

(READ THIS WITH COMPANION ARTICLE ABC'S OF VALUE: THE PRINCIPLES)

## 8 More Principles of Value



By **Brian Madigan LL.B.**

There are eight more principles of value that are relatively widely accepted when it comes to real estate. They relate to some economic forces

Here are the Sships :

Substitution  
Supply and Demand  
Highest and Best Use  
Increasing (decreasing) Returns  
Progression  
External factors  
Regression  
Surplus Productivity

### **Substitution ~ (looking for value)**

Buyers will try to spend their money wisely and get the most for their money. A buyer will not pay more for something than the cost of obtaining an equally desirable alternative.

This particular principle is more of a principle in economic theory than real estate. It is a frequent guiding principle to buyers seeking appropriate choices. What can a buy? What does it cost? What else can I buy? How much extra does it cost? What do I give up if I want to save some money on the price? These are really just a simple set of choices facing every buyer. If there is better value elsewhere, the buyer will go elsewhere.

### **Supply and Demand ~ (primary market force)**

If the product is in short supply, the price will go up. If the price goes up, demand will fall, since fewer buyers can afford the product. If the product is in abundant supply the price will fall, because there just aren't enough buyers. If the price

goes down, demand will increase, since more buyers can afford the product.

This market force has been at work in the early civilized market places and for thousands of years thereafter.

### **Highest and Best Use (houses not farms)**

There is the current use of the property to consider and also its future or potential use. A 100 acre farm is a nice farm. It can be well equipped for farming operations and quite productive. Often the value will be estimated at around \$10,000 an acre. This is good for a farm!

However, what if that same farm was right on the edge of a housing development. Now, it could easily be worth \$200,000 per acre. That's \$20 million. You now know, that this farm is going to fall into disrepair. It will be sold to a developer for 20 times what a farmer would pay for it. By the way, there lots of land for farms but only a few properties along the edge of the expanding municipalities that can be converted into subdivisions.

### **Increasing/Decreasing Returns (just too many)**

The plus factor slows down and might even turn negative. This concept in economics is the law of diminishing returns. Add a garage that cost \$30,000, this may add \$25,000 in value. Add a second one, and you may have little to no additional value. In fact, two separate buildings in the rear yard might be an eyesore. Add a third, an the property could actually be worth less. So, marble floors in the foyer are nice, marble floors in every room can detract value. Sometimes, wallpaper can feature a particular area. Today, if it's throughout the house, buyers look to the cost of ripping it all out. The more you have the more it will cost to remove it.

### **Progression ~ (the cheapest house on the street)**

Generally, you will find that properties are roughly similar in terms of value. However, the older the neighbourhood, the more likely you will find a significant disparity. In fact, someone may demolish a building and construct a new one. This new property with a market value substantially higher than the rest will start to pull up the values on the street. As the street gets better an better, there is a rather measurable benefit to the cheapest house. It goes up in value too. Because, people will pay a little more for this house on a good street than they will pay for this same house on a bad street.

## **External Factors ~ (airport and expressway)**

Generally, there are some factors that are perceived to add value and others that will detract value. On the plus side:

- A quiet neighbourhood
- A court or cul-de-sac
- Larger lots
- Good setbacks from the road
- Ravine and natural environments
- Backing onto a golf course

On the negative side:

- Noisy, too close to the airport or expressway
- Lack of privacy
- Too close to school
- Too close to commercial plaza
- Too close to hydro corridor
- Too close to a dump or contaminated site

You have to remember when it comes to real estate: location, location, location. The property is in one spot and you can't move it. So, if there's an airport beside you, it's going to get noisier in ten years. This is an undesirable influence. And, no matter what you do to the house, you can't fix it.

## **Regression ~ (the most expensive house on the street)**

This is the exact opposite of progression. If you have the best house on the street, its value will come down closer to the average street value. Basically, if you have \$700,000 to spend, you want to be on a \$700,000 street, not a \$400,000 street. The higher priced house will be negatively impacted.

## **Surplus Productivity ~ (income is attributed to the land)**

This is at first a somewhat difficult concept. The principle is this: once all costs have been satisfied, in a project, the net income flows to the land. Here. Think of location. So, if you have two identical farms, with the exact same costs. Once you have some extra profit, that extra profit is attributable to the land (or the location). The superior farm had better soil, better sunlight, better growing conditions etc.

Let's try one more example. Two identical buildings constructed by the same builder. They each cost \$2 million to build. But, one is sitting on land that's worth \$2 million and the other is sitting on land that's worth \$500,000. Which

property do you think is downtown? Which property will have the higher rents? And, which property will make the most profit. When you are figuring out the costs, once they have all be paid and satisfied the net income or the profit is then attributable to the location. So, when you are said and done, it could be that the suburban building provides more profit since its operating costs might be lower (decreased municipal taxes). Nevertheless, the point here, is that the net income is to be attributed to the land, and land in this context simply means location.

If you need to remember these eight principles of value, why not try the acronym “**Sshippers**”: short for Substitution, Supply and Demand, Highest and Best Use, Increasing (decreasing) Returns, Progression, External factors, Regression, and Surplus Productivity. It’s a good way to remember them.

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