SLIDE 20 – Principles of Value (Cover Page)

SLIDE 21

Foundations of Real Estate Value

A number of economic forces interact in the marketplace to contribute to real estate value. Among the most recognized of these principles are those listed below.

Economic Principles Underlying Real Estate Value

Supply and demand
Utility
Transferability
Anticipation
Substitution
Contribution

Change
Highest and best use
Conformity
Progression and regression
Assemblage
Subdivision

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Supply and demand – The availability of certain properties interacts with the strength of the demand for those properties to establish prices. When demand for properties exceeds supply, a condition of scarcity exists, and real estate values rise.

When supply exceeds demand, a condition of surplus exists, and real estate values decline. When supply and demand are generally equivalent, the market is considered to be in balance, and real estate values stabilize.

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Anticipation – The benefits a buyer *expects to derive from a property over a holding period* influence what the buyer is willing to pay for it.

For example, if an investor anticipates an annual rental income from a leased property to be one million dollars, this expected sum has a direct bearing on what the investor will pay for the property.

Substitution. According to the principle of substitution, a buyer will *pay no more for a property than the buyer would have to pay for an equally desirable and available substitute property*.

For example, if three houses for sale are essentially similar in size, quality and location, a potential buyer is unlikely to choose the one that is priced significantly higher than the other two.

Contribution. The principal of contribution focuses on the degree to which a particular improvement affects market value of the overall property. In essence, the contribution of the improvement is *equal to the change in market value that the addition of the improvement causes*.

For example, adding a bathroom to a house may contribute an additional $15,000 to the appraised value. Thus the contribution of the bathroom is $15,000. Note that an improvement's contribution to value has little to do with the improvement's cost. The foregoing bathroom may have cost $5,000 or $20,000. Contribution is what the market recognizes as the change in value, not what an item cost. If continuous improvements are added to a property, it is possible that, at some point, the cost of adding improvements to a property no longer contributes a corresponding increase in the value of the property. When this occurs, the property suffers from diminishing marginal return, where the costs to improve exceed contribution.

Change – Market conditions are in a state of flux over time, just as the condition of a property itself changes. These fluctuations and changes will affect the benefits that can arise from the property, and should be reflected in an estimate of the property's value.

For example, the construction of a neighborhood shopping center in the vicinity of a certain house may increase the desirability of the house's location, and hence, its value.

Highest and best use –This principle holds that there is, theoretically, a single use for a property that produces the greatest income and return. A property achieves its maximum value when it is put to this use. If the actual use is not the highest and best use, the value of the property is correspondingly less than optimal. Technically, highest and best use must be legally permissible, physically possible, financially feasible, and maximally productive.

For example, a property with an old house on it may not be in its highest and best use if it is surrounded by retail properties.

If zoning permits the property to be converted to a retail use, its highest and best use may well be retail rather than residential.

Conformity – This principle holds that a property's maximal value is attained when its form and use are in tune with surrounding properties and uses. For example, a two-bedroom, one-bathroom house surrounded by four-bedroom, three-bathroom homes may derive maximal value from a room addition.

Progression and regression – The value of a property influences, and is influenced by, the values of neighboring properties. If a property is surrounded by properties with higher values, its value will tend to rise (progression); if it is surrounded by properties with lower values, its value will tend to fall (regression).

Assemblage. Assemblage, or the conjoining of adjacent properties, sometimes creates a combined value that is greater than the values of the unassembled properties. The excess value created by assemblage is called plottage value.

Subdivision. The division of a single property into smaller properties can also result in a higher total value. For instance, a one-acre suburban site appraised at $50,000 may be subdivided into four quarter-acre lots worth $30,000 each. This principle contributes significantly to the financial feasibility of subdivision development.