Understanding Value.......

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Marbella Real Estate News

What separates Asset Folio apart in a highly competitive market place - we understand the value of real estate and pass this information on to our clients.

Below is an overview of what a typical client will be looking for to make the correct decision when purchasing their property for investment or lifestyle in Spain.

There are various types of value given to real property, such as investment value, market value, insurable value, assessed value,-liquidation value, or replacement value.-

Types of Real Estate Value

First of all, let's briefly go over several common types of commercial real estate value, then we'll dive into the difference between-investment and market value and clarify with an example.

Market Value-is what's typically meant when referring to a property's value and is the value used for loan underwriting purposes. The-Appraisal Foundation has a specific definition for market value as published in the Uniform Standards of Professional Appraisal Practice-(USPAP). According to the Appraisal Foundation, market value is-the most probable price a property would bring in a competitive and open-market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently and knowledgeably, and assuming the-price is not affected by undue stimuli.

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Investment Value - refers to the value to a specific investor, based on that investor's requirements, tax rate, and financing.

Insurable Value-– This covers the value of the portions of a property that are destructible for the purposes of determining insurance-coverage.

Assessed Value-–-Assessed value is the value determined by the local tax assessor to levy real estate taxes.

Liquidation Value-–-Liquidation value establishes the likely price that a property would sell for during a forced sale, such as a foreclosure-or tax sale. Liquidation value is used when there is a limited window for market exposure or when there are other restrictive sale-conditions.

Replacement Value-–-This is the cost to replace the structure with a substitute structure that is identical or that has the same utility as the-original property.

A property can have any of the above types of value at any given time, with no two values necessarily being the same. This is an important-point to remember when trying to understand the value of a commercial real estate property. This is especially true when determining-market value and investment value.

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Approaches to Market Value

Market value is what's determined by an appraisal. During the commercial loan underwriting process, most lenders will require a third-party-appraisal in order to determine a market value estimate, which is then used to find an appropriate loan amount and collateral value.

How do appraisers determine market value? First, before a market value can be estimated by an appraiser, the highest and best use for-the property must be determined. The highest and best use is the legal use of a property that yields the highest present value. This-process usually begins with evaluating the zoning laws to-understand the legally permitted uses for the property.

Once the legally permitted uses are understood, the physically possible uses are then considered, within the bounds of the zoning-ordinances. This takes into account the physical limitations of the property such as topography, size, layout, etc.

Finally, the financial feasibility is considered for all of the uses that are legally permissible and physically possible. The financially feasible-use that produces the highest financial return is the highest and best use.

Once the highest an best use is determined, the appraiser can then determine market value. Appraisers may use three basic approaches-to estimate market value: the sales comparison approach, the cost approach, and the income approach, using either the-Direct-Capitalization Method-or the-Discounted Cash Flow Model. We-discuss each of these approaches in detailhere, but below we'll briefly-summarize.

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Sales Comparison Approach

The sales comparison approach links the value of a property to prices that recent buyers have paid for similar properties. In reality no two-properties are exactly alike, but this approach can provide a reasonable estimation of value when there is a large quantity of recently sold-comparable transactions.

Income Capitalization Approach

The income based approach to market value derives property value from the income it produces. The two methods used to value a-property based on income are the-direct capitalization method-and the-discounted cash flow valuation method.

Cost Approach

The cost approach bases value on the cost of reproducing a property, less any accrued depreciation. Accrued depreciation can come from-three sources: physical deterioration, functional obsolescence, and external obsolescence. Once the replacement cost is determined and-the accrued depreciation is netted out, the cost is added to-the value of the land to determined an appropriate value based on cost.

Reconciliation of Value

In a full appraisal the above values are typically reconciled by using a weighted average to determine the final value estimate. For-example, it may be determined that a higher weight should be given to the income approach because the available comparable sales data-is weak, and as such this would be reflected in the final reconciled-market value.

Approaches to Investment Value

While the market value process is usually used in appraisals for loan underwriting purposes, when deciding how much to pay for a-property, investors also consider how much a property is worth. Investment value is the amount that an investor would pay for a specific-property, given that investor's investment objectives, including target-yield and tax position.

Because investment value depends on an investor's investment objectives, investment value is unique to the investor. As such, different-investors can apply the same valuation methods and still come up with different investment values. Investors can choose from a variety of-valuation methods when determining investment value,-unlike appraisers who have to adhere to strict procedural guidelines. The following-are the most common measures of investment value:

Comparable Sales (Comps)-– This is the same sales comparison approach mentioned above that is used by appraisers. Typically-investors will compare similar properties on a per square foot or per unit basis.

Gross Rent Multiplier-–-This is a simple ratio that measures investment value by multiplying the gross rents a property produces in a year-by the market based-Gross Rent Multiplier (GRM). The gross rent multiplier is usually derived from comparable properties within the same-submarket.

Cash on Cash Return-–-The-cash on cash return-is another simple ratio used to determine investment value. It's calculated by taking the-first year’s proforma cash flow before tax and dividing it by the total initial investment.

Direct Capitalization-–-This is the same-direct capitalization-approach mentioned above that is used by appraisers. Capitalizing the-income stream of a property is a very common and simple way to determine both market and investment value for a commercial property.

Discounted Cash Flow-–-The-discounted cash flow model-is used to find an-internal rate of return,-net present value, and a capital-accumulation comparison. While the simple ratios above are quick and easy, they do come with several built-in limitation that are solved by-a discounted cash flow analysis.

The safest policy is of course to make sure a transaction makes sense both from an investment value perspective as well as a market-value perspective. Keep in mind that investment value is much more subjective than market value, and as such it can be abused. To avoid-falling victim to investment value abuse, it’s best to always-estimate market value whenever a relevant market exists. -Be especially-skeptical if someone claims that investment value differs from market value in a way that supports his or her sales pitch. They might be-right, but as the saying goes, trust but verify.