4 THE VALUATION PROCESS

4-0 INTRODUCTION

This Chapter addresses the development of the three approaches to value:

- o Sales Comparison Approach
- o Income Capitalization Approach
- o Cost Approach

It also addresses their impact in arriving at a final value conclusion that reflects the conditions denoted on the Valuation Conditions (VC) Form. These approaches form the foundation for developing a value and lead to the final reconciliation for an estimated market value.

The VC form identifies key components of the property analysis and requires the appraiser to:

- o describe the results of the visual inspection
- o identify known conditions, if any
- o reconcile their findings with the approaches to value

This Chapter conforms to the current Uniform Standards of Professional Appraisal Practice (USPAP) and the requirements of the URAR. In developing and coming to a conclusion about value, the appraiser must be aware of and comply with all state and federal laws and requirements. Furthermore, strict compliance with USPAP is required for all FHA appraisals.

4-1 MARKET VALUE ESTIMATES

In accordance with HUD/FHA requirements, an appraiser must do the following:

- o define the type of value being considered for the property appraisal
- o ascertain the definition of market value appropriate for the appraisal
- o indicate whether the estimate is the most probable price that the property will sell for on the open market

> Follow the standards of USPAP. Key sections that are most applicable are provided below.

A. DEFINITION OF MARKET VALUE

The definition of market value that applies to HUD/FHA is cited from the Uniform Standards of Professional Appraisal Practice. This is the definition of value which must be used for all appraisals performed for FHA-insured mortgages.

"The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus."

Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. The buyer and seller are typically motivated.
2. Both parties are well informed or well advised, and each is acting in what they consider their best interest.
3. A reasonable time is allowed for exposure in the open market.
4. Payment is made in terms of cash in United States Dollars or in terms of a financial arrangement comparable thereto.
5. The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions.

(4-1)

B. PROPERTY RIGHTS APPRAISED

Identifying property rights to be valued determines the criteria for selecting market data and for comparable transactions. The following table is an example of property rights.

Property Type	Occupancy	Property Rights Appraised
Single-family	Owner	Fee Simple
Two-to-Four family	One unit owner-occupied, other units	Leased Fee

	rented	
All property types	Ground lease	Leasehold Estate

The appraiser examines property rights to determine what rights, if any, the property owner has conveyed to others. The conveyance of rights to others impacts the value of the property. For example, a single-family owner-occupied property has fee simple property rights that are absolute and unencumbered - unlike a leasehold estate where property rights are specified to use and occupancy for a stated term. The appraiser must determine to what extent, if any, the transfer of property rights impacts the property's value.

Fee Simple is defined as absolute ownership unencumbered by any other interest or estate.

Lease Fee is defined as an ownership interest held by a landlord with the right of use and occupancy conveyed by lease to others; usually consists of the right to receive rent and the right to repossession at the termination of lease.

Leasehold Estate is defined as the right to use and occupy real estate for a stated term and under certain conditions that have been conveyed by a lease.

C. PURPOSE

The purpose of an appraisal is the stated reason for performing an appraisal assignment. The purpose is typically stated as the basis for an underwriting decision. For HUD, the purpose is to determine market value for mortgage insurance purposes.

D. INTENDED USE OF APPRAISAL/FUNCTION

(4-1) The intended use or function for all appraisals prepared for FHA is to support the underwriting requirements for an FHA-insured mortgage.

E. USE OF THE APPRAISAL

The use of the appraisal is to support FHA's decision to provide mortgage insurance on the real property that is the subject of the appraisal. Therefore, intended users include the lender and HUD.

F. EFFECTIVE DATE OF VALUE

The effective date of value is either the date when the appraiser physically inspects the subject property or another date specifically defined by the lender.

> If another date is used as the effective date, indicate the alternative date and the date on which the subject property was physically inspected.

G. SCOPE

The appraiser must perform a complete appraisal as defined by USPAP, considering all of the applicable approaches to value and developing the appropriate approaches identified in this Handbook. Departure is not allowed.

