JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

2. Appraisal Topics

d. "Lecture on Land Investment and Appraisal", no date

Index

Misc lectures

LECTURE ON LAND INVESTMENT AND APPRAISAL

I. Introduction

A. University of Wisconsin increasing its role in real estate education. Enrollments in the introductory course, major course work, masters program and Ph.D. program have all increased about 25%. Extension program will expand.

B. Appreciation for opportunity to go into one subject in depth.

C. Subject of land suitable for development offers three levels of analysis - as an investment, as an appraisal problem, and as an appraisal for courtroom testimony.

II. Land development as a business is a highly complex subject. Appraisal of land for sub-dividing requires simulation of the thinking of a developer. Testimony in court as to vacant land values requires further simplification of the development problem to ease presentation to the jury. Therefore all three subject areas begin with concern for the development process.

A. The land developer is in the business of manufacturing building sites. He is a merchant as well as a manufacturer. Since the process requires great amounts of capital, long years of commitment, high risk, and persistent personal attention, the developer must be sure that the opportunity for profits justifies the effort before he starts the project.

B. The first step is a feasibility study with several major components:

1. A market and a marketing analysis.
2. A technical engineering analysis.
3. A legal-political analysis.
4. A summary analysis of financial feasibility.

C. Many developers do only a market analysis which includes data on population, employment, and incomes in an area along with other data describing the outlook for community growth. However, in most cases one is only concerned with these figures to judge ones timing or identify major sources of buying power. It is far more important to do a marketing analysis.

D. The developer must slot his product to small sub-markets in only one sector of a community. Any one project is attempting to tap only a few specialized types of demand. Merchandising is more important than market timing, and although the developer is manufacturing lots he must be selling a way of life, a neighborhood, environment, or intangible pleasures and satisfactions.

1. Every developer in a particular community will be paying about the same for the required physical improvements. The real profit in development comes from his ability to create intangible values of natural attractiveness, prestige, special amenities and so on to differentiate his package of site and utilities from any others offered in the community.

2. Marketing strategy is eventually concerned with creating a partial monopoly.

   a. The first monopoly is location such as the by-passed site, lake access, etc.
   b. The second monopoly is timing, but unless one is protected from following competitive development, this is a temporary advantage. (Multicon)
   c. The monopoly of product differentiation can also come from slanting the project to a particular group on the basis of prestige, high style architecture, a particular hobby such as riding, fishing, or families located in a community on a temporary basis.

E. Marketing strategy may also exploit a natural asset or liability of a site. Low groupd along the river might become a park, ravines might create privacy bands for lot clusters, treeless areas might become playing fields, a pitch and putt and so on. The developer must design his project so that he automatically sells the less desirable areas with the good.

1. Not only should the developer sell all the land, he should sell it as quickly as possible.

2. Since land value is related to density, the first thought is to have as many lots as possible. But if you can only sell so many lots a year, too many lots means that the carrying costs plus the discount of income wipes out the profit. It would be better to mix rental units with single family, thereby maintaining average density for the project but reducint the number of units to be sold and thus indirectly the time period for the development.

3. Moreover mixing land uses permits a more paid increase in the density level which might make possible sale of a filling station site, super market site, etc.

4. The planned unit development also permits the developer to reach alternative sub-markets, create depreciation cover for land sale profits, and motivate community political agencies with immediate increases in accessible improvements.

F. Any marketing study should include:

1. A review of local public capital budgets to discover timing, direction, and type of community improvements for the next five years.

2. A review of all plats filed in your marketing area for at least the previous five years with a description of improvements offered, deed restrictions, special site features, school district, parish, and access by auto. For each subdivision you should record number of lots sold by warranty deed, by land contract and divide by number of lots available and number of years on the market. This figure will be an absorption rate which is one of the most critical points of development analysis.

3. The absorbtion rate should also be calculated as to the number of actually built places for a given period of time.

4. Total number of building permits in the area for the past theee years.

5. Situs pattern map.

6. Detailed inspection of competing models and lot sales program.

7. Questionnaire to new home owners.

8. Information on prospective competititon from local planning agencies

9. Consumer survey in established areas to discover what people might trade up for.

10. Discussion with bank trust departments to see what estate managers might recommend.

11. Look with imagination for centers of influence and remember that a lot with all the utilities is not enough. You must sell the sizzle instead of the steak and there is no mass market in real estate. There any only many small groups with special interests and concepts of what a home should be and these specialized needs should be the target of any development project - rental or sale.

