school of thought that is emphasized in modern day appraisal. Because of this concept, forces outside the property itself have a direct bearing on its value.

The difference between objective and subjective value can be illustrated by a gallon of bottled water. This product required certain cost factors in its creation. It is put on a shelf with competing products in a supermarket to compete for consumer dollars. Hopefully, the sales price will be greater than the cost to produce and deliver this product to the supermarket. This product may have appeal to a particular purchaser who shops comparatively, then makes the decision to purchase this product from among competing products. At the time of the purchase, the product had a certain level of desirability.

Let's suppose that during the night a water main bursts, and all the homes along the street are left without water. The next morning, the purchaser of the bottled water gets out of bed to brush his or her teeth. Has the desirability and utility of the bottled water increased?

In an extreme example, let's suppose a person has been stranded in Death Valley for three days and is at the point of total dehydration. This same bottled water, if available, may have an entirely different value to the person dying of thirst.

In these three instances, the product is the same. Under the objective school of thought, the value would be the same in all three cases. Under the subjective school of thought, however, the value would change considerably in the three instances. The value may increase to the shopper if no other means of water were available; the price would escalate dramatically to the dehydrated person dying of thirst. In all cases, however, the product is the same.

Real estate is evaluated on a subjective, not objective, basis. A home or warehouse does not have value just because it is there (objective); it has value due to numerous characteristics, such as the location, the quality, and the size, among other items.

Consistent with the concept that value is more subjective in nature, this Chapter focuses on real estate influences from a subjective point of view.

PART ONE Value Versus Price

The appraiser must have a clear understanding of the difference between *price* and *value*. Often, these terms are used interchangeably; however, economic theory makes a clear distinction. The terms are identified as follows:

■ PRICE

Price relates to the actual number of dollars a commodity or service brings when it is sold. Price is therefore a fact and not a theoretical concept.

For example, a price would be: 1050 Main Street sold for \$100,000. It may have been sold from parents to son, and its value could have been \$125,000.

■ VALUE

Value relates to the worth of a commodity. This is more of a theoretical concept rather than an actual fact. The value would be an estimate, such as in the example below:

The market value estimate of the fee simple interest in the property located at 1000 Second Avenue is \$125,000, as of January 1, 1995.

When studying markets, appraisers often become aware of price levels that may or may not be reflective of the values of the individual properties. In practical application, appraisers study price levels under the concept that most are occurring at or near their actual values; the value of a parcel of real estate can be estimated utilizing sales prices of other similar properties.

PART TWO Types of Value

There are many types of value that an appraiser can estimate. The most common is market value; however, there are other types of value that can be estimated for various reasons. It is a good idea for the appraiser to never use the term *value* without a modifier (such as market, investment, insurable, etc.) so that the reader has a clear understanding of the value which the appraiser is reporting.

■ MARKET VALUE

Market value is the most common value estimated by appraisers. At least 90 percent of all appraisals address this value concept. Although the exact definition of market value has changed through the years, it has become more standardized in the recent past.

The most widely accepted definition of market value is that used in the *Uniform Standards of Professional Appraisal Practice* (USPAP). According to this source, the market value definition follows:

“Market Value” means: The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

- a. Buyer and seller are typically motivated;
- b. Both parties are well informed or well advised and are acting in what they consider their own best interests;
- c. A reasonable time is allowed for exposure in the open market;
- d. Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
- e. The price represents the normal consideration for the property sold unaffected by special or creative financing or sale concessions granted by anyone associated with the sale.

In some states, the market value definition may vary slightly from that specified in the *Uniform Standards of Professional Appraisal Practice* (USPAP), the most commonly cited source. In these instances, the appraiser should cite the actual definition and be sure that his value conclusion is consistent with the definition employed.

This value concept is generally held to be synonymous with the term *value in exchange*. This latter concept, however, is not as widely utilized.

■ INVESTMENT VALUE

Investment value is the worth to a particular investor, using a specific investor’s parameters or assumptions as seen in the following examples.

An example of investment value would be an insurance company that purchases income-producing type property and is willing to pay more for it, resulting in a lower net return, because the insurance company does not pay income taxes. This particular investor would be expected to pay more for a property and have a different internal investment value than the typical market participant.

Another example of investment value could involve a situation in which a developer is renovating an older apartment building that is on the historic register. In this instance, certain federal income tax credits may be available to promote such an endeavor. Without consideration of the investment tax credits, the net benefits derived from the rental of this apartment complex may not justify the cost to renovate the building. By factoring in the investment tax credits, however, the endeavor could well be financially feasible to this developer. In this case, the market value without consideration of the tax credits would be substantially less than the investment value which takes into account the tax credits.