H. SPECIAL LIMITING CONDITIONS AND ASSUMPTIONS

The appraiser must adequately identify, report and quantify any extraordinary assumptions or limiting conditions that directly impact the valuation. Examples include:

- o a negative external influence (proximity to a municipal landfill, for example)
- o proposed road improvements
- o a pending zone change

4-2 HUD/FHA REQUIREMENTS

HUD/FHA requirements for market value estimates are as follows:

- o The appraiser must appraise the property to determine market value under the requirements detailed in Chapter 4-1 of this Handbook.

- o The appraiser must evaluate the physical condition of the property and note it on the Valuation Conditions (VC) Form of the Comprehensive Valuation Package. Note any necessary repairs. If repairs are in process, disclose the extent or status of those repairs at the time of the appraisal. Always base the value on the completion of repairs and include this as a special limiting condition when repairs are required and expected to be completed.

- o The appraiser must evaluate whether the property is free of hazards, noxious odors, grossly offensive sights or excessive noises that may:

- endanger the physical improvements
- affect the livability of the property or its marketability
- affect the health and safety of its occupants

> If any of these conditions exist, recommend correction of the problem or rejection of the property and explain.

(4-2)

For more information, see Chapter 2-2 of this Handbook.

o The appraiser must determine if the subject property possesses sufficient remaining economic life to warrant a long-term mortgage, assuming a reasonable level of continued maintenance. If the property does not warrant a long-term mortgage it will be ineligible for FHA mortgage insurance.

o The appraiser must indicate if the property conforms to applicable Minimum HUD/VA Property Requirements detailed in Chapter 3.

> If the property does not conform to the Minimum Property Requirements, note it in the VC section of the appraisal report and require correction of the deficiency or rejection of the property and explain.

> If there are so many necessary repairs that an "as-repaired" value cannot be determined, or if correcting the deficiencies would require major rehabilitation/alterations, return the appraisal to the lender with a detailed explanation.

4-3 NEW AND PROPOSED CONSTRUCTION REQUIREMENTS

Before performing an appraisal for new or proposed construction, the appraiser must have the plans and specifications and a fully completed Builder's Certification. The lender must provide this information to the appraiser prior to issuing the assignment. Without these items, the property will not be acceptable for FHA insurance purposes.

A. NEW CONSTRUCTION

The appraiser must develop the cost approach for new construction less than one year old. Appraise new construction in the same way that existing properties are valued under the specifications outlined in this chapter of the Handbook. Also, consider using the Gross Rent Multiplier method when developing the income approach for three- or four-unit buildings.

B. PROPOSED CONSTRUCTION

Appraise proposed construction consistent with the methodology presented in this chapter. USPAP requires that the appraiser be provided with written specifications of the proposed structure. Specifically, the Lender must provide the appraiser with these documents:

o builder's plans, specifications and construction documents

o completed builder's certification (Form HUD-92541)

(4-3) o Builder's Warranty (Form HUD-92544)

o the 10-year Warranty, when required (the Secretary has proposed a 1-year Home-Owner Warranty period)

o all reports and information available (i.e. sales agreement, title report, environmental assessments or studies and inspection reports)

> If these documents are not provided, return the incomplete appraisal to the lender. Check the box stating that the valuation is subject to completion and that the value is contingent on the structure receiving a certificate of occupancy.

4-4 UNIQUE PROPERTY APPRAISALS

Appraisers are sometimes faced with unique properties: a log home, an extra small home, lower than normal ceiling heights, etc. Eligibility of these properties depends on whether or not the property is structurally sound and readily marketable. If a property meets these criteria, the appraiser estimates market value. However, depending on the uniqueness of a property, the final determination to accept or reject the property is made by the lending institution's underwriter.

Excess land is another area in which to exercise caution. Land is considered to be excess if it is:

o larger than what is typical in the neighborhood

AND

o capable of a separate use

o If there is excess land, describe it but do not value it. In this instance, the appraisal is based upon a hypothetical condition. A legal description of the portion being appraised is required.

