



**Marshall & Swift**

## How the Cost Approach Shines the Light on a Troubled Market

*In 2005, Marshall & Swift's then Chief Managing Editor, Richard Vishanoff, stated in this article that without the checks and balances that the cost approach method of valuation provides, the real estate industry was in danger of being surprised by falling values coming on the heels of an inflated market. Vishanoff's words, reprinted here, serve as a reminder that lenders can ensure accountability and avoid unrealistically high appraisals by requiring the use of the cost approach.*

*"I don't like using the cost approach. It's too time consuming. Market-based appraisals are always more reliable. Besides, I'm not required to include the cost approach in my appraisals. It's not relevant anymore."*

### **Sound familiar?**

If you are skipping the cost approach you could be doing a great disservice to your clients and to your appraisal practice. Here's why...

### **The Cost Approach To Value & Today's Real Estate Crisis**

The cost approach is the most reliable valuation method for a variety of assignments. It is primarily useful when projecting costs for new or proposed construction or where a lack of market activity limits the effectiveness of the sales comparison or market approach. It is an essential method when land value is well supported, when improvements represent the highest and best use of land, and for special-purpose properties not frequently exchanged on the market.

The cost approach is an excellent way to verify the validity of market value and to adjust estimates to account for unique features of the subject. It is also extremely useful in determining depreciation values for physical deterioration or functional or external obsolescence, as applied to the market approach.

### **Dollars and Sense**

The market approach supposes that the value of a property is best measured by what similar properties in similar environments have sold for, all differences accounted for. Obviously, prices can not exceed what buyers are willing to spend, but in times of housing shortages and increasing demand, it becomes difficult to gauge what a reasonable price is.

Based on the reasoning that a buyer will not pay more than the cost to reproduce or replace the subject, the cost approach is used to determine a replacement or reproduction cost minus depreciation. That figure is then added to the estimated land value to complete the appraisal. Many argue that the cost approach can be unreliable and one-sided. Depending on the extent of the training and expertise of the appraiser, this can be the case. But in these instances, incorrect usage and wrongly applied methodology are more to blame than the method itself.

## **Market Approach: Appraiser Beware**

Today's real estate market presents unique challenges for appraisers who only use the market approach. In many markets throughout the country, a housing shortage coupled with increased demand has driven prices up considerably. In markets such as these it is quite common to see a surge in prices that misrepresents the real value of the subject property. While sales of previously owned homes keep the economy churning, not nearly enough new units are being built to satisfy short-term demand. If market values substantially exceed replacement cost, including land, there is a significant risk that values will slide over the next few years when the expected supply surge catches up with demand.

In addition, loan officers hammer away at appraisers to hit the inflated prices on the sales contract. This further fuels an already hyper-inflated market. In hot housing markets and when applied correctly with current building costs and local multipliers, the cost approach can produce an estimate that is more in line with sustainable real estate values than the inflated valuations that are commonly derived using the market approach.

## **Cost Approach & Quality Control**

The cost approach has always served a crucial quality control function. Historically, it has been used to verify market-based estimates and to help identify a potential runaway or rapidly declining market. If the cost approach comes in well below market prices, it may be a signal that the market is rising beyond sustainable levels. If the cost approach comes in significantly above the market, it may signal that prices have dropped below reasonable levels. In other words, the cost approach provides a much needed reality check in both strong and weak markets, establishing a trustworthy benchmark of value.

Economies across the globe have witnessed time and time again that markets without reality checks are capable of generating obscene transaction values, resulting in dangerous bubble scenarios. Amid fears of the current housing bubble bursting, appraisers would do well to incorporate the cost approach into their daily operations to ensure report accountability and avoid over-inflated appraisals.

## **Manufactured Housing & Fannie's New Forms**

In June 2003, Fannie Mae announced that all market-based property valuations of manufactured housing must be further supported by the cost approach. Fannie Mae defines a manufactured home as "any dwelling unit built on a permanent chassis and attached to a permanent foundation system."

It deems the supplemental analysis and reporting to be necessary to address the unique property and appraisal issues associated with this type of housing. Basically, the new requirement employs the cost approach as an added safeguard to assure appraisal integrity and accountability. Fannie Mae added this new requirement to help ensure that appraisers contracted to value a manufactured home have the requisite knowledge, experience and access to data sources necessary to accurately perform the valuation.

More recently, with the latest release of its new test forms, Fannie Mae abandoned its attempt to severely limit the role of the cost approach on the new URAR form. Many in the industry feared that moving away from the cost approach would result in lower quality and less thorough appraisals. Apparently, Fannie Mae heard their voices and agrees.

The role of the cost approach in modern appraisals is unmistakably significant and should not be underestimated. Be careful not to be swayed by those who feel otherwise. Ignoring the cost approach may cost us all in the long run.

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