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Farm Real Estate Appraising

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Why Appraise?

Each of us is a user of real estate - we own, use, invest in property for a business or residence. Normally the farmer's largest financial commitment is for land, and land is the bulk of his assets.[1]

In many instances the individual has less knowledge of the value and evaluation process of real estate than he has of the value and pricing sequence of a two dollar pair of work gloves. Many farmers commit $50,000 to $100,000 of cash and future earnings in land with less knowledge and planning than they take on a $1,000 piece of equipment.

Competence in evaluating land is important because with today's high capital commitment in agriculture, mistakes can be costly. To estimate values of farm properties, all the know-how available and a strict procedure for deriving the estimated value are necessary.

Consolidating land into larger units to more efficiently use machinery and technology has helped push the price of farm land upward. Increased turnover of rural land around urban areas, interstate highways—particularly major intersections—lakes, and man-made reservoirs create rapid change in land value. Effects of this development extend outward from the action center.

None of us are free from decision making concerning real estate: to buy, sell, rent, lease, insure, develope, mortgage, etc. We all make decisions directly or indirectly to remodel, modernize, or rehabilitate improvements on real estate. These are broad, every-day problem areas with which the individual is confronted. Each require some type of appraisal.

No one is born with the gift of understanding the why, when, and how factors which influence and create real property values. It is an art and science learned through study and experience. Many buyers and sellers do not know that formal appraisal procedures exist. The farmer is left with the choice to make. He can make his own appraisal decision or he can seek professional appraisal assistance. The cost of a good appraisal can be money well spent.

[1]Investment in land and buildings account for over two-thirds of the total investment on farms participating in the University Mail-In Farm Record Program.

Appraisal

What Is An Appraisal

A simple, yet meaningful answer: that it is an estimate of dollar value—in other words, the worth of the property in the market place. It may be in a number of forms. It could be based either subjectively or objectively. However, in appraising real estate and those facilities which may be upon it, the appraiser strives for objectivity in establishing value.

It is imperative one keep in mind that social ideals, political and government regulations, economic changes, and and natural forces either create, modify, maintain, or destroy the value of real property. Therefore, an appraisal made on property is made for a specific purpose, at a particular time, not six months or a year hence, and usually not for multiple purposes.

Using detailed procedures in making a good appraisal is too large a task and is too complex in nature to explain in simple terms. To tell anyone how to make an appraisal is not possible in the limited space available, let alone to convey a good understanding of the various real estate value concepts and the problems in processing information and data. It takes years of training, hard work, and a good understanding of real estate, economics, and sociology, with a degree of good judgment and integrity for an appraiser to accomplish the task of making a good and fair real property appraisal.

When Is An Appraisal Justified

An appraisal may be justified any time a transaction, investment, or accounting value is desired or when any action is taken where real estate is involved. To be slightly more specific, one should be guided in having a professional appraisal made by type and location of property. When it is obvious that value involved is minimal or when the individual taking the action is basically certain of value there is little need for acquiring an extensive, detailed appraisal report with the delay in time and expense incurred.

There are a number of times when a formal appraisal is necessary or should be made:

- When buying or selling properties of considerable value,
- In acquiring a loan (generally required),
- In estate settlement,

- When merging ownership of multiple properties,
- When an investor purchases real estate mortgages and notes,
- In determining inheritance taxes,
- In condemnation proceedings of land,
- In determining damage to remainder, after part is taken.

The above list is only an example in order to give the reader an idea of situations where appraisals are important and does not attempt to include all the functions of real estate appraisals.

Basic Procedures In Appraising

When confronted with making an appraisal, the first thing the appraiser must do is to determine precisely what the problem is. This may require considerable preliminary study because any doubts about the purpose of the appraisal must be eliminated before proceeding. (Simply, the purpose of an appraisal is to estimate a specified type of value.)

To assure himself of understanding the problem, the appraiser normally follows a prescribed route of inquiry or basic steps in defining the problem.

First, it is necessary that the property being appraised be completely and adequately identified; mailing address, common recognized land mark, map and legal description by range, township, section, and part if possible.

Second, the subject should be described in detail. For instance, it should be mapped giving details of the location of buildings, soil types, waterways, crop land acres per field, etc.

Third, the appraiser should state the purpose of the appraisal (such as to estimate market value for sale of the property or loan value for purpose of acquiring a loan).

Fourth, the rights involved must be specified in clear and concise language. Are there easements through the property, taxes overdue, liens, fee simple title, etc?

Fifth, it is customary to ascertain the date for which the appraisal is desired.

Sixth, the appraiser must define the value to be estimated. (There is only one market value, but there are occasions when value for a particular function is sought.)

