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Appraisal Report: The Role of New Construction in the Relocation Appraisal

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The appraisal process relies heavily on the principle of substitution in developing an estimate of value. This principle holds that typical potential buyers in a marketplace usually are unwilling to pay more for a property than the cost of acquiring an equally desirable substitute property. Therefore, it follows that market price levels for residential real estate (all real estate, for that matter) are influenced significantly by the supply and pricing of alternative properties available to buyers. The appraisal process, then, must include a thorough analysis of the availability and pricing of comparable properties.

Although examination of past sales in a marketplace can, at times, be helpful in developing such an analysis, as appraisal that is based solely on such historical sales information runs the risk of not providing a timely indication of value. This is particularly true in transitional markets where market price levels are appreciating or depreciating. This is why page 5 of the ERC Residential Appraisal Report includes a comparative analysis of available competing listings to facilitate a more accurate estimate of the anticipated sales price of a property.

In considering competing listings, the availability and pricing of new construction should be examined carefully. Since most potential buyers consider new construction more desirable than a previously owned home, the availability of new homes is a limiting influence on the anticipated sales price of a transferee's existing home.

Based on the principle of substitution then, previously own homes usually must be offered for sale at a price lower than the cost to purchase new construction in order to be competitive. Thus, new construction tends to set the price ceiling below which previously owned homes will sell, and is very useful in developing an upper limit in estimating the anticipated sales price. Exceptions to this concept can be found in extremely volatile markets in which prices are rising rapidly and the availability of new construction is limited. Such situations can result in a rapid sales pace and extended completion and delivery times for new homes. Potential buyers who require more immediate occupancy may be willing to pay a premium; therefore, previously owned homes occasionally sell for more than new construction. Such situations, however, are extremely rare. In most cases, new construction sets the price ceiling for previously owned homes.

Whenever new construction is available, the dynamics of a market are influenced significantly. Those familiar with the process of buying and selling homes are quick to recognize that a home's appearance affects its marketability. Appearance is affected by, among other things, the physical condition of the property and the appeal of its decor. When new construction is available in a market, the significance of condition and decor in previously owned homes is magnified, since professionally decorated model homes increase buyers' expectations. As the supply of available new construction increases in a market, the effect of property appearance is intensified. Under these circumstances, the previously acceptable "average" appearance of a previously owned home may become unacceptable to a potential buyer without a substantial price discount. Therefore, when new construction is plentiful in a market, the appraiser should view a subject property with a much more critical eye and carefully consider and adjust for the appeal of the exterior design and the condition and appeal of the interior decor. Any resulting adjustments for these categories on page 6 of the ERC form should be based on their anticipated effect on sales price rather than solely on cost to cure. Keep in mind that the availability of new construction similarly affects the appeal to prospective buyers of other property characteristics such as architectural design, quality of construction, and functional utility. Appraisers must carefully consider emerging trends in new construction and analyze their impact on the sales prices of previously owned homes.

The way new construction is marketed also is an important consideration. While previously owned homes typically are sold through a real estate agent, new homes often are sold through the efforts of a combination of people that may include a real estate agent as well as the builder. As was previously mentioned, in marketing new homes, the builder may decorate and furnish model homes in a way that will significantly affect the expectations of buyers and further disadvantage previously owned homes. Furthermore, builders occasionally are unwilling to cooperate with local real estate agents. This can severely diminish the marketability of previously owned homes within that builder's project because real estate agents, recognizing that a potential buyer is likely to view the new construction as more desirable, may become unwilling to bring buyers to view previously owned homes in that project for fear of losing that buyer to the sales office. The net result is that previously owned homes within this project will receive limited showing activity from the real estate community, which greatly compromises their marketability and anticipated sales price.

Sales concessions associated with new construction yield another interesting point of analysis. Generally, builders offer sales concessions on new homes to stimulate sales activity and reduce the holding periods and associated carrying costs. In appreciating real estate markets, these concessions usually are unnecessary because of the healthy pace of sales and relatively limited competition associated with these market conditions. When the market conditions begin to deteriorate, however, and sales activity slows, a builder naturally will seek ways to stimulate waning buyer interest and sales activity. Under these circumstances, builders are more likely to offer sales concessions on new construction. These sales concessions usually take the form of free construction upgrades and extras, but sometimes include below-market financing, the waiver of lot premiums, or even cash allowances and credits. Such sales concessions further increase the competitive advantage new homes hold over previously owned homes and, consistent with the principle of substitution, the anticipated sales prices of previously owned homes within that particular submarket and price range are lowered. In locations where a market deterioration is prolonged, sales concessions will become increasingly prevalent, will accelerate the decline in market prices, and will become the driving force behind the market.

Clearly, the availability of new construction in a market is a significant factor appraisers must consider in estimating the anticipated sales prices of residential real estate. That is why the "ERC Residential Appraisal Report," distinguished by its depth of analysis, includes an examination of competing listings and new construction.

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