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The Timely Advantage of Actual Cash Value

This month I'll explore another advantage of Actual Cash Value appraisals, an advantage that's particular to current real estate market conditions.

Extreme Real Estate Markets

When real estate market supply and demand are out of balance (think strong demand and an undersupply), when there are shortages of construction materials and labor, when there are delays in manufacturing of components and equipment, or when the market is affected by inflation, then strange things can happen.

Sound familiar? Well, for much of the U.S. today, especially coastal communities that continue to draw people and development, those are the prevailing conditions. Consequently, whole-property market values have risen dramatically, and appraisers are challenged to keep up.

The Traditional Appraisal Method

When a whole-property traditional appraisal is made to estimate the "market value" to support a permit application for work on a floodplain building so the local official can make a substantial improvement determination (or substantial damage if the building was damaged), an appraiser must answer several questions:

1. What is the conventional market value of the whole property?
2. What is the value of the land (the site) as though vacant?
3. What is the contribution value of the improvements to the site that are other than the under-roof portion of the building (think accessory structures, decks, fences, pools, etc.)?
4. Are there any occupancy or use factors that skew the value?

We know how this works, where the formula is:

[Market Value of the Whole Property] – [Land Value] – [Contribution Value of Other Improvements]
= the Building "market value" for the SI/SD determination

Usually, the whole property market value is estimated by the sales comparison approach. Of course, that means there must be plenty of good comparable sales. In many markets the last couple of years has seen an undersupply of product (especially residential properties), which means sometimes there aren't enough comparable sales to allow the appraiser to develop the whole property market value. That undersupply, coupled with a strong desire of some people to move away from urban centers and toward warmer climates and the coast, is part of the reason for dramatic price increases. Another part of price increases is that new construction is not keeping up with demand because construction is shackled by supply chain and labor shortages. With limited options, some home buyers pay much more to get a house than can be rationalized by the traditional appraisal method.

So, are recent dramatic price increases a function of increasing land value, increasing building value, or a temporary aberration? When there aren't enough sales of buildable land to analyze, it's difficult to know how

much land value contributes to the overall price increase. These days, it seems like the availability of a home, especially one that's move-in ready, is the crucial factor, not the availability of land. Deciding how to allocate the purchase price between land and improvements is challenging for appraisers using the traditional appraisal method, especially when some sales make it appear a home is worth more than it would have cost to build just a few years ago. Appraisers should not make unsupported value allocations between land and buildings. To be a valid subtraction from the whole property value, the valuation of the land should be supported by analysis of comparable land sales.

The same problems occur when an appraiser tries to figure out the contribution value of site improvements and accessory buildings. To be a valid subtraction from the whole property value, what value should be allocated to those improvements when it is already hard to explain the contribution value of the home?

All licensed appraisers know how to prepare appraisals using the traditional appraisal method. But figuring out supportable values that must be subtracted to result in the "market value" the NFIP requires local officials to use for SI/SD determinations takes extra work that most appraisers are not accustomed to doing. Coupled with a lack of comparable land and home sales, that means risk is introduced at every step in the process, increasing the likelihood that the final value conclusion might be unreliable.

When good market data are not available, or when the data available don't seem rational, how reliable is the resulting estimate of building value? Do we have alternatives?

Actual Cash Value Appraisal Method

Yes – the alternative is the Actual Cash Value (ACV) appraisal method (you knew that was coming, right?). ACV is **only** about the building, which means we don't have to be concerned with lack of comparable land sales.

To develop the ACV, an appraiser has to answer only two questions:

1. What would it cost to reproduce a replica or copy of the existing building (sometimes called "in-kind replacement cost")?
2. How much physical depreciation should be subtracted from the reproduction cost?

We know how ACV works, where the formula is:

$$\begin{aligned} & [\text{Building Reproduction Cost}] - [\text{Physical Depreciation}] \\ & = \text{the Building "market value" for the SI/SD determination} \end{aligned}$$

The ACV appraisal method isn't immune to extreme real estate market conditions. However, the challenge for the appraiser is solely one of tracking construction costs. Otherwise, applying the method is the same no matter how extreme the real estate market conditions.

The difficulty of tracking construction costs should not be dismissed lightly. Under normal conditions cost estimating services like Marshall & Swift, RSMeans, or CoreLogic's Commercial Express run three or more months behind the construction industry activity, and those companies can take another four to six weeks to compile the information before publication. When you factor in the impact of supply chain delays, rapidly rising labor rates, materials shortages, and emerging inflation, construction costs can increase faster than those services can publish the data. Delays in data publication introduces a complication for appraisers during extreme markets like we see today. When so many homes are constructed on speculation and often sold before construction is complete,

there are few fixed-price construction contracts that appraisers can use to validate the data from the cost estimating companies.

Conclusion

What's a property owner to do when they need a market value for SI/SD purposes? Look for an appraiser who is well versed in ACV, which also means they probably keep a finger on the pulse of local construction costs. Despite the challenge of tracking costs, ACV provides a more stable, reliable estimate of building value. The process is simple and direct because it focuses only on the building, and there is no threat that value associated with use and occupancy will skew results.

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