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Estimating External Obsolescence

by Philip G. Spool, ASA

My previous two articles were about estimating physical depreciation and functional obsolescence (find them at *WorkingRE.com, Library*). In my article on functional obsolescence, I indicated that it is very complicated to understand and to estimate. I also discussed calculating functional obsolescence in the cost and sales comparison approaches. This article discusses estimating external obsolescence, which is the least applied of the three types of depreciation/obsolescence.

The real estate appraisal books have very little discussion of external obsolescence. Just like my article on functional obsolescence, I read and re-read many appraisal books regarding external obsolescence and how it is determined. Not much is written on it and I can understand why. It is used very little and is good in theory but difficult to apply in the real world. Much of it is based on judgment, which is why it is easy to criticize someone else's report. I imagine this article will be the same, in that I can explain what it is theoretically but find that real-world examples are easy to state but difficult to support.

What Is External Obsolescence?

External obsolescence consists of locational obsolescence and economic obsolescence. According to the *Dictionary of Real Estate Appraisal, Fifth Edition* (Appraisal Institute), if you look up locational obsolescence and economic obsolescence,

they would both indicate "see external obsolescence." So that is what I did. External obsolescence is defined as "an element of depreciation; a diminution in value caused by negative externalities and generally incurable on the part of the owner, landlord, or tenant." The Appraisal Institute's (AI) book, *The Appraisal of Real Estate—Thirteenth Edition* states, "External obsolescence may be caused by economic or locational factors. It may be temporary or permanent, but it is not usually considered curable on the part of the owner, landlord, or tenant."

For those appraisers who have been in the business more than 25 years (over 40 for me), we were taught that there was physical depreciation, functional obsolescence and locational obsolescence. Economic and external obsolescence were never mentioned until much later. This article will discuss the composition of external obsolescence, which is locational and economic obsolescence. In either situation, locational or economic, the loss in value is caused by something *outside* of the property. Functional obsolescence is caused by something *inside* of the property. While external obsolescence is the loss in value caused by something outside of the property, it only affects the building portion of value in the cost approach. This is important to know and will be explained in this article.

What Is Locational Obsolescence?

It is easier to discuss and understand locational obsolescence as it is the most common form of external obsolescence. Some examples of locational obsolescence include the subject property being located on a busy street or having access



This article discusses estimating external obsolescence, which is the least applied of the three types of depreciation/obsolescence.



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from one direction only (either a one-way street or divided highway), being located across from a school where access to your driveway is hampered by cars lining up to pick up children after school, a high noise volume affecting your peace and quiet or a residence located next to or backing up to a commercial property.

Paired Sales Analysis

Locational obsolescence can be estimated by a paired sales analysis. For the purpose of this article, I will use the example of a single family residence to calculate locational obsolescence. Estimating locational obsolescence begins in the sales comparison approach. The best and perhaps easiest way to calculate locational obsolescence in a single family residence is by comparing two sales that are similar in all or most attributes except one, which is the negative aspect of the location of one of the two properties.

This method is commonly known as the "paired sales analysis." For example, a house located on a very busy street or where access to the house is very difficult, might sell for \$50,000 less than a house that is not on that street but a few blocks away where access is unaffected. This is the easiest way to calculate the locational obsolescence in the sales comparison approach. Keep in mind that when calculating the loss in value by the paired sales analysis, all other differences must be adjusted for first. An example would be one house has a two-car garage while the other has a one-car garage. The gross living area for the two properties might be different. All of these adjustments should be made first. It is best to pick the one sale that is not affected by the location and adjust the affected (subject) property differences to the non-affected property. Ideally, after these adjustments are made, the difference would be the result of the location of the subject. If the result is \$50,000, for the difference between the paired sales

after all other adjustments are made, then the \$50,000 would be reflected in one of the line item adjustments, such as location or view.

Rent Loss Method

A rarely used but perfectly acceptable way to calculate locational obsolescence for a single family residence is a comparison of the rental rate difference between a house affected by its location, versus one not affected by its location, and then calculating the locational obsolescence by using a gross rent monthly multiplier times the rent loss. The first step is to find the rental rate of a house affected by its location (assume a rental rate of \$1,250 per month) compared to a house nearby that is not affected by its location (assume a rental rate of \$1,500 per month). The rental rate difference is \$250 per month. This method only works if there are rentals of houses affected by their location—otherwise this method is not applicable.