Once the appraiser is satisfied that the above conditions have been met and his comprehension of the problem is adequate, he is ready to survey in total the whole problem. If there are no unusual qualifications, the problem is to estimate the market value of the property in its highest and best use. Here the appraiser may face another problem. After examination of property and location, one may find evidence the present use is not the most profitable. In this case, all the other factors upon which an opinion of highest and best use is based must be taken into consideration and analyzed.

Also during the preliminary period, the appraiser determines as near as possible the amount and character of data required to accomplish his appraisal and possible sources of this data. Data requirements will depend upon a number of factors relating to the type of property to be appraised. One will find that to give an appraisal opinion of value on a productive farm unit requires considerable data and information, and in more detail than the typical appraisal on an urban residence.

Approaches To Estimated Value

The appraiser should have accumulated enough data and information to determine the dominant approach he will use in establishing the estimated value of the property.

There are three major approaches or methods used in appraising: the market value approach, the cost approach, and the income approach.[2] Each approach has its own peculiarities and is best adapted to certain types of appraisal problems. For example, when the emphasis may be on estimated value for insurance, the cost approach would be more fitting in that insurance claims are more often adjusted on the basis of cost. On the other hand, in condemnation or market sale of property, the market data approach is best, for one is looking for value of property in the open market. The income approach is appropriate when income producing properties can be compared and the seller or investor is more interested in income flow. This does not mean that the income method is not useful and has no valuable contribution in appraising farm land, but implies that it is more appropriate for use in appraising, say, apartment houses.

These procedures for estimating value of real property are difficult and complex to the layman and are best not attempted on sizeable capital commitments. Expertise in handling the appraisal process is a necessity and a trained, competent person should be used by anyone attempting to establish value on a major real property investment unless he is in a position where incompetence, risk, and mistakes are of little concern.

Market Approach

For most farms the market value approach is normally superior to other methods used in estimating value.

This process of estimating value involved four major steps:

1. A definition of the function for which the appraisal is to be used.
2. The selection and analysis of comparable sales which have most recently been made in the near area.
3. Determination of the comparability of the farm being appraised to those sold.
4. The correlation of the data obtained between the comparable sales and tract being appraised, particularly adjustment in time and location, improvements, soil type, and management.

In the market approach to estimate value, the comparable sales used must be bona fide transactions. Here we speak of genuine market sale transfers, excluding such transfers as with-in family sales, tax sales, sales by foreclosure, etc. One of the many difficulties encountered in appraising is in the selection of nearby farms that have sold recently for use as comparables. If the appraiser finds good comparables, the measurement of quality in comparison with the farm being appraised is still a difficult task and the expertise of the appraiser is demanded for good and fair appraisal.

Not only must the appraiser know what data and information is relevant in making the appraisal but also the quantity and quality of such data needed.

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[2]There are other methods to value estimates, however, they are normally variations of the major approaches.

The appraiser must be knowledgeable about the general area where he is appraising. He should be familiar with the local farm technology being used and the management requirements needed to operate a successful farming business. The appraiser considers soil productivity, kind of crops grown and yield history, current price levels and trends, and present use being made of the farm. He needs to be aware of alternative uses for the unit as well as a host of other related materials. Once he is satisfied he has acquired and exhausted sources of information, the appraiser sets about to sort, analyze, correlate, and compare this volume of data and information he has collected. He makes those adjustments that are necessary and obvious in arriving at an estimated fair market value of the subject property.

Income Approach

In this approach to estimate value of real property, the appraiser is primarily concerned with the present worth of the expected future benefits. Net income is the key to value in this method. The appraiser must be well informed on economic, social, and political trends and other factors affecting value. He should have experience and possess a degree of expertise in investments to use this method with confidence. This may appear odd in that the income method is probably the most mechanical and straightforward method used by the appraiser in making his estimates.

In its simple form the method is as follows: after the appraiser selects comparable investments of similar class, location, and type to subject property and analyzes the information, he capitalizes the net income of the property being appraised to determine its estimated value and relates this to comparable property values.

There are four basic steps followed in the income method:

1. Collect income data on the subject property and on comparables for one or more years or other periods of time. The data is analyzed, adjusted, and related by a comparative method to suggest what gross income the subject property must produce to attract an investor.
2. Obtain accurate data on expenses (operating costs, taxes, insurance, etc.) both on the subject property and comparables to be used. Take note if there is a trend in these expenses being paid and make the necessary allowances.
3. Estimate the remaining useful economic life of the property (buildings) in order to give the probable duration of contributing income. Economic life means "that period over which a property may be profitably utilized."
4. Select an appropriate capitalization rate and determine the best method or technique for analyzing the net income.