4-5 COST APPROACH

The cost approach is an indication of value based on the premise that a buyer would not pay more for a property than the cost to construct a property of equal utility. The cost approach is not necessarily the best indication of market value for many properties, but it is often applicable for new(er) or proposed construction and special use properties. Such situations include the following for single family one- to four-unit dwellings:

Property Age	Cost-Approach Requirement
Proposed Construction	Required
New Construction	Required
Existing, less than one year	Required
Existing, regardless of age	Market acceptability of cost as an indication of pricing and value

Unless the cost approach is deemed reliable on the above table or considered applicable in the appraiser's judgment, developing this approach is not required for a HUD/FHA appraisal. The reporting requirement of USPAP known as the departure rule does not apply because the appraiser must always use the cost approach to value when considered applicable.

USPAP Requirements

Strict compliance with USPAP standards is required for all FHA appraisals.

Reporting Requirements

> If the cost approach was excluded, report it in the reconciliation and insert the rationale for its exclusion.

A. COST APPROACH METHODOLOGY

1. Land Value Estimate

(4-5) Standard Rule 1-3(b) of USPAP requires appraisers to "recognize that land is appraised as though vacant ... ". The appraiser estimates the value of the land because it is generally considered to be a permanent, non-depreciating asset. There are exceptions to this generally agreed upon premise, but the exceptions will rarely be a factor in FHA/HUD related appraisals. Exceptions may include land with an erosion problem or a polluted property.

2. Excess Land

Excess Land is defined as the area by which the plot exceeds the area of a readily marketable real estate entity. This occurs when the subject lot is considerably larger than typical lots in the neighborhood and the excess is capable of separate use. Generally, the defining characteristic is an excess portion that can be subdivided and marketed as an individual parcel. However, in small communities and outlying areas, appraisers must use different criteria because the market may accept a wide variance in lot sizes. This segment of the market may show wide differences in lot use.

> If the plot contains excess land, delineate and appraise separately the readily marketable real estate entity and the existing or proposed improvements. Describe the excess land but do not appraise it with the primary 1 - 4 family residential building that is subject to a mortgage.

The lender will require that the value of excess land be excluded from the maximum mortgage amount that will be calculated only on a reasonable amount of land and improvements.

3. Sales Comparison Approach For Land Value

In areas with an active real estate market, the sales comparison approach is generally the primary method used. This method allows for collecting, verifying and analyzing recent and similar land sales to be compared with the subject land. Before a conclusion is reached, the comparable land sales are adjusted for differences between the sales and the subject property.

(4-5) 4. Alsite

In areas with a significant lack of comparable sales to develop the sales comparison approach, use the alsite method, which assumes a market-accepted ratio between land value and property value. Although the value estimate from this method is inherently less accurate than that of the sales comparison approach, it is still an acceptable approach.

> The appraiser must document, support and justify the chosen alsite ratio.

5. Extraction

Extraction is a method to deduct the depreciated contribution of the subject's improvement from the total sales price of the property. The remainder represents an estimate of land value. This approach is also inherently less accurate than the sales comparison approach.

> The appraiser must document, support and justify the estimate of the depreciated contribution of the improvements.

B. IMPROVEMENT COST ESTIMATE

Replacement cost is the preferred method for developing the Cost New of the subject improvements. Typically the appraiser uses the Replacement Cost New and quantifies all forms of depreciation, except obsolescence. An alternative is the reproduction cost. HUD does not require a specific method.

The replacement cost of property is estimated to enable the application of the substitution principle. Estimates of the replacement/reproduction cost of property are not estimates of value, although they indicate the possibility that value, in an equivalent amount, may exist. Value depends entirely upon usefulness, not on the cost. Value tends to conform to cost, but this is not to imply that it is always equivalent to cost.

