Approaches to value – construction costs

Scott Andrew
1932
Marshall & Swift founded as a publisher and source of building cost data for the construction, appraisal and insurance industries.

1936

1940s
Marshall & Swift provide “square foot” and “unit count” building cost estimation guides.

1983
Marshall & Swift introduces “total-component” estimating to consider labor and materials for each unique home.

2012
Marshall & Swift is the leading provider of cost data and technology in North America.
What is construction cost data?

*Hard costs of construction*
- Material costs
- Labor costs
- Equipment rental costs

*Soft costs of construction*
- Mark-ups
- Taxes
- Fringes

*Location specific cost influencers*
- Site research
- Regional research
- Building code changes

*Construction expertise*
- Historical construction research
- Style research
- Assembly research
Construction cost data

- Local economies
- Local cost influencers

- 5-digit zip code localization
- 80 years of indexes

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Recognizing Real Estate Values

“One of the greatest injustices which can be done to real estate is the making of appraisals which are too high or too low...” “While such an appraisal reflects only the opinion of the individual making it, should such an appraisal be used for lending purposes, not only will the individual property be affected, but the appraisal results will be transmitted to the entire neighborhood.”

“The return of construction is dependent upon the proper recognition being given to material and labor costs as they affect real estate. In other words, appraisals can not be made with accuracy unless these facts are included within the appraisal. If the foregoing thought had prevailed five years ago, many people would not be holding high-valued real estate whose value has slumped 50% or more because the value they bought never was in the property.”

“The valuing of real estate remains a science only so long as current economic facts are used. Such facts are available to those who will use them.”

Times Star - October 9, 1934
Development costs’ role in property valuation

- The only value method that includes construction costs in a quantifiable capacity is the Cost Approach.
  - Set formula based on tangible value.
  - Applicable regardless of characteristics.
  - Advises the validity of other value methods.

- Development costs as market barometer.
Legislative support for construction costs

- Federal Housing Authority (FHA) mandates multiple approaches to value.

- FHA methodology based on three principles: [1]
  - The Principle of Replacement (Cost Approach)
  - The Principle of Substitution (Market Comparable Approach)
  - The Principle of Income Capitalization (Income Approach)

Dynamics of a multi-value approach

- Unique measures = unique value results
- Values reconciled
- Derived (reconciled) values = greater lender protections
Cost approach use today

➤ USPAP
  • Cost approach is optional unless needed to produce a **credible result.** [1]

➤ Fannie Mae
  • Appraisals that rely solely on the cost approach as an indicator of market value are not acceptable. [2]
  • **Fannie** Mae does not require the cost approach to value except for the valuation of **manufactured homes.** [2]

➤ Freddie Mac
  • If the subject property is a **manufactured home,** the cost approach is required and provided. [3]
  • The cost approach is based on commercially available information (e.g., Marshall & Swift), and adequate detail is provided so that the calculation can be re-created. [3]
  • **The indicated value by cost approach supports the sales comparison approach.** [3]

Reliance on single value methodology

- As of the end of 2010, **23.1 percent** of all U.S. homeowners with a mortgage owed more on their homes than their homes were worth. [1]

- As of the end of Q1-12, **34.1 percent** of all U.S. homeowners owe more on their homes than they were worth. [2]

- **26 percent** of all the homes sold in the United States last year were foreclosures or short sales. [1]

- Since the real estate peak, U.S. home values have fallen by a staggering **$6.3 trillion**. [1]

- Americans owe **$1.2 trillion** more than their homes are worth. [2]

Construction costs as real estate barometer

Market Price divergence from construction costs – United States

Value approach discrepancies - U.S. created by Marshall & Swift (Data Sources: Market Values calculated using Q4 2010 average sales price data from National Association of Realtors and United States Census Bureau, trended using S&P/Case-Shiller Home Price Indices; Replacement Cost determined using average cost data by region from U.S. Census Bureau and Marshall & Swift’s Construction Cost Indices, including allowance for land value)
Construction costs as real estate barometer

Market Price divergence from construction costs – Phoenix

Value approach discrepancies – Phoenix created by Marshall & Swift (Data Sources: Market Values calculated using Q4 2010 average sales price data from National Association of Realtors and United States Census Bureau, then trended using S&P/Case-Shiller Home Price Indices; Replacement Cost determined using average cost data by region from U.S. Census Bureau and Marshall & Swift’s Construction Cost Indices, including allowance for land value)
Construction costs as real estate barometer

Value approach discrepancies - Washington D.C. created by Marshall & Swift (Data Sources: Market Values calculated using Q4 2010 average sales price data from National Association of Realtors and United States Census Bureau, then trended using S&P/Case-Shiller Home Price Indices; Replacement Cost determined using average cost data by region from U.S. Census Bureau and Marshall & Swift’s Construction Cost Indices, including allowance for land value)
Proposed actions

**Required use of multiple value methods including the Cost Approach**

- Values derived using all available information.
- The method of value determination must be comprehensive and defendable.
- Protection against price inflation and deflation due to changing market dynamics.
- Development of the Cost Approach broadens the data available for analysis.
- Cost approach based on real and tangible value elements.

**Construction costs as a barometer**

- Historical relationship between development costs and market price.
- Deviations from this historical relationship are reasons for concern.
- Useful in identifying markets that are quite possibly over/under priced.