


# Working RE

Real Estate Appraisers & Inspectors

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# Land Value: Extraction Method

By Philip G. Spool, ASA



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Every December I make a pilgrimage to Orlando, Florida to observe the Florida Real Estate Appraisal Board (FREAB) hearings. This past year (2011) something happened that surprised even me.

One appraiser who was brought up on various charges was asked a very simple question pertaining to the cost approach in the appraisal report. One of the FREAB panel members asked how the appraiser arrived at the site value. The appraiser hesitated and then replied that the land value was based on the *cost new* arrived at from *Marshall & Swift*, then deducted that from the *market value* of the subject property, arrived at from the sales comparison approach. As an instructor of real estate appraisal courses and continuing education classes, I almost bolted from my seat to immediately correct the appraiser. Fortunately, one of the panel members politely corrected the appraiser. I was surprised that the FREAB panel did not require additional educational courses, beyond what the appraiser was required to do as a result of performing a faulty appraisal.

I have reviewed many appraisal reports where the appraiser performs the cost approach just because the client requests it, even though it is not considered a credible approach to the market value of the subject property. I see some of the same boilerplate statements in these reports, such as "due to the lack of land sales, the appraiser used the extraction (or abstraction) method." (By the way, both "extraction" and "abstraction"

are correct. For purposes of this article, I will call it the extraction method.)

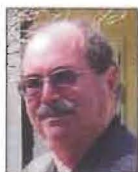
An extraction method is used if there are no land sales to arrive at the site (land) value. Again, land and site in this article are interchangeable, but technically land represents the undeveloped parcel, while site represents the parcel as if ready to be built on.

Going back to the appraiser's reply to the FREAB panel, two distinct statements the appraiser made are blatantly wrong. The first mistake is subtracting the replacement cost new and the second is subtracting the improvement cost from the value arrived by the sales comparison approach. How do you calculate the site value? The three most common methods to calculate site value are (1) sales comparison method, (2) allocation method, and (3) extraction (abstraction) method. I will briefly discuss the first two methods then explain the subject of the article: the *extraction method*.

## Sales Comparison Method

The sales comparison method is probably the most preferred and reliable method for estimating site value. This method is similar to valuing an existing house, comparing the subject to recently closed sales of vacant lots. As no two houses are the same typically, no two vacant lots are the same. The most common differences include the size, width and depth of lot, location, and if the comparable lot is cleared or in need of clearing trees, shrubs, and leveling the land. All of these differences must be taken into consideration.

Once the sales price per square foot is determined for each comparable sale, the reconciliation process begins. Probably the most important comparison



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is the lot size differential. Basic appraisal theory indicates that smaller lots tend to sell for a higher price per square foot than larger lots, just as larger lots tend to sell for a lower price per square foot than smaller lots. However, one should consider the most ideal lot size for the end use, in this case a single family residence.

For example, if the average lot size is 15,000 sq. ft., would a 10,000 sq. ft. site cost or be worth more per square foot than the 15,000 site? Not in all cases. One has to consider the demand for the 10,000 site versus the 15,000, just as one has to consider the demand for a 20,000 site. If the ideal house size is best reflected on a 15,000 sq. ft. lot in the area, then perhaps a 10,000 would reflect an inferior designed house, representing less demand for the smaller lot. If the lot size is 20,000, then the extra 5,000 sq. ft. of land could represent surplus land.

Many appraisers confuse the difference between *surplus land* and *excess land*. Surplus land is land that cannot be sold off separately, while excess land can be. In many cases, a large lot that is considered to have excess land is worth more than a large lot that has surplus land, due to the fact that two buildable lots are worth more than one buildable lot. The shape of the lot is also important. All of these situations have to be taken into consideration when reconciling the value of the subject's lot.