■ VALUE IN USE

Value in use relates to value to a specific user rather than the market in general. It does not relate to the price level most individuals would be willing to pay (see the examples below).

For example, a homeowner with a physical disability may choose to install a \$15,000 heated swimming pool for physical therapy reasons. His value in use would be commensurate with the cost of \$15,000. The house may be located in a neighborhood where most homes are generally in the \$125,000 to \$150,000 range. In this neighborhood, the market may react to the existence of a swimming pool by paying only a \$3,000 premium. The contributory value of this pool is \$3,000, which reflects the incremental difference in market value. The value in use, however, is \$15,000.

Another example of value in use is an industrial building that has 40-foot ceilings to accommodate overhead cranes that service a particular manufacturing function. The excessively high ceilings and overhead cranes could very well contribute to value in use commensurate with the cost of these items if there is market demand for these peculiarities; however, the market may be dominated by typical warehouse users who require 24-foot ceilings and no overhead cranes. In this case, typical purchasers would not be willing to pay a significant premium, if any, for the higher ceilings and overhead cranes.

■ INSURABLE VALUE

Insurable value relates to the cost to reproduce improvements. Insurance proceeds for building reconstruction for damages caused by fire, flood, or other hazard, are usually based on the cost to reproduce the structure. When estimating insurable value, the

appraiser is therefore interested in estimating costs to reproduce a building or component. Insurable value usually does not relate to land which is generally considered to be unaffected by hazards.

■ ASSESSED VALUE

Assessed value relates to the value of property established by municipalities for purposes of establishing a basis for taxation. Real estate taxes generally comprise a major source of revenues for local municipalities. Assessed value usually relates to market value.

For example, a municipality's assessed value may be 40% of the market value as estimated by the county tax assessor.

The following is an example of a tax valuation, assessment, and ultimate tax determination:

Market Value (Tax Assessor's Office)	\$100,000
Assessment Factor	$\times \underline{0.40}$
Assessed Value	\$40,000
Millage Rate (\$35.00 Per \$1,000 of Assessment)	$\times \underline{0.0350}$
Tax Charge	\$1,400

Because of the magnitude of most tax valuation programs, there are often numerous inconsistencies and errors in the assessor's reported market value of individual parcels. For this reason, tax valuations may or may not be consistent with the actual market value of properties.

A related term is *ad valorem* tax. The term *ad valorem* means *based on value*. The intent to relate the tax charge to the market value of property is thus illustrated.

■ GOING CONCERN VALUE

Going concern value relates to an ongoing, established business operation. Implicit in this value concept is the premise that the business will continue to operate. A McDonald's restaurant may have a certain going concern value which includes all the business aspects of the enterprise whereas the market value of the real estate may be restricted to the land and buildings.

When estimating going concern value, appraisers are often called upon to allocate the total going concern value among the basic components of the enterprise, which could be:

- a. Land
- b. Building improvements
- c. Franchise
- d. Furniture, fixtures, and equipment (FF&E)
- e. Goodwill

Because going concern value encompasses all aspects of the enterprise, it usually exceeds the capacity of most real estate appraisers and requires a separate discipline known as *business valuation*.

■ LIQUIDATION VALUE

Liquidation value relates to the concept that the property requires immediate transfer. Liquidation value would result with an abbreviated marketing period such as an auction or bank foreclosure sale. This would not meet the criteria of the market value definition that *a reasonable time is allowed for exposure in the open market*. To estimate liquidation value, a discount is usually applied to the property's market value; the discount is based on other liquidation sales.

P A R T T H R E E Fundamental Conditions of Market Value

Because the most common purpose of an appraisal is to estimate market value, this definition requires additional attention. Conditions implicit in the market value definition are addressed in the following paragraphs.

■ BUYER AND SELLER ARE TYPICALLY MOTIVATED

The two parties should be acting for typical reasons such as a buyer of a home purchasing for shelter or investment and a seller disposing to move to a different location or to another home. One example of an atypical motivation would be a bank receiving the property via foreclosure and deciding to sell the property via auction. Another example is the case in which a seller sells a property for a price that appears to be less than market days before the seller declares bankruptcy or experiences foreclosure. It will not always be readily apparent what the motivations are; the appraiser will likely find out in the data verification process, in which an appraiser confirms the details of a transaction for accuracy and motivations (discussed in Chapter 12).

