The Sales Comparison Approach

The sales comparison approach, also known as the *market data approach*, is used for almost all properties. It also serves as the basis for a broker's opinion of value. It is based on the principle of substitution-- that a buyer will pay no more for the subject property than would be sufficient to purchase a comparable property-- and contribution-- that specific characteristics add value to a property.

The sales comparison approach is widely used because it takes into account the subject property's specific amenities in relation to competing properties. In addition, because of the currency of its data, the approach incorporates present market realities.

The sales comparison approach is limited in that every property is unique. As a result, it is difficult to find good comparables, especially for special-purpose properties. In addition, the market must be active; otherwise, sale prices lack currency and reliability.

Steps in the approach

The sales comparison approach consists of comparing sale prices of recently sold properties that are comparable with the subject, and making dollar adjustments to the price of each comparable to account for competitive differences with the subject. After identifying the adjusted value of each comparable, the appraiser weights the reliability of each comparable and the factors underlying how the adjustments were made. The weighting yields a final value range based on the most reliable factors in the analysis.

Sales Comparison Approach

1. Identify comparable sales.
2. Compare comparables to the subject and make adjustments to comparables.
3. Weight values indicated by adjusted comparables for the final value estimate of the subject.

Identifying comparables

To qualify as a comparable, a property must:

Resemble the subject in size, shape, design, utility and location	Have sold recently, generally within six months of the appraisal	Have sold in an arm's-length transaction

An appraiser considers three to six comparables, and usually includes at least three in the appraisal report.

Appraisers have specific guidelines within the foregoing criteria for selecting comparables, many of which are set by secondary market organizations such as FNMA.

For example, to qualify as a comparable for a mortgage loan appraisal, a property might have to be located within one mile of the subject. Or perhaps the size of the comparable must be within a certain percentage of improved area in relation to the subject.

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The time-of-sale criterion is important because transactions that occurred too far in the past will not reflect appreciation or recent changes in market conditions.

An arm's length sale involves objective, disinterested parties who are presumed to have negotiated a market price for the property. If the sale of a house occurred between a father and a daughter, for example, one might assume that the transaction did not reflect market value.

Principal sources of data for generating the sales comparison are tax records, title records, and the local multiple listing service.

Adjusting comparables

The appraiser adjusts the sale prices of the comparables to account for competitive differences with the subject property. Note that the sale prices of the comparables are known, while the value and price of the subject are not.

Therefore, adjustments can be made *only to the comparables' prices, not to the subject's*. Adjustments are made to the comparables in the form of a value deduction or a value addition.

Adding or deducting value. If the comparable is *better* than the subject in some characteristic, an amount is *deducted* from the sale price of the comparable. This neutralizes the comparable's competitive advantage in an adjustment category.

For example, a comparable has a swimming pool and the subject does not. To equalize the difference, the appraiser deducts an amount, say $6,000, from the sale price of the comparable. Note that the adjustment reflects the contribution of the swimming pool to market value. The adjustment amount is not the cost of the pool or its depreciated value.

If the comparable is *inferior* to the subject in some characteristic, an amount is *added* to the price of the comparable. This adjustment equalizes the subject's competitive advantage in this area.

Adjustment criteria – The principal factors for comparison and adjustment are *time of sale, location, physical characteristics, and transaction characteristics.*

Time of Sale – An adjustment may be made if market conditions, market prices, or financing availability have changed significantly since the date of the comparable's sale. Most often, this adjustment is to account for appreciation.

Location – An adjustment may be made if there are differences between the comparable's location and the subject's, including neighborhood desirability and appearance, zoning restrictions, and general price levels.

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Physical characteristics – Adjustments may be made for marketable differences between the comparable's and subject's lot size, square feet of livable area (or other appropriate measure for the property type), number of rooms, layout, age, condition, construction type and quality, landscaping, and special amenities.

Transaction characteristics– An adjustment may be made for such differences as mortgage loan terms, mortgage assumability, and owner financing.

Weighing comparables

Adding and subtracting the appropriate adjustments to the sale price of each comparable results in an adjusted price for the comparables that indicates the value of the subject. The last step in the approach is to perform a weighted analysis of the indicated values of each comparable.

The appraiser, in other words, must identify which comparable values are more indicative of the subject and which are less indicative.

An appraiser primarily relies on experience and judgment to weight comparables. There is no formula for selecting a value from within the range of all comparables analyzed. However, there are three quantitative guidelines:

- The total number of adjustments
- The amount of a single adjustment
- The net value change of all adjustments

As a rule, *the fewer the total number of adjustments, the smaller the adjustment amounts, and the less the total adjustment amount, the more reliable the comparable.*

Number of adjustments – In terms of total adjustments, the comparable with the fewest adjustments tends to be most similar to the subject, hence the best indicator of value. If a comparable requires excessive adjustments, it is increasingly less reliable as an indicator of value.

The underlying rationale is that there is a margin of error involved in making any adjustment. Whenever a number of adjustments must be made, the margin of error compounds. By the time six or seven adjustments are made, the margin becomes significant, and the reliability of the final value estimate is greatly reduced.

Single adjustment amounts – The dollar amount of an adjustment represents the variance between the subject and the comparable for a given item. If a large adjustment is called for, the comparable becomes less of an indicator of value. The smaller the adjustment, the better the comparable is as an indicator of value.