C. TYPICAL REPLACEMENT COST

The replacement cost estimate must reflect the costs typically found in an area - not necessarily the costs of a particular builder or owner. This method is typically preferred to the reproduction cost.

D. UNUSUAL AND NON-TYPICAL COSTS

Some of the items or allowances in the cost estimate may not represent equivalent value in a particular case. An owner might erect a house that would cost more than the houses that generally characterize the neighborhood, but the value of the home to the typical prospective owner in that neighborhood might be less than the replacement cost of the property. The cost of construction also may be in excess of value at a given time. Under some circumstances, a reduction in cost may be in prospect. If construction costs decline, value may also decline if it was originally equal to cost.

(4-5) E. RECOMMENDED METHODOLOGIES

Generally, the Marshall and Swift square foot method is the most applicable method for estimating the Replacement Cost New. This is a simplified procedure and all appraisers must have the knowledge and skill to apply this methodology. This method may not be used for custom-built homes or unique buildings that require the segregated cost method.

Typical residential construction with which HUD is involved should be rated "fair," "average" or "good" quality. Mass produced, tract-built homes are rated either "fair" or "average," meeting only the minimum construction requirements of lending institutions, mortgage insurance agencies and building codes. Appraisers must review the basic description to determine the correct construction type.

The appraiser will complete the cost approach for each proposed construction case based on the construction type and quality rating of the property as shown in the Marshall and Swift Cost Handbook.

> Reference on the form the pages and revision date where the figures were obtained (usually two pages).

> Include a marketing expense with the replacement cost of improvements and an applicable current multipliers.

F. REMAINING ECONOMIC LIFE

Remaining economic life is an estimate of the remaining time period in which the improvements continue to contribute value to the property (building and improvements). The appraiser must consider the effect, if any, of modifications or renovations on the improvements. This effect is typically expressed in years.

4-6 SALES COMPARISON APPROACH

This is often the most applicable approach in estimating the market value of a single-family one- to four-unit property. This approach relies on:

o the availability of sales data
o the volume of transactions
o the reliability of reporting the transaction data confirmed and developed under this approach

When developing a value indication by the sales comparison approach, always include the assumptions and data from the other approaches on the VC form.

A. DATA REQUIREMENTS

1. Sales Data vs. Comparable Sale

Any transaction in the market is a sale, but not all sales are comparable. Consider the type of transaction and physical characteristics of any sale before considering the sale a comparable.

(4-6) 2. Selection of Comparable Sales for Analysis

Identify the relevant market based on the area in which the property competes and the forces/dynamics that affect the comparable sale properties. This is necessary in relating the sales to the subject.

Consider the amount of time that has elapsed between the sale date and the effective date of the appraisal. Sales data should not exceed six months between the date of the appraisal and the sale date of the comparable, and must not exceed twelve months. An explanation is required for sales dates in excess of six months.

Consider neighborhood and other external factors that influence property value, including real estate and non-real estate influences. For example, when most of the neighborhood's residents are employed by one major employer who is relocating out of the region, the neighborhood may experience a decline in values. The term "non-real estate influenced", however, must never include racial composition.

Consider the quality and quantity of data available for the given assignment. A lack of quality data in a market may force reliance on data in a similar market not necessarily the subject's immediate market area. However, clearly explain and justify any sales from outside the subject's immediate market area

3. Excluded Sales Transactions

When using conventional sales data, the appraiser must be aware of the terms of the sale and adjust the conventional sales price to reflect any unusual terms. For example, there are sales that must be excluded; however, some transactions may be included but adjusted for factors such as below-market financing to provide a cash equivalent sales price.

4. Current Offerings and Listings Analysis

Using these types of sales are discouraged. However, under certain slow market conditions or in markets with rapidly increasing pricing, it may be acceptable to include properties offered for sale. Proceed with caution when analyzing and adjusting these offerings. Recognize the inherent negotiability in price between an offering and a consummated sale. Clearly label these comparables as offering, listing, under agreement, etc., but present them as additional comparable data only.

