

Residential Cost Approach

4 hrs

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Class Outline

This 4-hour class is a review of the basic principles, methodology, and application of the cost approach for residential appraisal assignments. Upon completion, students should have a general understanding of the steps necessary to complete the 1004 GSE one-unit residential appraisal form's cost approach section in a compliant and credible manner.

1) Introduction (20 MIN)

- a) Understand how market participants relate value to cost
- b) Review the basic formula: $Value = Cost - Depreciation$

2) Discuss the main components in the cost approach: (60 min)

- a) Site acquisition costs (site value)
 - i) Raw, vacant land vs. a site ready-for-development
- b) Improvement costs
 - i) Define *hard, soft, direct, and indirect* costs
 - ii) Understand the difference between *reproduction* and *replacement* cost
 - iii) Identify and value the contributory value of the *improvements to the site* (landscape/hardscape, driveways, pools, utility tie-ins, etc.)
- c) Depreciation
 - i) Physical depreciation (physical deterioration)
 - ii) Functional depreciation (functional obsolescence)
 - iii) External depreciation (i.e., a busy street or economic depreciation, market trends)

3) Practical Application (90 min)

- a) Review the methods and sources for estimating building and site-improvement costs
 - i) Primary focus on replacement cost-new
 - ii) Identify some common building-cost estimate sources (*Marshall & Swift, AppraiserBase, Building-Cost.net, etc.*)
 - iii) Discuss the difference between Comparative-Unit, Unit-in-Place, and Quantity Survey Method for estimating building costs (note: Quantity Survey method discussed but not exemplified)
 - iv) Review an example of estimating replacement cost new for a typical one-unit residential property; this example includes contributory value of the site improvements
- b) Review the concept of Entrepreneurial Incentive vs. Entrepreneurial Profit
 - i) Discuss why the cost approach model requires the consideration of entrepreneurial incentive (EI)
 - ii) Discuss methods for obtaining estimates of obtaining EI
 - iii) Review an example of including EI in the cost approach analysis

- c) Review the methods for determining age and extracting depreciation
 - i) Effective Age, Actual Age, Total Economic Life, Remaining Economic Life
 - ii) Physical depreciation (physical deterioration)
 - iii) Functional depreciation
 - iv) External depreciation
 - v) Review an example of estimating all three types of depreciation

- d) Review the methods used to conclude site value
 - i) Sales Comparison
 - ii) Market Extraction
 - iii) Allocation
 - iv) Income Capitalization (briefly discussed, not demonstrated)
 - v) Yield Capitalization (briefly discussed, not demonstrated)
 - vi) Review examples of site valuation by sales comparison, market extraction, and allocation methods

4) Complete a cost approach analysis using the GSE 1004 appraisal report form (40 Min)

- a) Using the previously completed site value estimate, complete the site valuation-analysis section of the cost approach. **Emphasize the importance of providing enough data so the intended user can replicate the process**
- b) Using the previously completed replacement cost-new estimates, complete the building cost section of the cost approach
- c) Using the previously completed depreciation estimates, complete the depreciation section of the cost approach
- d) Conclude an indicated value by cost approach for the subject property
- e) Discuss the importance of reconciling the indicated value by cost approach within the appraisal report.
 - i) Strengths and weaknesses of the cost approach
 - ii) Avoid terms like “the cost approach is not applicable”; the cost approach is usually applicable (it can be *applied*), but it may not be necessary for credible results
 - iii) Suggested comments to include that identify the cost approach is a market value analysis and not an insurable value analysis

5) Discussion and Questions (30 min)