If an appraisal is performed for mortgage qualification, the appraiser may be restricted from making adjustments in excess of a certain amount, for example, anything in excess of 10-15% of the sale price of the comparable. If such an adjustment would be necessary, the property is no longer considered comparable.

Total net adjustment amount – The third reliability factor in weighting comparables is the total net value change of all adjustments added together. If a comparable's total adjustments alter the indicated value only slightly, the comparable is a good indicator of value. If total adjustments create a large dollar amount between the sale price and the adjusted value, the comparable is a poorer indicator of value. Fannie Mae, for instance, will not accept the use of a comparable where total net adjustments are in excess of 15% of the sale price.

For example, an appraiser is considering a property that sold for $100,000 as a comparable. After all adjustments are made, the indicated value of the comparable is $121,000, a 21% difference in the comparable's sale price. This property, if allowed at all, would be a weak indicator of value.

Broker's comparative market analysis

A broker or salesperson who is attempting to establish a listing price or range of prices for a property uses a scaled-down version of the appraiser's sales comparison approach called a comparative market analysis, or CMA (also called a competitive market analysis).

While the CMA serves a useful purpose in setting general price ranges, brokers and agents need to exercise caution in presenting a CMA as an appraisal, which it is not. Two important distinctions between the two are objectivity and comprehensiveness.

First, the broker is not unbiased: he or she is motivated by the desire to obtain a listing, which can lead one to distort the estimated price. Secondly, the broker's CMA is not comprehensive: the broker does not usually consider the full range of data about market conditions and comparable sales that the appraiser must consider and document. Therefore, the broker's opinion will be less reliable than the appraiser's.

Sales Comparison Approach example

The subject property is:

8 rooms-- 3 bedrooms, two baths, kitchen, living room, family room; 2,000 square feet of gross living area; 2-car attached garage; landscaping is good. Construction is frame with aluminum siding.

Comparison property A:

Sold for 100,000 within previous month; conventional financing at current rates; located in subject's neighborhood with similar locational advantages; house approximately same age as subject; lot size smaller than subject; view similar to subject; design less appealing than subject's; construction similar to subject; condition similar to subject; 7 rooms-- two bedrooms, one bath; 1,900 square feet of gross living area; 2-car attached garage; landscaping similar to subject.

Comparison property B:

Sold for $120,000 within previous month; conventional financing at current rates; located in subject's neighborhood with similar locational advantages; house six years newer than subject; lot size smaller than subject; view not as good as subject; design is more appealing than subject's; construction (brick and frame) better than subject's; better condition than subject;

10 rooms – four bedrooms, three baths; 2,300 square feet of gross living area; 2-car attached garage; landscaping similar to subject.

Comparison property C:

Sold for $115,000 within previous month; conventional financing at current rates; located in subject's neighborhood with similar locational advantages; house five years older than subject; lot size larger than subject; view similar to subject; design and appeal similar to subject's; construction similar to subject; condition similar to subject; 8 rooms – three bedrooms, two baths; 2,000 square feet of gross living area; 2-car attached garage; landscaping similar to subject.

Comparison property D:

Sold for $109,000 within previous month; conventional financing at current rates; located in a neighborhood close to subject's, but more desirable than subject's; house approximately same age as subject; lot size same as subject; view similar to subject; design less appealing than subject's; construction (frame) poorer than subject's; poorer condition than subject; 7 rooms – two bedrooms, one and one half baths; 1,900 square feet of gross living area; 2-car attached garage; landscaping similar to subject.

Sales Comparison Approach example

	Subject	A	B	C	D
Sale price		100,000	120,000	115,000	109,000
Financing terms		standard			
Sale date	Now	equal	equal	equal	equal
Location		equal	equal	equal	-2,000
Age		equal	-1,200	+1,000	equal
Lot size		+1,000	+1,000	+1,000	equal
Site/view		equal	-1,000	equal	equal
Design appeal		-1,000	-1,200	equal	+1,000
Construction Quality	good	equal	-3,000	equal	+1,000
Condition	good	equal	-5,000	equal	+2,000

	Subject	A	B	C	D
No. of rooms	8				
No. of bedrooms	3	+500	-500	equal	+500
No. of baths	2	+1,000	-1,500	equal	+500
Gross living area	2,000	+1,000	-5,000	equal	+1,000
Other space					
Garage	2 car/Att	equal	equal	equal	equal
Other improvements					
Landscaping	good	equal	equal	equal	equal
Net adjustments	good	+4,500	-17,400	0	+3,500
Indicated value	112,000	104,500	102,600	115,000	112,500

Sales Comparison Approach example

Conclusion

In view of all adjusted comparables, the appraiser developed a final indication of value of $112,000 for the subject. Underlying this conclusion is the fact that Comparable C, since it only has two minor adjustments which offset each other, it is by far the best indicator of value. Comparable D might be the second best indicator, since the net adjustments are very close to the sale price. Comparable A might be the third best indicator, since it has the second fewest number of total adjustments. Comparable B is the least reliable indicator, since there are numerous adjustments, three of which are of a significant amount. In addition, Comparable B is questionable altogether as a comparable, since total adjustments alter the sale price nearly 15%.