The second step is to calculate the gross rent monthly multiplier (GRMM). The GRMM number is based on the *unaffected* houses that have been rented. The gross rent monthly multiplier is determined by the sales price of a house divided by its monthly rental rate. Hopefully, there are several houses that have sold and rented in order to establish a more accurate GRMM. Let's say that a house sells for \$300,000 and was rented for \$1,500 per month. The GRMM is 200 (\$300,000 divided by \$1,500). For this article, let's assume that the other GRMMs are also coming in close to 200. The GRMM is not a dollar amount or a percentage amount. It is just a number.

The locational obsolescence by the rent loss method would be the \$250 per month rent difference times the 200 GRMM, equal to \$50,000. The \$50,000 would be reflected in one of the line item adjustments, such as location or view.

Whatever method you choose to estimate the locational obsolescence (paired

sales analysis or rent loss method), the amount of locational obsolescence arrived at for the sales comparison approach considers the entire property, both land and building. In the cost approach, only the building portion is considered. This will be discussed in detail below.

Cost Approach

The cost approach separates the land (site) value from the building value. This is very important because the appraiser should not use the total amount of locational obsolescence calculated in the sales comparison approach and apply that amount in the cost approach. This is considered "double dipping." The examples given above indicate a locational obsolescence of \$50,000 that is applied in the sales comparison approach. For the cost approach, the appraiser must consider only the building portion as the land portion is determined by estimating land (site) value that already reflects the location problem.

Therefore, the building-to-total value must be determined. The best way to make this determination is to first calculate the site value and compare it to the total value in the cost approach without considering any locational obsolescence. For example, you estimate the site value of the single family residence to be \$100,000 and you estimate the total value by the cost approach to be \$400,000. The land-to-total value ratio would be \$100,000 divided by \$400,000 or 25 percent. This would leave the building-to-total value ratio at 75 percent. The \$50,000 in locational obsolescence as calculated in the sales comparison approach should only consider the building portion or 75 percent of the \$50,000, equal to \$37,500. This would be the amount of locational obsolescence to be reflected in the cost approach.

What Is Economic Obsolescence?

Just about all of the appraisal books overlook economic obsolescence, yet it is

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distinctively different from locational obsolescence. Both economic and locational obsolescence make up external obsolescence. The best way to describe economic obsolescence is a loss in value due to market conditions. Examples that will cause a property to have economic obsolescence include an oversupply of inventory, loss in rental income, a decline in sales price due to the economy or an increase in vacancy, and collection loss due to an increase in unemployment.

Most recently, many parts of the country have experienced an increase in the amount of foreclosures. There are many reasons for this but they are mostly attributable to an overzealous inflation of property values, including homes that should not have been considered an investment but homesteaded properties. People were buying up houses with the expectation of increasing values and then flipping them for a quick profit. As an appraiser, it was quite difficult to support an increase in market value every month as we utilized closed sales, which is historical data.

Those appraisers who utilized an increase in market conditions (time) adjustment in the sales comparison approach had difficulty in the cost approach. In fact, the cost of building materials did increase but nowhere near the rate of increase that the overall sales prices were increasing.

If there was any support to increase the overall value in the cost approach, it would have been in land sales but pure land sales were not plentiful and again,

were of closed sales that occurred several months prior to the date of valuation. This scenario did not reflect any economic obsolescence. But when the "bubble" did burst, values spiraled downward and, in many locations, decreased to around 50 percent of its peak, with some areas more and others less.

Economic obsolescence occurs when the sales price of a property is well below the site and building costs combined. An example would be a fee simple townhouse in a new development. Take a 1,200 square foot fee simple townhouse that sold for \$150,000 at the peak of the market but now is being sold for \$75,000. If the cost to build the townhouse is \$80 per square foot, then the cost new for the building component would be \$96,000 (1,200 sq.ft. times \$80 per sq.ft.). Let's also assume the site value is \$15,000 (20% of \$75,000). The total cost new, which is the market value by the cost approach (assuming no physical deterioration, functional obsolescence or locational obsolescence) is \$111,000 (\$96,000 plus \$15,000) or \$36,000 greater than the sales price of \$75,000. Perhaps the \$36,000 would be considered economic obsolescence. That is a judgment call in my opinion.

