

How much for Square meter?

The importance of discretionary factor in property appraisals

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Paseo por Madrid

130 x 190 cm óleo/lino

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It's not surprising that property appraisals made by experts and certified appraisers can differ by double the amount.

It's advantageous for real estate buyers and sellers, as well as bankers and investors, to minimize discrepancies and ensure that the outcome of an appraisal is always close to its market value; as important factors such as initial negotiation price, debt coverage ratio, debt cost and association terms depend on it.

Market Value is the most likely value that an individual will pay for a property, assuming the buyer and seller are well advised, have the same information, and act in favor of their interests.

The differences on the appraisal amount rely on the assumptions employed by the appraisers, such as: government approval's time (necessary to carry out real estate development), price and speed of sales, construction costs, and appraisal method.

The value of a property is linked to its optimal value.

So how can we narrow these differences to obtain a reliable and objective appraisal?

The value of a property is linked to its optimal use. First it is necessary to identify the real estate project that provides the largest benefit based on the following:

1. Identify zoning. The zoning has a direct impact on the value of the land, the potential problems of investing in land when zoning problems may arise is one risk factor in the site evaluation. The cost of already zones land may be higher, but the risk of antigrowth movements among citizens, or denial of rezone applications by local governments, is largely removed when zoning issue is not on the table. Traditionally the cities with the most development are likely to resist a rezone, due to the need to respect urban plans and abide by existing construction rules and regulations.



Peces

130 x 180 cm., óleo/lino

Agosto, 2006

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2. Validate physical feasibility. The projects that are physically feasible depend on a number of factors and restrictions such as:

- Plot ratio; ratio representing the maximum floor area permitted in proportion to the site on which it sits.
- Construction ratio; ratio representing the maximum buildable area permitted in a portion to the site on which it sits.

3. Analyze financial performance. Analyze a pro-forma version of what is expected to occur during the acquisition, construction, completion, tenancy or sale of the project, in different scenarios, the assumptions used must be an outgrowth of the technical and market study.

4. Select the option that offers the best financial performance. Select the optimal real estate project for the lot through a series of metrics, such as; Internal Rate of Return (IRR), Present Value calculations, cash-on-cash, on both leveraged and unleveraged basis, loan to value, and debt services coverage ratio; then define value of the property through the residual appraisal model (shown below).

In a highly complex appraisal exercise, additional variables should be considered: demolition costs, antigrowth movements, government approval's time, and political factors such as crime rates and union relations.

The most common appraisal methods are:

Comparative appraisal: is a sales comparison approach, is estimated by comparing properties similar to the subject property that have recently been sold. No two properties are precisely comparable so adjustments must be made to account for discernible differences.

A major premise of the comparative approach is that the value of a property is directly related to the prices of comparable, competitive properties.

- **Advantages:** one of the easiest and fastest methods.
- **Disadvantages:** you need reliable transactions on similar properties (zoning, feasibility, location, shape, topography, etc..) to indicate value patterns or trends in the market. This information is not always available. Distortions result when offering prices and information from dated operations are included in the analysis. Lack of a standard adjustment criterion. Although some academics and government entities have established appraisal guidelines and procedures for adjustment applications, many are limited to certain tracts of land and the dynamism of the market.



Mapa Mundi

140 x 180 cm.,

óleo/algodón

Septiembre, 2005

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Residual appraisal: the residual technique subtracts the cost and profit associated with a proposed development, in order to arrive at a net land value associated with the expected financial benefits for the subject development.

- **Advantages:** no need for a representative sample of Real Estate operations on similar properties and it determines the maximum value of a lot in accordance with expectations and desired profitability of the project.
- **Disadvantages:** small changes in parameters or assumptions generate significant changes in the result of the appraisal, so you want to generate numerous scenarios and weight the variables differently. Lack of a standard risk criterion, when determining the capitalization and discount rates used in the process.

Conclusions and Recommendations

While the feasibility of the optimal use is what determines the value of a property, the discretion of the assumptions and the methodology used can significantly change the result of an appraisal. Therefore it is recommended:

1. A recent and reliable market study that substantiates the feasibility analysis of the optimal real estate project as well as commercialization budgets and forecast.
2. A technical study that supports the construction budget and program of the selected project, based on the strength of the soil, cost of materials and labor expenses depending on the city, for example; labor expenses are approximately 1.3 times higher in Cabo San Lucas than in Mexico City.
3. Set the cost of the appraisal service at the beginning; in many cases the price charged is a function of the resulting appraisal value, which creates a conflict of interest, generating perverse incentives that could skew the objectivity of the appraiser.
4. Apply more than one methodology. There is not one methodology better than another, so it is recommended to have them complement each other, using at least two methods to compare the different results and find the midpoint that best suits the current state of the property.

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