3 Methods of Real Estate Valuation + An Overview

If you're starting a real estate business, surely, you know how important the value of a property is. Good luck trying to write a business plan, sorting your financing, taxation, and sales listings, and conducting an investment analysis without gauging property value.

Valuing real estate is quite complex since no two properties are exactly the same. Real estate investors often wonder how much they should spend on a certain structure due to this fact. If you're one of those people, this article shows you the basic ins and outs of real estate valuation, from its definition to its common methods.

Defining Real Estate Valuation

Real estate valuation (sometimes called property valuation or real estate appraisal) is a process of gauging a real estate investment's economic value. This often aims to seek out a property's fair or below market value; this is the price an informed seller has willingly set on his or her real estate property in order to sell it to an informed buyer.

With that said, real estate valuation is an absolute must in real estate investments. It helps figure out how much has to be shell out for property tax and property insurance. Since mortgage lenders require home appraisals before handing out loans, why not do it anyway? Set those marketing ideas aside for a while and concentrate on this first.

Methods of Valuation

Valuations are usually carried out by certified and professional appraisers. However, real estate investors can also do them by themselves. Do note that their methods are less formal compared to that of appraisers. Buyers are free to research and draw their own conclusions as well.

There are 6 factors that can affect a property's value: property size, condition, utilization, location, supply, and demand. Since real estate investment decisions are based on appraisals, these 6 should be carefully considered on your property checklist.

Appraisers commonly use 3 methods to determine a property's value. Each method is independent of one another; this means that appraisers mainly use only one method rather than a mix of all 3. Since each method leads appraisers to different valuations, lenders have to be 100% sure about the method they're dictating.

Let’s dive into the specifics and look at each method, shall we?

Sales Comparison Approach

Among the 3 methods, the sales comparison approach is the most well-known. It’s also known to some as the market approach. Appraisers exclusively or extensively use it for residential real estate appraisals, especially for getting mortgages.

The sales comparison approach uses the sales prices of other homes that are similar to the property appraisers are appraising in a certain area. Appraisers refer to these homes as “comparables” (or comps). As its name suggests, these properties should share specific features with the subject property. These features are namely: age, number of rooms, condition, square footage, and size. But out of all these features, the most important thing to consider here is the property’s location.

How does the sales comparison approach work? Here’s an example for you: say that a home down the street from your two-bedroom subject property has recently been sold for $250,000. Unlike the latter, the former only has one bedroom. Surely, your subject property is worth a little more than that, right?

If you’re going to use this approach, make sure you make necessary adjustments to account for the differences you spot in your comparisons. After all, no two properties are going to be exactly alike.

Cost Approach

The name alone is a dead giveaway for what this second method heavily considers. The cost approach is based on a property or building’s cost, a land’s cost, and property replacement (or construction) costs.

A land’s cost can be determined by reviewing the recent sales of nearby lands. Meanwhile, construction costs can be figured out by real estate investors in two ways: replacement cost and reproduction cost approach. The former focuses on the cost of using new construction materials and construction methods to construct a structure with similar uses or functions. On the other hand, the latter prioritizes the construction of a replica of a structure using the same materials, design, and construction methods that the structure was built through.

It’s important for owners to know that this method doesn’t really apply to residential properties. Appraisers usually use the cost approach for real estate properties that aren’t sold easily (or special use properties), such as hospitals, government buildings, and schools. They also apply this to new construction and commercial properties.

If this is the approach you're using, here's a pro tip to help you out. If your final valuation is lower than the property seller's asking price, you may find yourself in an overheated market. If the market value is higher than the asking price, your sights could be set on a buyer's market.

Income Approach

If the previous two methods looked at a property's brick-and-mortar value, this one does a 180 and looks at it as an income-generating entity.

The income approach (otherwise known as investment value approach) mainly calculates a real estate property's current value through dividing its generated net income by the capitalization rate. Appraisers kick things off here by collecting their subject property's income and expenses statements. They should gather those of nearby similar properties as well. Why? They're done in order to estimate net operating income (NOI).

NOI estimation can be done in 4 steps. Let's go over each one briefly.

Gross Potential Income Estimation

A gross potential income is the total income of a real estate property that's generated with an occupancy of 100%.

Effective Gross Income Estimation

This can be determined by estimating the vacancy costs of nearby similar properties. An effective gross income estimation shows a normal loss of income, which is caused by probable vacancies.

Property Expenses Estimation

Property expenses are typically divided into 2: there are fixed expenses, and there are variable expenses. Mortgage payments and property taxes belong to the former, while management fees and utilities are classified under the latter.

NOI Calculation

If you're done estimating the expenses, subtract the amount you've reached from the effective gross income.

After the NOI has been calculated, a suitable cap rate should be selected. Appraisers or investors figure this one out by making use of market sales of nearby similar properties.

Once that’s all said and done, all there’s left to do is divide the NOI by the cap rate to determine property value.

The main takeaway here is that each method isn’t a one-size-fits all approach. Now that all 3 have been explained, you’ll know which one to pick when doing your real estate valuation. Make sure your chosen method suits your subject property and the reason for your valuation in the first place. Good luck!