The apparent simplicity of this method often misleads the layman as well as the inexperienced appraiser. It perhaps is the most difficult of the three approaches to value. Value judgments are necessary and the degree of accuracy of the judgments only comes about through continued study and field experience. The selection of comparable properties for reliance is an art. One of the most common pit-falls is the use of an inappropriate capitalization rate. The uninformed appraiser as well as the layman may use a market interest rate for capitalizing purposes. It is true that the going interest rate can be used and is often as good as any constructed rate for capitalization purposes. However, this is the critical area in the income approach of estimating value. The meaning of these rates should be understood and evaluated correctly.[3] To illustrate, assume an annual net income of $30,000 capitalized at 6 percent and the same income capitalized at 6½ percent. The difference in capitalized value is over $38,000 as a result of ½ percent change in rate. The following formula is commonly use in determining capitalized value.

$$\frac{\text{Net Income}}{\text{Capitalization Rate}} = \text{Value}$$

Cost Approach

In farm appraising, the cost approach is limited in use, but does have a significant role in the valuation of farm buildings. In recent years, the reduction in farm numbers and combining of farmstead buildings have become troublesome in total farm valuation. In some cases, they may have a zero or negative value.

The cost approach, like the income approach, can be put in four basic steps:

1. Estimate the value of land as vacant
2. Estimate the current cost of reproducing existing buildings
3. Estimate and deduct all causes of depreciation.
4. Add the land's value to the depreciated reproduction cost of all the improvements.

In this method, the estimated value of land (without improvement) is usually done by the market data approach to value.

To estimate the current reproduction cost of improvements is sometimes troublesome in arriving at reliable figures. To obtain the value of the present improvements, once reliable figures on cost are collected, depreciation must be deducted. Here depreciation becomes a problem to the appraiser for he must determine and evaluate not only deterioration but obsolescence.

Either through experience or existing age-life tables, the appraiser determines a percentage figure he can use in estimating value of improvements. To illustrate by the straight line method, assume the new cost for a building was $10,000 with an expected life of 20 years. 100 ÷ 20 years = 5. 5% of $10,000 = $500. In 10 years the building is worth one-half of its cost, or $5,000. (10 x $500)

The next problem the appraiser must consider is whether there is evidence of functional obsolescence—"a lack in

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[3]Interest rate in the rate of yield earned from an investment. One might use the definition of interest rate as the cost of money in the current market.

Capitalization rate on the other hand, is defined as a term exjressing a fixed relationship between two magnitudes and used as a means of measurement; or capitalization rate expresses the relationship between annual net income and the value of property.

The selection and methods of construction of the applicable capitalization rate are many and varied and require understanding and knowledge beyond the scope of this guide.

desirability or efficiency in style, layout, and design"—as compared with that of a new property which serves the same function. If so, how much, and what negative value should be applied? He may also be faced with economic obsolescence—"this is related to loss of value exterior to the property itself." This may be a result of political action such as zoning, for instance, or it may be due to a change in actual market value or change in transportation routes. These factors must be analyzed and valued relative to the subject property.

Only after these steps are completed can the appraiser arrive at his estimated value of subject property. By taking his computed land (vacant) value and the value placed on improvements (less depreciation of all types), adding the two, and correlating to certain adjustments made, he can ascertain an acceptable opinion on value. There are other variations in the approach to arriving at value of improvements such as the building residual technique. As stated earlier, the cost approach, like the other approaches, is a specialized approach to estimated value and is the dominant method used for some appraisal problems, but in farm properties it is limited in its use.

Some General Considerations

If at all possible, the good appraiser will apply all three approaches in making his final estimate of value. Though one of the approaches is often dominant, which one will depend primarily on the type of property and most factual data at the disposal of the appraiser.

As a result of urban sprawl, new highways and relocation, recreation, zoning, and general social and economic pressures forcing land use change, the need for having property accurately appraised greatly increases.

Real estate appraisal does not claim to be an exact science, nor to be infallible or simple in solving all complex appraisal problems. However, procedures to estimate value have been established over long years of experience and hard work by interested individuals in compiling and assembling relevant facts. Factors known to influence real estate value have been analyzed and logically arranged so as to improve the soundness of the appraisal conclusion.

A good appraisal for the right purpose on the appropriate property made by a good appraiser can be money well spent. A poor appraisal made through inexperience can be worse than no appraisal.

When the need for an appraisal arises, you should inquire about in selecting an appraiser. As far as possible, make yourself knowledgeable about what a good appraisal report contains.

You want a good job done. Competence, good judgment, integrity, and an unbiased estimate are attributes of a good appraiser. Formal training alone does not make an expert appraiser. Have confidence in the appraiser you employ so that you may have confidence in his appraisal report.

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