5. Sales in Escrow

If a bona fide transaction is imminent, sales in escrow are considered to be reliable indications of market pricing. Exercise care in identifying the planned date of closure for the sale and any extraneous circumstances that may impede the closing on the projected date.

6. Distressed Sales

Using distressed sales is strongly discouraged because of the special circumstances surrounding these transactions.

(4-6) 7. Resite Sales

Using resite sales from a corporate seller at a below market value is strongly discouraged when the purchaser is the resite company because of the unusual circumstances surrounding these transactions.

Both distressed and resite sales are strongly discouraged because they fail to meet the test of "market value," particularly item No. 1: "The buyer and seller are typically motivated." However, these sales can exceed normal market transaction and affect market values.

8. Confirmation of Sales and Transaction Information

The appraiser must verify all market and comparable information used in the appraisal process and is accountable for any information presented as "fact" used to develop the subject property's value estimate. Verification ensures that the information is accurate and meaningful and provides the appraiser with a firm understanding of market motivations and trends. The goal of the verification process is to ensure that only information that accurately reflects current market conditions and trends is presented and that meaningful conclusions can be reached from this information.

During the verification process, it is necessary for the appraiser to gain an understanding of the motivations surrounding the sale in order to:

- o determine if the sale was arm's length and not distressed
- o understand current market conditions that influence value

Whenever possible, interview a party to the sale to determine the expectations and motivations for purchasing the property. Also, determine whether significant capital expenditures funded by the seller were made shortly after the transaction occurred. if so, determine whether the expenditure needs to be added back into the sale price to reflect the actual conditions surrounding the sale.

The appraiser must verify sale information with the buyer, the seller or one of their representatives (broker, lender, lawyer, etc.) . If the sale cannot be verified with someone who has first-hand knowledge of the transaction, use public records. However, the appraiser must clearly state how the sale was verified and to what extent. Do not use or rely heavily on any sale that was not verified with an involved party or one of their representatives because concessions have become more common in the market.

B. ADJUSTMENT PROCESS

Other factors that affect the use of comparable sales must be considered. Account for differences between the subject property and each comparable sale. The analysis of sales includes both quantitative and qualitative factors. Remember that the comparable data is adjusted to the subject property. Present these adjustments as dollar amount figures and justify

The sequence of adjustments are part of the URAR. All FHA appraisers should be familiar with the adjustment grid within the URAR. Adjustments are indicated as a dollar amount. If an adjustment is not necessary, the appraiser can either enter "equal" or $0 as the

adjustment.
(4-6) An individual line item adjustment should not exceed 10%. The total adjustments to the comparables should not exceed 15% net and 25% gross of the sales price. If adjustment exceeds a parameter, the appraiser must explain why as part of the appraisal report.

Adjustments to the sales include:

o Property Rights Conveyed. Refer to the property right appraised section of this chapter. This adjustment is always the first adjustment made to all sales.

o Sales or Financing Concessions. Account for and adjust for any special sale or financing terms, including sales concessions, non-market financing terms, points, buy downs, closing terms and swaps/exchanges. The most common scenario involves the seller paying points in the form of settlement help to the buyer. To reflect the amount, adjust the sales price of the comparable sale downwards. Typically this amount will not exceed six percent of the sales price for typical transactions.

o Condition of Sale. Account for the conditions surrounding the sale, including foreclosure/ distressed sale, purchased by an adjoining owner, sold between family members, auctioned or any unusual factor that could be reflected in the price paid.

o Market Conditions. Account for changes that have occurred or are occurring from the date of sale of the comparable transaction to the date of appraisal, including appreciation, new development, availability of financing, loan terms, supply and demand.

o Property Adjustments. These are required if the difference between the sale and the subject is quantifiable and supported by the market.

Location - Account for location considerations.

Physical Characteristics - Account for physical differences between the comparables and the subject, including condition, view, design/ appeal and quality of construction. These are typically entered as individual categories.