G. Technical feasibility is concerned with engineering problems.

1. The first decision is sewer, septic, or private sewage plant. This decision will affect site selection for soils, size of lot, type of development, political orientation, absorbtion rate and capital required of the developer. Soil tests are a must.

2. Storm water drainage, required greenways, ponding areas, and topography will determine saleable areas.

3. Official map or preliminary community plans will predetermine street layout, school site, etc.

4. Traffic access will determine points of entry, commercial sites, convenience and safety, as well as initial area for development. Today it is possible to save trees by moving them, convert marshes into ponds, dedicate woodlands for park and otherwise capitalize on the terrain.

5. Technical feasibilities might also include legal questions such as:

   a. Method of acquisition of land consistent with developer.
   b. Legal and tax limits on liability.
   c. Alternatives jurisdiction in regard to planning, zoning, school districts, utilities and annexation.

H. All of these considerations combine into analysis of financial feasibility. An honest analysis of feasibility requires that there be:

1. A marketing target, a preliminary technical plan, and a preliminary capital budget.

2. Feasibility is concerned with cash flow and the investment value of net cash to the owner.

3. In order to analyze it properly there must first be a plan and a schedule for completion of construction, for sales, and for closeout of remaining land contracts. In short a simple critical path analysis using three units of time might be best. (Show combined time-line and work sheet)

4. Review mimeo handout.

5. Cash flow could also consider the income tax bite on sales revenue since profits are taxed pro-tata on each lot.

I. Ellwood graph.

1. Time-line of development.
2. Front money--leverage.
3. Limited liability.

III. Appraisal of land for subdivision

A. Appraisal of vacant land which may be suitable for development today requires much of the same analysis as the investor might require. Highest and best use is a deceptive concept.

1. Highest and best use implies feasibility for marketing, technical, legal and financial viewpoints.

2. Terrible mistakes are made when the appraiser simply assumes that if development around the subject site is of a certain type, then the subject site is best used this way too.

3. Consider the owner of 15 acre parcel on a main traffic artery, adjacent to a city park, in an area not subject to zoning. The community is growing and there are subdivisions on three sides of the site. Typical appraiser would say highest and best use would be a subdivision, assuming that a developer would compete directly with neighboring projects.

4. But this assumption violates the first objective of marketing strategy - to create a monopoly. Might not the highest and best use of the site be a rental project in the path of growth for those not yet ready to buy.

5. Neighboring developments would protect it from competition rather than provide competition and the higher densities might mean higher values. Sale of the land would be a capital gain, development of the apartment complex might create a permanent livlihood or a lease of the site might provide a lifetime income.

6. In other words, the appraiser who takes the commission on a project with highest and best use is not fully predetermined must gain:

   a. either a budget for technical counsel and a preliminary plan
   b. or explicit instructions from his client as to the assumptions the appraiser must make in determining highest and best use.

7. The appraiser cannot in good faith conjure up a development without knowledge that sptic tanks will work, that a certain area would be absorbed by storm greenways or the city master plan, or that highway access is available at the right point. Highest and best use presumes someone with the proper capacities has qualified the site as to essential technical feasibility.

8. Such site qualifications then makes possible the use of appraisal methods as the following which range from the most preliminary estimates to sophisticated analysis.

C. The market comparison method requires comparison of similar acreages and not a combination of lot prices and acreages. Sales prices, conditions of sale, and objective of buyer should be verified in each case. Unusual conditions exclude transactions.

1. Prices should then be compared on a per acre basis, and it might be desirable to divide large sales into several types of land where marsh land, lace acreage, etc. may distort acreage prices on useable ground.

2. Adjustments should be made for time, looation, economy of development, proximity to other developments, schools, and adverse influences such as power lines, nuisance land uses, or other major differences.

3. The appraiser is expected to make rational and supportable adjustment. Additional capital cost items should include an equal amount for carrying costs.

4. For example, the developer may pay for extending sewer, water and gas lines to his development or for extension for storm water facilities or deposits for school sites, acquisitions, etc. This always requires cash.

5. Therefore when comparing sites on income or market basis, be sure to define the cost of land to include offsite improvements as this will explain or change the definition of market price considerably. Whenever comparing two sites, compare costs as of the time both sites are fully prepared for an improvement as there may be several hundred dollars difference in cost between raw land and land with services at its border.

D. The triple discount method offers a rough estimation of land values by providing a short cut on the income method. (Use transperency to demonstrate.)