### Allocation Method

The allocation method is not commonly used, but if a newly constructed home is built on a site that was purchased recently, it can be effective. The allocation method can be applied as a percentage or proportion of the total value of an improved property. For a comparable improved sale, either the land or building portion must be determined. If the house is relatively new, estimating the cost of improvements and dividing the costs by the sales price of the house will give you the percentage

Property Address	100 Prospect Drive	230 Albondigas Ave.
Date of Sale	August 2012	September 2012
Sale Price (A)	\$450,000	\$375,000
Replacement Cost New	\$275,000 *	\$250,000 *
Less: Depreciation of Improvements	\$91,575 **	\$83,250 ***
Depreciated Value of Improvements (B)	\$183,425	\$166,750
Site Value (A less B)	\$266,575	\$208,250
Site Size	15,000 sq.ft.	12,000 sq.ft.
Site Value per Sq. Ft.	\$17.77	\$17.35

table 1

\* Based on Building-Cost.net

\*\* Based on an Effective Age of 15 years and a Total Economic Life of 60 years (15/60 = 25%)

\*\*\* Based on an Effective Age of 20 years and a Total Economic Life of 60 years (20/60 = 33.3)

of the improvements to the purchase price of the comparable. The allocation method is not as reliable to apply on an older house because estimating accrued depreciation is too subjective. If new developments are being constructed nearby, consultation with the developers is helpful if the developers can provide the building costs associated with the houses being sold. This includes site improvements, such as landscaping, driveway, open patios, and swimming pools.

For example, a relatively new house sells for \$300,000 and you determine the cost of the building improvements and site improvements to be \$200,000. The improvements represent 66.7 percent of the overall purchase price. That leaves 33.3 percent attributable to the land. If houses that are recently sold nearby the subject property range from \$270,000 to \$320,000 and are overall similar to the subject improvements (land-to-building ratio, age/condition and extra features), applying the 33 percent would indicate a land value ranging from \$89,900 to \$106,600, rounded. While an allocation as a ratio of land to total sale price

indicates a ratio of one to three in this example (land portion is \$100,000/total sale price \$300,000), it is easier to apply the allocation method as a percentage of land to total sale price.

### Extraction Method

In a nutshell, site value is the difference between the sale price of a property and the contributory value of its improvements. So how do you determine the contributory value of the improvements? There are several ways to do this. The contributory value of the improvements is the same as the depreciated value of the improvements as observed in the market. In other words, it can be construed as cost new, less the accrued depreciation. Accrued depreciation is calculated as the effective age divided by the total economic life of the improvements. If you still have your appraisal books from your basic appraising course, look up *Accrued Depreciation*. An excellent reference book you should always have is *The Appraisal of Real Estate*, currently the Thirteenth Edition, by the Appraisal Institute. When valuing the subject property the appraiser calculates

the effective age by an onsite visit to the property and observes any physical deterioration in order to arrive at the effective age. However, the appraiser does not have the luxury of visiting the interior of a comparable sale or even walking around the outside of the comparable sale that is a good candidate for the site value by the extraction method. But if the property is listed on the Multiple Listing Service, there is a possibility that there are photographs of the interior and exterior of the property. You can also contact the listing agent to get additional information regarding the physical condition of the improvements to arrive at a more supportable effective age. Remember, effective age of a property is based on the appraiser's judgment and observation.

Therefore, the proper procedure would be for the appraiser to calculate the replacement cost new of the

improvements first and then subtract the depreciated value (contributory value) of the improvements. But what about the site improvements such as the swimming pool, driveway, landscaping, etc.? Yes, that too has to be subtracted from the replacement cost new of the improvements. Where do you get your replacement cost figures? There are several sources. One is Marshall & Swift (also referred to as Marshall Valuation Service). Another is *Building-Cost.net*, which is free.

Another method, though one that is not supportable, is to obtain the *Property Assessor's* estimate of the depreciated value of the improvements of a recently closed sale. The land value would be the sales price less the property assessor's estimate of the depreciated value of the improvements. I indicate that this is not supportable because an owner can have his/

her property assessment successfully appealed resulting in a reduction in the improvement portion of the assessment while another recently sold house may not have had its property assessment appealed, resulting in no reduction. Just remember assessments are based on the mass appraisal system and not looked at individually.

You can prepare a chart to fill out and maintain in your workfile. A good example is found in table 1 (page 34).

In conclusion, the next time you explain how you arrived at your site value in your appraisal report and you state that you used the extraction or abstraction method, be sure you use the correct procedure in addition to having your support in your workfile, or better yet, indicated in detail within the text addendum of your appraisal report.

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