

PERSPECTIVES ON 'COST APPROACH' TO VALUATION

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The Perspective

By Definition, the cost method also known as the Depreciated Replacement Cost (DRC) method of valuation is a method of determining the value of a property or an asset by reference to the cost of replacing the property or asset as new, and then making allowance for depreciation to take care of age, wear and tear and other forms of obsolescence. Put simply, the cost approach is a method of real estate valuation where the value of real property is determined by what it would cost to rebuild the building if it was destroyed or to build an equivalent structure. It also factors in the worth of the land on which the building is situated, as well as the cost of any loss in value, or depreciation that occurs over time. This approach is based on the underlying logic that buyers will not pay more for the building than they would pay if they needed to cover the current cost of producing a similar property.

The cost approach is one of the three main methods used in calculating the value of real estate properties. The cost approach method is based on the assumption that a potential buyer of a property should pay a price that is equal to the cost of constructing an equivalent building. The market value of a real estate property is the sum of the value of the land and site improvements on the land, less any accrued depreciation.

Reasons for “resuscitating” this approach

Henry S. Harrison, in the Fall 2006 issue of his Real Estate Valuation Magazine Online, included an article titled “Let’s Resuscitate the Cost Approach.” Here are two quotes from that article that are still true today:

“How credible do you think a current estimate of market value will be if it is based solely on three sales made to low down-payment buyers at the height of the recent feeding frenzy?”

“The Cost Approach answers several key questions: What would it cost to build that house today? What should it be insured for? What would a reasonably well-informed buyer actually pay for that house—without the special market condition of a feeding frenzy?”

Is the cost approach realistic?

There are several advantages and disadvantages of the cost approach valuation method. Cost approach is used for properties that do not have many comparable properties available in the market. For example, if a property is unique, there won’t be existing replicas of it in the broader market. The cost approach operates on certain assumptions that could prove to be faulty. When cost approach is used, it assumes the availability of sufficient land on which to build an identical property. A similar parcel of land may not be available, which would make the process of

valuation inaccurate. It could also be challenging to find the exact building materials for the reproduction method, as certain construction materials become obsolete over time.

Steps in the Cost Approach Method

The formula for calculating the cost approach is as follows:

Property Value = Replacement/
Reproduction Cost – Depreciation
+ Land Value

Since the cost approach is not based on comparable properties or the property’s ability to generate revenues, the method considers the amount that will be incurred to build a property today, assuming that the existing structure is to be destroyed and rebuilt afresh. Hence, it takes into account the value of the land where the property is built, less any loss in value.

The following is the process of the cost approach method of real estate valuation:

Estimate the reproduction or replacement cost of the structure

The step involves estimating the current cost of building the structure from scratch and the site improvements. The cost can be estimated using the following two methods:

- ⊙ **Replacement method :** The replacement method estimates the cost of constructing a building with the same utility as

the structure being evaluated, using the current construction materials, standards, designs, and layouts.

- ⊙ **Reproduction method :** The reproduction method estimates the cost of constructing a duplicate of the property, using similar materials and construction practices. It also uses the designs, standards, and layouts that were in place at the time the property was constructed.

Construction Costs

There are a lot of costs to take into consideration when determining the cost of building. Let's start off by differentiating between direct and indirect costs. Direct costs are any costs directly associated with the construction process (direct labour and material costs). Indirect costs are the other costs that come along with a construction project (insurance, taxes, administrative fees, etc.).

Whether you're using the replacement or reproduction cost approach, there are four main methods to choose from when finding total building construction cost:

- ⊙ **Comparative Unit Method:** Start off with a lump-sum estimate per square foot. Then categorize costs according to construction materials. These categories can be narrowed down further based on quality.
- ⊙ **Segregated Cost Method:** From the name, you can tell that costs are not taken from a lump-sum view. Here component costs are directly related to separate construction material and quality, then added up. So take individual costs of things like the roof, plumbing, flooring, etc. and

then combine them to get the final cost.

- ⊙ **Unit-in-Place Method:** This method is similar to the previous one but it breaks down each major cost material into its more detailed cost components. Include overhead costs in this method.
- ⊙ **Quantity Survey Method:** This method requires the most time, but it is the most accurate. Here, each individual cost involved in construction/renovation is estimated.