E. A capitalized income approach is based on the time line of development and sale. It requires analysis of cash flow discounted back to the present or to the beginning of the development committment.

1. The previous illustration of the cash flow for particular project is similar to what is expected of an appraiser except that the appraiser may use average cost figures rather than specific bids on a particular project. Moreover the appraiser should use the before tax income.

2. The appraiser should use a high discount factor. 15 or 20% as far more realistic than the 7 or 8% which some appraisers have used.

F. Time is the enemy of the developer. The passing of time means the accumulation of carrying charges and the postponement of profit, most of which is realized in the later stages of development. Since the developer will generally be discounting his profits at a higher rate of interest than a lender may be requiring on his balance, anything which can postpone repayment of debt or release of title may be to the developers advantage.

1. Weighted release values on land contracts adds value for the appraisal of the development interest.

2. Anything which postpones repayment of bank balance reduces front money required by developer or sppeds the recovery of capital in the years when the present value discount is lowest.

3. While the seller of the land may wait for his money and the lender will finance amny of the improvements on ths subdivision to create lots and collateral value, the developer must pay cash for offsite improvements.

IV. Testimony as to land value

A. NAREB Code of ethics, Part II

Article 17: The realtor should not undertake to make an appraisal that is outside the field of his experience unless he obtains the assistance of an authority on such types of property, or unless the facts are fully disclosed to the client. In such circumstances, the authority so engaged should be so identified and his contribution to the assignment should be clearly set forth.

Article 18: When asked to make a formal appraisal of real property the realtor should not render an opinion without carefulaand thorough analysis and interpretation of all factors affecting the value of the property. His counsel constitutes a professional service.

The realtor should not undertake to make an appraisal or render an opinion of value on any property where he has a present or contemplated interest unless such interest is specifically disclosed in the appraisal report. Under no circumstance should he undertake to make a formal appraisal when his employment or fee is contingent upon the amount of his appraisal.

B. The appraiser in court must state highest and best use of the property - in this case vacant land. Highest and best use requires demonstration of feasibility and feasibility must be further subdivided as we have done today:

1. Market feasibility.
2. Marketing feasibility.
3. Technical feasibility.
4. Legal feasibility.
5. Financial feasibility.

C. In short the appraiser must work with professional authority to establish each level of feasibility or leave his valuation subject to complete rebuttal and dismissal where any element of feasibility can be proven not to exist.

D. When using the market comparison approach, it is totally unacceptable to take the price of a half acre parcel, convert it to an acre price and multiply it by the number of acres in the subject property. Moreover it is not acceptable to compare commercial land with residential land - that is given highest and best use, comparables must have the same highest and best use, at least within broad classifications within classifications such as residential single family. To subtly distort value by an application of the wrong comparables is a prima faca case of incompetence for the problem at hand or misrepresentation and prehaps perjury in extreme cases. Certainly it is grounds for investigation by the committee on ethics for the board.

E. If testimony is based on the income approach to value, you begin with premise of a business operation in which land is a residual value after proper allowance for both direct and indirect expenses and a discount which recognized the risk and the passage of time.

1. The essential assumptions for time long analysis can be supported by factual evidence rather than guesses simply drawn from quote "experience".

2. Critical assumptions which should be supported by facts:

   a. Direction and quality of platting.
   b. Absorption rate for previous three years.
   c. Market prices.
   d. Direct cost figures from a developer.
   e. Indirect cost allowances.
   f. A capitalization rate which recognized risk.

F. The realtor who testifies to value on proposed subdivision should remember that:

1. The jury consists of homeowners in large part who can recognize with good American common sense a shoddy proposal or one which is well thought out and executed with some demonstration of technical ability.

2. The jury all generally live in the same community as the realtor and the sincerity and skillfulness of his presentation establishes his image with 12 potential clients where one good listing would more than offset the fee for a sloppy or unethical performance, at the behest of an attorney whose methods might also be suspect.

3. The fact that the jury may give an excessive award does not necessarily mean that they respected the appraisal testimoney of those who appeared for the property owner. Instead it may mean that they sympathized with the owner, opposed the exercise of governmental authority or lacking the will or the confidence to thoroughly critique the arguments presented. Nevertheless one good appraisal presentation will establish a standard to which all others participating in the trial will be held by the jury. The single fee for an appraisal suspect in conclusion or in technique will be more offset by the long term loss of professional image and reputation.