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Appraisal of work-in-progress buildings

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Abstract

One of the most apparent signs of the international real estate crisis is the many unfinished construction investments. The various states and professional organizations are attempting to mitigate investment risks with regulations and methodology instructions, and, thus inspiring new confidence, to kick-start financing, which is the engine driving the real estate market. New methods and approaches are necessary in the area of real estate appraisal also, to ensure that the market value of works in progress could be accurately determined at all times, thereby facilitating the management of risks and reinforcing the confidence of the investors.
The author of the article reviews and evaluates the methods with which the value of works in progress can be estimated well, and which can replace the static, simplistic approach currently used by appraisers. While comparative methodology is not suitable to tackle the problem, as the first practical step, in the net replacement cost based valuation approach the Market Value of the land, as value-forming factor, must continuously be examined. The income-based calculation approach can easily be made suitable for the determination of the Market Value of works in progress.

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Keywords: Appraisal, Real Estate; Risk Mitigation; Work in-Progress;

1. Introduction, the problem

This article discusses a *real estate appraisal* issue in an area which has not been explored by the relevant – valuation and project management – professional literature, even though the importance of this problem has been accentuated by recent events in the real estate market and the countless unfinished investments ensuing from these market processes. In this article, the author also examines these real estate market processes, in order to ensure that the methodology suggestion offered by him is adequately supported. The methodology problem to be solved is the appraisal of works in progress, because at present the investors and financers cannot receive an adequate view of the current Market Value of the development while the implementation of the investment is in progress.

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Unfinished and incomplete investments resulting from the crisis can be found throughout the world; overgrown yards, empty concrete frames and abandoned cranes evidence the burst of the real estate bubble from India through Turkey to Central Europe. The real estate industry has always been known for its cyclical nature; at times the dynamic of investments is halted, and at times it proceeds to grow. Before the crisis, one of the basic tenets of the real estate market was that, despite the market's cyclical nature, real estate values continuously rise at a rate exceeding the general inflation rate. At the same time, the *real estate crisis,* which started about five years ago, has challenged all of the prior set-in-stone real estate paradigms. In the course of the crisis all of the earlier market topoi have toppled, and we are facing a new, as of yet unknown real estate market. It has also turned out that the *demand for real estate use*, which continuously grew for decades, after the crisis has not only refused to continue to grow – as a result of the change in the composition of the demographic and, particularly, the spread of Internet technology – but in fact has been dramatically decreasing. When exploring the reasons for the falling demand, suffice it to refer to the rise of ever more common telework, or the effects of e-commerce, or the decline of the population. As a result, after the crisis a high number of unused properties can be found – office buildings, apartments, small business units. Additionally, oversupply has halted the investors and frozen investments for the long term.

Although it appears that in numerous areas of life the economic crisis is of the past, the real estate indicators – apart from a few exceptions – *have not been restored;* this statement is particularly true about economies where the real estate market is vulnerable, underdeveloped or overheated. For this reason, the attitude and risk management of the *financers* has fundamentally changed since the crisis. The goal of the various regulations and legal provisions set in place after the crisis is that financing would be confined into the constrains of fairly well estimable risks. Such examples are the regulation system [1] referred to as BASEL III.; the UCITS IV* directive related to collective investments in transferable securities, or the continuously tightening IFRS† regulations, which set forth the norms of international accounting.

Construction loans are still *difficult to obtain* on the real estate market, due, in addition to the new regulations, to the financers' previous bad experiences and their resulting lack of confidence. One of the bad experiences related to investments is linked to the reliability of real estate valuations. For earlier financer practice, presenting the prevailing *invested costs* was sufficient; real estate appraisers gave an estimate of the prevailing value of construction works in progress with the increasing amounts of the verified expenditures added. For measuring the expenditures, most frequently the *EVA (Earned Value Analysis) model,* already familiar from Project Management, or a similar approach was used.

The EVA methodology is a well-known project management tool, which allows the simultaneous measurement of the progress of the project and the performance of the contractor. Numerous professional articles deal with the application and promotion of this method, or provides a comprehensive analysis of it, such as Anbari [2]. However, the EVA approach examines the performance during the construction solely from the aspect of financial/technical progress, with the planned budget and the planned implementation period being the basis for the calculations. In this examination, the market evaluation of the project, the changes in the market data, and the corresponding prevailing Market Value changes are not included; with the EVA method only a static compliance with a technical condition system can be checked. From the aspect of real estate appraisal, the problem with the EVA model is that it does not reflect the changing market conditions, it only takes into account the current expenses.

The *everyday practice of real estate appraisal* treats the EVA methodology loosely: It estimates the financial and, based on that, the technical performance on the valuation date, usually on the basis of the data provided by the investor. The appraiser rarely conducts his or her own invoice review or actual quantity surveys. The appraiser adjusts the

* DIRECTIVE 2009/65/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)
† IFRS: International Financial Reporting Standards, continually published by the IFRS Foundation