<u>Basics of Value in Real Estate</u>

Value in real estate is somewhat of an arbitrary concept. Primarily this is due to the fact that real estate market as a whole is an inefficient market in which the setting of value is a function of the *meeting of the minds* – the price is what the buyer and seller agree on. The distinction here is that the drivers behind this agreement, the underlying motivators behind the sale, can and do impact the sales price in a very substantial way.

For example, if a homeowner has been transferred to another city where she has already bought another house, she may be very motivated to get rid of the mortgage associated with the house she is no longer living in, and is therefore willing to take a loss on her equity. In other words, if she really needs to sell quickly she may be inclined to accept a lesser offer than if she was in no hurry, and it is why we can negotiate a price on a piece of real estate which is considerably lower than the market would peg the value at.

This is very different from the mechanisms responsible for setting value in other markets. After all, if you want to buy stock, bond, mutual fund, or even oil futures you have to pay the price set buy the marketplace in its entirety. There is no way to legally achieve a purchase price lower than that which is on the tickertape at the moment when you execute the transaction. This, of course is one great advantage of the real estate market. Another is that there is absolutely nothing that you can do to improve the value of the asset in an efficient market, while in real estate there are a host of things that can be done to improve the value.

Thus, while presenting great advantages for the skilled investor, the inefficient nature of real estate market makes it quite difficult to peg value. The process of valuation is definitely not an exact science, as much as we would like to believe that it is. Although, in my opinion the process is much more logical on the investment side of the equation than the owner-occupant because it is based on the income, which is tangible; in other words, the value is a function of income. More on this a bit later; for now let's cover some basics.

The three methods of valuating property are:

I. Comparative Market Analysis
II. Replacement Cost
III. Income Approach

The replacement cost approach, much as it sounds, is the process of figuring out the cost of replacing a structure if it should be destroyed. This method is used by insurers and government entities but it has practically no bearing on what we do as investors. On the other hand, we extensively use the comparative market analysis and the income approach, although they accomplish different objectives. But before I discuss those, I must define a few universal concepts relative to value in real estate.

4 Characteristics of Value (DUST)

Demand: The reality is simple: If nobody wants what you have, then how do you sell it? And if you can't sell it, wouldn't the value be $0? Therefore, if there is no demand, then there is no value; little demand constitutes little value; strong demand drives high value.

Utility: Utility is the capacity of a property to fulfill whatever the market expectation relative to its use may be. Let's say you find an old house which you want to convert into a small medical office. You buy it, remodel it, and begin to deliver furniture when you receive a letter from the city or county informing you that this house is zoned residential and as such you can not have a medical office in it. Would you have spent the money on this house if you had known that you would not be able to use it as intended? No way. Ooooops!

Or, let's say that you are a beginner investor, and you bought a house to remodel and flip. But because you don't know what you were doing, you spent too much early on and ran out of money before you finished putting the kitchen cabinets on the wall. Can you sell this house to an owner-occupant? No – how is anybody supposed to live in a house with no kitchen? In other words, if the property is meant to live in, then it has to possess all of the attributes that fulfill its function. Thus, even though the house may be well-located and will be worth $200k when completed, such as it is the house isn't worth anywhere near that. If you can't use the property as intended, then what's it worth? Zoning and structural deficiencies are only two of many aspects that can impact utility, and therefore value.

Scarcity: Last I checked, God quit making dry land a few years ago – when we run out, we run out. This makes dirt a finite commodity, and consequently it goes up in value as it becomes scarcer. This is one of the reasons why you can expect to pay $500,000 for a 1-room hole in the wall in Manhattan, but it would only set you back $40,000 in Lima, OH. Relative to the population, there is a lot more dirt in Lima.

Transferability: You could be holding a priceless asset, but if you can't legally sell it then you can not unlock the value.

If any of the above characteristics are not intact, then the asset loses part or all of its value.

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