Quantifying (Calculating) Economic Obsolescence for Any Property

Economic obsolescence would probably be considered the difference between the value at its peak versus the current value. I would tend to disagree with this as the peak was a false value as it reflected buyers not concerned with true value but knowing or thinking they could unload the property in a matter of months and make a profit.

Economic obsolescence has to be within a defined time frame and a defined market area. A good example would be if a majority of the property owners or renters in a neighborhood are dependent on a base industry such as a factory that closes due to the poor economy or where a business files for bankruptcy,

etc. If the closing of the factory results in a greater than normal number of houses for sale or if the vacancy rate exceeds the typical vacancy rate for that area, this negative effect can be quantified. There would be no economic obsolescence in the sales comparison approach as sales should be relatively recent and within the same general neighborhood as the subject, if the property is a single family residence.

For single family residences, only the cost approach (building portion only) would reflect the economic obsolescence; for a commercial property it would be the cost and income approaches. But why do the cost approach at all? Most likely the cost approach is not applicable in estimating the market value of the property unless it is proposed, under construction or relatively new. Otherwise, don't do the cost approach. Hopefully the lender understands that the cost approach is not applicable in providing a credible opinion of market value.

It is easier to quantify (calculate) economic obsolescence for commercial properties than residential properties as the best test of economic obsolescence is the loss in rent to the affected property by the economy at a particular location. Again, it has to be a defined time period and general area that is effected.

The best example I can give is when I had to travel to Ft. Myers, Florida, to testify at a hearing for a deficiency judgment. My attorney requested that I stay at a La Quinta hotel that was convenient to him. Not knowing Ft. Myers too well, I booked a room at the Interstate 75/Ft. Myers airport location that was convenient to his office and very convenient for me, as Interstate 75 was the highway I was traveling from Miami to Ft. Myers. After I told the attorney that I booked a room there, he told me that he wanted me to change my reservation to another La Quinta in nearby Ft. Myers Beach, that is right off of Sanibel Island where he lives, as it would be more convenient

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for him to pick me up at that location. I switched hotel locations with no problem. It was even better for me because of the lower price. The price would normally be higher near Ft. Myers Beach than near I-75/Ft. Myers airport but this was at the time when the BP oil spill occurred in the Gulf of Mexico. There was a perception of possible oil contamination on Sanibel Island, which is a tourist destination year round, causing many cancellations.

I inquired at the front desk about the effect of the media's reporting of potential oil coming onshore from the location of the oil rig and was told that there was no problem at all with the beach nor would there be (which he was correct about). However, their occupancy level dropped significantly due to the press coverage. The hotel rooms and amenities at each hotel are identical (Ft. Myers Beach vs. I-75/Ft.

Myers Airport) but the perception of the oil spill affected the economy of the hotels in and near Ft. Myers Beach and Sanibel Island.

An analysis of what the net rent would have been with and without the effect of the drop-off of the occupancy rate would have been easy to determine and it would have resulted in a lower value due to the effect of the oil spill (or perceived effect) at this particular location. The result would have been a reduction in value due to the *economic obsolescence* that resulted in this particular location as the occupancy level was not affected at the I-75/Ft. Myers Airport location.

As in estimating locational obsolescence, economic obsolescence has to reflect the building portion only. Therefore, the building-to-total value must be determined just like in the cost approach for locational obsolescence.

The best way of making this determination is to first calculate the site value and compare it to the total value in the cost approach without considering any economic obsolescence. If the land-to-total value ratio is 25 percent, the building-to-total value ratio would be 75 percent. Multiply the capitalized rent loss amount with the building-to-total value ratio to arrive at the economic obsolescence. This amount can be applied in the cost and income approaches.

In conclusion, if your subject property has external obsolescence, whether it is locational or economic, an adjustment for it in the sales and cost approaches could be made and supported for single family residences, and in the income approach (for two to four unit residential properties and commercial properties). **WRE**

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