Estimate the depreciation of the improvements

Depreciation is the loss in value of the building and or its improvements, and it causes the difference between the value of improvements and the current contributing value of the improvements. When estimating the depreciation of the property, you should consider the physical, functional, and economic depreciation. There are three forms of depreciation :

- ⊙ **Physical depreciation** is the wear and tear of buildings over time.
- ⊙ **Functional depreciation** happens when a property's worth reduces due to outdated design and features. It is also affected by changes in consumer tastes and preferences.
- ⊙ **Economic depreciation** is the decrease in the income value of the property due to influential economic factors. This can include: Recession, A general decrease in real estate properties, Development of properties such as a sewer treatment plant, a landfill, etc.

Estimate the market value of land

The next step is to estimate the value of the land on which the property is being built. The most appropriate method of estimating the land value is the direct comparison method, where the current price of land is obtained from the value of recently sold plots of land. It is the market value that you would pay for the land today if it was vacant.

Deduct accrued depreciation from the reproduction/replacement cost

After obtaining the total value of depreciation of the improvements, deduct the figure from the estimated reproduction or replacement cost obtained in step one.

Add the depreciated cost of the structure to the estimated value of the land

The final step is to add the depreciated cost of the structure and improvements to the estimated value of the land.

When to Use the Cost Approach?

There are several different contexts and scenarios in which a cost approach appraisal may be used to value a property.

- ⊙ **Insurance Companies:** Insurance companies may use the cost approach to appraise a property in order to determine how much it would cost to replace the property in the event of damage or destruction.
- ⊙ **Single Use Buildings:** The cost approach may be used to appraise single-use buildings such as office buildings, hotels, and warehouses.
- ⊙ **Unique Properties:** The cost approach may also be

used to appraise properties that are unique or have been significantly customized. This is because it can be difficult to find comparable properties on the market.

- ⊙ **Special Use Properties:** The cost approach may also be used to appraise exclusive use properties such as schools, libraries, hospitals, and museums.
- ⊙ **New Construction:** The cost approach can also be used to appraise newly constructed properties. The cost approach works best when there is little depreciation to account for and similar land is available nearby. This means it can be especially useful for appraising new construction

Benefits of Cost Approach

This approach is accurate in evaluating special-use and unique buildings. The cost approach does not focus on the prices of similar homes. Rather, it calculates how much the building would be if it were created from scratch. This method factors in the worth of the land and already makes deductions for any loss in value. Another advantage of the cost approach is that it is a very solid capital valuation method supported by current market costs and operating environment. It provides a clear value for the tangible property, because that value has been clearly separated from all other assets. Used in conjunction with the income approach, the cost approach allows intangible assets to be valued indirectly. Tangible values established through the cost approach are subtracted from the enterprise value established by the income approach; the remainder is the value of the intangible assets.

Limitations of the Cost Approach

One of the limitations of the cost approach is that it assumes that the buyer is in a position to find a vacant plot of land where to build an identical property, and that is not always the case. If there is no vacant land, the estimated value of the property will be inaccurate. Also, an area can be fully developed, and local authorities can be restrictive on new developments, and so it will be impractical to estimate land values in that area. Another limitation is that it will be difficult to estimate the depreciation of older properties because there are many factors to take into account. For example, construction materials used during the construction of older property may no longer be available or in use. Estimating the value of such a property allows a lot of room for subjectivity.

Conclusion

Cost approach refers to the method of valuing a property (real estate) in which the accrued depreciation is deducted from the replacement cost of the property at current prices. It is one of the basic valuation methods, holding the premise that a potential real estate user should not pay more for a property than an equivalent would cost. The cost approach is also based on the fact that real estate components could be added together and summed to get an estimate of value when valued separately. This means that the cost of construction plus the land, less depreciation is the limit of the market value. When a property is new, it yields a more accurate market value. Similar to its counterparts, the cost approach may have other forces that prove it inaccurate. For example, if vacant land is not available to compare against, the professional valuing the property will have to derive an

estimate, making the end value less accurate.