■ BOTH PARTIES ARE WELL-INFORMED

The buyer and seller should have sufficient knowledge and information to make an informed decision that is self-serving. An example of an uninformed buyer is a job transferee who flies into the new job market on Friday and has the weekend to find a home, negotiate the price, and offer a contract on the home by Sunday afternoon. Although the buyers are acting in their best interest, they are not informed purchasers and may pay too much (full list price or close to it) when an appraisal may have saved them thousands of dollars. If higher quality data does not exist, an appraiser may still use this sale, but a comment or even an adjustment may be necessary, especially if the buyer/seller/agent discloses the buyer's duress and could offer a dollar figure for the premium that was paid versus the price that normal market negotiations would have likely produced.

■ REASONABLE TIME

The property must be exposed on the open market (via typical market channels which differ from local market to local market) for a time that is typical for sales in that market. The typical rule-of-thumb is 60 days to 120 days for a home that is priced appropriately in an active market and with available financing and, quite importantly, marketed professionally. Professional marketing includes real estate listing publications and online computer services and a well-distributed flyer, as well as an accessible, professional, and cooperative real estate agent.

For example, it would be improper and inconsistent for a banker to direct an appraiser to estimate the market value of a home in a neighborhood of \$1,000,000 homes with a marketing period of 30 days if it normally takes such a home 120 days to 240 days in that market to effect a sale that would meet the test of market value. The 30-day assumption is unreasonable and would be asking the appraiser to estimate the liquidation value, not the market value.

■ PAYMENT IN CASH

Payment is based on United States dollars or in terms of financial arrangements comparable thereto—the exchange used in the sale is cash or terms equivalent to cash.

For example, assume the sale of a \$100,000 house in which the seller received \$100,000 cash; obviously that meets this criteria. But suppose the seller received \$94,000 in cash and a truck worth \$6,000; this is still \$100,000 cash equivalent, assuming of course that the truck really is worth \$6,000, which may take some additional research.

■ NORMAL CONSIDERATION

If the sale involved some part of the consideration being noncash equivalent, an adjustment is necessary for “cash equivalency” for terms conceded or granted in the sale.

Say a home sells for “\$100,000.” In your verification process, you find out the buyer obtained a \$90,000 loan from a bank and gave \$2,000 in cash to the seller with the remaining \$8,000 in the form of a second mortgage (for five years) that the seller financed at a below market interest rate of 5 percent. The market rate at the time of sale was 8.5 percent. If the cash equivalency of that \$8,000 second mortgage is \$6,500, then an adjustment should be made to the sale in the amount of \$1,500, that is, the cash equivalent sales price is \$98,500, not \$100,000.

In its original form, the sale did not meet the definition of market value; however, it could still be used as a comparable after an adjustment for the below market financing.

Another example of cash equivalency would be the instance in which a home sells for \$300,000. In the verification process, the appraiser finds out that the buyer obtained a \$250,000 loan from a bank and gave the seller \$40,000 in cash. The remaining \$10,000 was paid in cash to the seller for the seller's country club membership. This sale, in its original form, did not meet the definition of market value. It could still be used as a comparable. However, after an adjustment of \$10,000 was made for the country club membership, an effective cash equivalent price of \$290,000 was indicated.

CHAPTER THREE Review Questions

- Which is the most common value estimate provided in an appraisal of a single-family residence?
 - Market value
 - Value in use
 - Going concern value
 - Insurable value
- Which type of value would likely be sought in the appraisal of an established business operation?
 - Investment value
 - Liquidation value
 - Value in exchange
 - Going concern value
- Which valuation would be based on a limited marketing period?
 - Assessed value
 - Liquidation value
 - Value in use
 - Going concern value
- Which value provides the basis of the real estate tax liability for a property?
 - Going concern value
 - Value in exchange
 - Assessed value
 - Insured value
- Which is a condition in the definition of market value?
 - Availability of credit
 - Buyer and seller are absolutely fully informed about every detail of every transaction within the last five years
 - Buyer and seller are typically motivated
 - Buyer and seller are not related in any way
- What is a reasonable marketing period for a single-family residence?
 - 90 days
 - 180 days
 - Until the seller gets his or her asking price
 - Unknown; each individual market is different and a reasonable marketing period depends upon an analysis of each market
- By definition, market value is
 - always the absolute highest price.
 - always the absolute lowest price.
 - the most probable price.
 - cost plus profit.
- A \$50,000 mortgage has a \$5,000 cash equivalency adjustment of \$5,000 because of below market financing. The down payment was \$3,000. What is the cash equivalent sales price?
 - \$50,000
 - \$55,000
 - \$48,000
 - \$58,000
- What is the value to a specific occupant?
 - Market value
 - Value in use
 - Value in exchange
 - Assessed value
- The value to a particular investor is
 - market value
 - assessed value
 - insurable value
 - investment value