Economic Characteristics - Account for economic characteristics between the comparables and the subject, including occupancy, rent level, lease structure or terms.

Property	Occupancy	Applicability Test
Single-family	Owner-occupied	Market indication of highest and best use as improved (either for rental or for owner-occupancy)
Single-family	Vacant	Market indication of highest and best use as improved (either for rental or for owner-occupancy)
Two-family-	One unit is owner- occupied; the other is vacant.	Optional, depending on the availability and reliability of market data
Two-family	One unit is owner-occupied; the other is rented.	Required if the property is located in a neighborhood with other rental properties; otherwise, optional, depending on the availability and reliability of market data
Three-to-four	One unit is owner- occupied;	Required

Family	other units are rented.	
One-to-four Family	Leasehold Estate	Required
One-to-four Family	Leased Fee Estate	Required

A. DATA REQUIREMENTS

The appraiser must choose similar market rentals to compare to the subject property.

Consider the transaction and physical characteristics of a rental before considering the rental as comparable.

1. Confirmation Of Leases And Transaction Information

The appraiser must verify all comparable information used in the appraisal process. The appraiser is liable and accountable for any information presented as a "fact" in developing the value estimate. This ensures that the information is accurate and meaningful and provides the appraiser with an understanding of market motivations and trends. The goals of the verification process are to ensure:

- o that only the information that accurately reflects current market conditions and trends is presented
- o that meaningful conclusions can be reached from this information

If possible, interview the lessee or the lessor to determine their expectations and motivation for entering into the lease.

Verify lease information with the lessor/lessee or one of their representatives (broker, agent, lawyer, etc.). If this verification is not possible, clearly state how the lease was verified and to what extent. Do not rely heavily on any lease that was not verified with an involved party or one of their representatives.

2. Adjustment Process

The appraiser must consider other factors that affect the use of comparable leases. The appraiser must account for differences between the subject property and the comparable leases to reconcile the actual lease income. This selection of comparable rentals is significant because the gross income multiplier should not be adjusted, only the comparable rental rate. These adjustments are typically presented as percentage or dollar amount figures. The appraiser must be able to justify and explain the rationale behind all adjustments. The sequence of adjustments should follow the same format as that presented in the sales comparison approach section; however, tailor the categories to the comparable rentals.

3. The Income Projection

In developing the projected gross rent for the subject, the appraiser needs to review and analyze the leases in place on the effective date of the appraisal. Also, consider leases that will commence or terminate around the effective date of the appraisal and the impact, if any, on the property.

The appraiser must take appropriate steps to ensure that the development of the income approach reflects the actual conditions at the subject property. If the subject is new, consider when the property income will stabilize. Include the justification for any assumption made - lease up time, for example. The income approach is typically based upon the "as stabilized" premises. Support this approach appropriately and clearly state the date when stabilized income will be achieved.

B. DEVELOPMENT OF RATES

The Gross Rent Multiplier (GRM) is the ratio between the sales price of a property and its gross rental income. This method is used to develop indications of a property value. The appraiser must consider the strengths and weaknesses of each comparable rental and develop an estimated multiplier that adequately reflects the income-generating ability of the subject property. This ratio is applied to the estimated income for the subject to conclude an indication of value by the income approach.

4-8 FINAL RECONCILIATION

The final analytical step in the valuation process is to reconcile value indicators. In this step, the appraiser must measure the strengths and weaknesses of each of the applicable approaches performed and develop this data into a single value estimate.

4-9 RECONSIDERATION OF APPRAISED VALUE
The underwriter may request reconsideration of the appraised value when new market data exists that

may not have been reflected in the appraisal. The lender can select new comparables and request a reappraisal. This request from the lender must be in writing and maintained in the appraiser's work file. The appraiser must decide whether to use the new comparables and perform the reappraisal. If the comparables were available when the initial appraisal was performed, the lender may not offer pay for the reconsideration.