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Real Estate Valuation 101

How to Determine Property Value

Real estate valuation is the process of determining the worth or value of a property.

It involves assessing various factors such as the property's location, size, condition, and market demand.

Valuation is essential for real estate investors to make informed decisions about the pricing of the property and potential returns.

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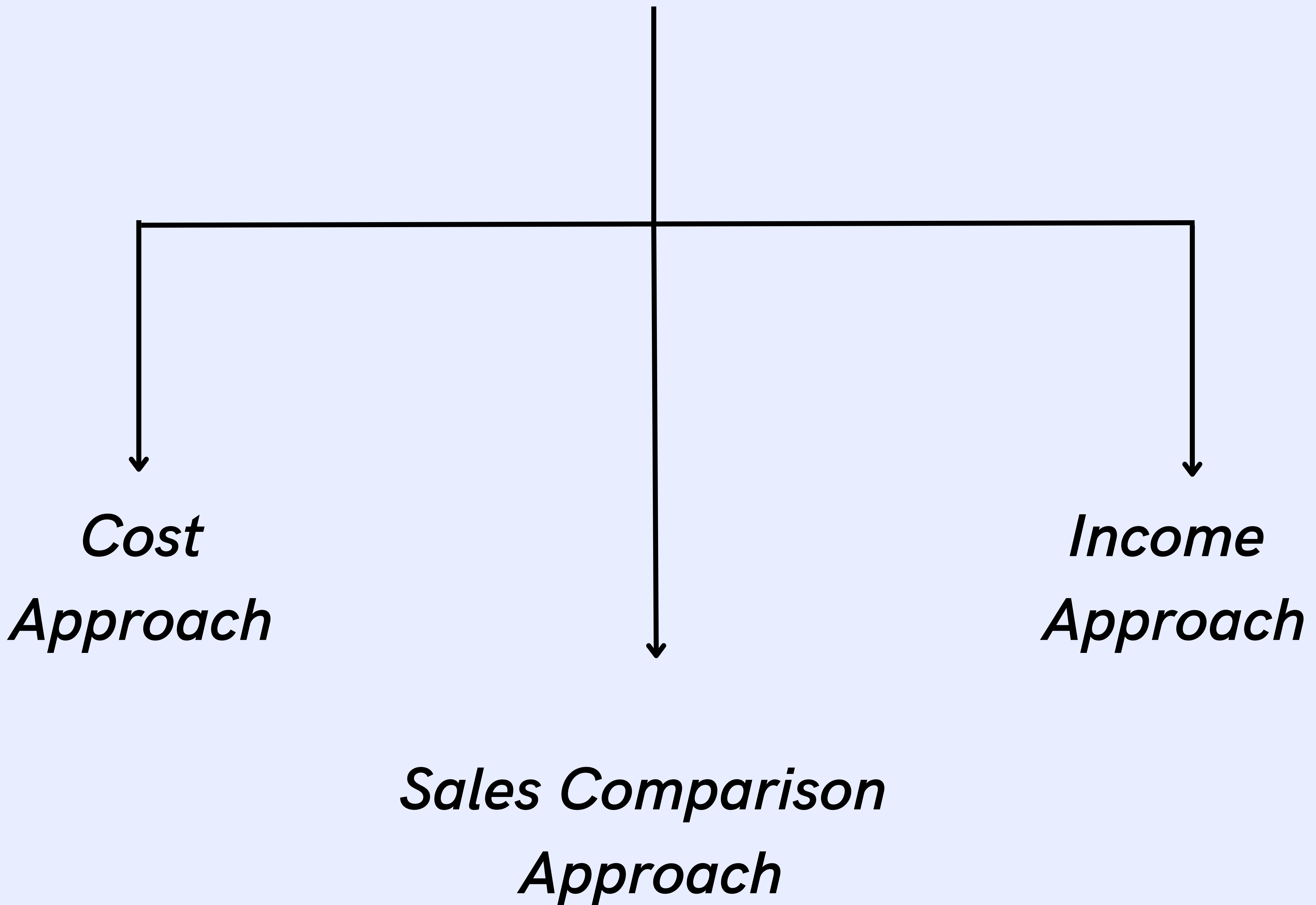
The Key Factors to Conder Before Valuation

1. Location of the property
2. Property size and features
3. Property Condition
4. Market demand
5. Economic factors
6. Future potential
7. Rental income potential.

Valuation Methods



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1) Cost Approach

The cost approach of valuation is a simple method to determine a property's value based on how much it would cost to build similar property today.

It involves estimating the cost of land, materials, labor,, and other factors necessary to build a similar property and adjust it for depreciation and obsolescence.

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Steps Involved in Cost Approach

Step 1:

Estimate the market value of the land. It is often valued using Sales Comparison Approach.

Step 2:

Estimate the building's replacement cost using the current construction cost and it should include the builder's profit.

Step 3:

Make adjustments such as building age and deterioration occurs as a result of normal wear and tear over time. Sometimes the location is no longer optimal.

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2) Sales Comparison Approach

The sales comparison approach is used to determine the value of a property by comparing it to similar properties that have recently sold in the same area.

By analyzing the sales prices of comparable properties, adjustments are made to account for any differences in features, size, condition, location, or other relevant factors.

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The sales comparison approach is valuable because it relies on real market data and reflects the actions and preferences of buyers and sellers in the current market conditions.

The sales comparison approach is most useful when there are a number of similar properties similar to the subject that have been recently sold.

However, it is essential to carefully select the most appropriate and truly comparable properties to ensure accurate results.

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3) Income Approach

The income approach is a commonly used method that estimates the value of a property based on its income-generating potential that is its rental cash flows.

This approach is particularly relevant for income-producing properties such as rental properties, commercial buildings, or multi-family units.

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It considers the property's net operating income (NOI), which is the potential income generated by the property minus operating expenses, excluding mortgage payments

Net Operating Income:

  Rental Income (if fully occupied)
\+ Other Income

= Potential Gross Income
\- Vacancy and Collection loss

= Effective Gross Income
\- Operating Expense

= Net Operating Income (NOI)

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Once the NOI is determined, the appraiser applies a capitalization rate (cap rate) to determine the property's value.

The cap rate reflects the investor's required rate of return. It is derived from the relationship between the property's NOI and its overall value.

$$\text{Cap Rate} = \text{Required Rate of Returns} - \text{Growth Rate of Cash flows}$$

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Finally, the value is determined by dividing the NOI by Cap Rate.

$$\text{Value of a Property} = \frac{\text{NOI}}{\text{Cap Rate}}$$

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