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The ABC's of Value: The Principles



By **Brian Madigan LL.B.**

There are a number of basic principles that are relatively widely accepted when it comes to real estate.

Here are the ABC's:

- **Anticipation**
- **Balance**
- **Change**
- **Competition**
- **Conformity**
- **Consistent Use**
- **Contribution**

Anticipation ~ The 3 Car Garage

How much would you pay for a garage? A double garage? A three car garage? Well, it all depends where the property is located. On small lots in the downtown areas of the City, a single car garage is at a premium. That is well worth having and something that you would pay for. What about the double car garage? In some upscale downtown areas, this is expected. In suburban areas it is commonplace. So, what about the three car garage? By the time you have a three car garage in downtown areas, buyers are valuing the potential of an additional lot, not the place for the third car. In the country, with significant distances to travel, it can be commonplace.

Let's look at a quick example of an area in the suburbs that has houses with both single and double car garages. There is a certain benefit to the double car garage. It will house an additional car, it will provide storage space and it could serve as a workshop. So, there is a certain utility to it. In addition, it often provides a higher profile to the house and makes the entire building look bigger. You might find than houses with a single car garage trade in the \$300,000 range and those with two car garages trade in the \$320,000 range. In the same neighbourhood, a

house with a 3 car garage might only trade for \$325,000. All things being equal, reasonably speaking we could conclude that a single car garage is expected. A double car garage adds \$20,000 in value and the three car garage, only an additional \$5,000. Most buyers are likely to find only marginal additional utility associated with the additional garage.

The factors that buyers will consider are:

- The additional potential resale value
- The additional space
- The improved appearance of the house

Buyers essentially anticipate the benefits that they will have in the future, if they purchase the property now.

Balance ~ (the house with a lobby)

Proportion is something well known to the Greeks and the Romans. It is very evident in their architecture. A large stately house with ascending columns to the second story will be very appealing in its appearance. Georgian and Colonial architectural continued to use these stately columns that you can still see today in the Greek Parthenon. However, large towering columns on a small narrow house just won't work. In the first case, the columns added value and in the second, they did not.

Or, consider the case of a mini-mansion of 7,000 square feet. You cannot have a 3,000 square foot front hall. That's a lobby, and should go with a hotel. And, if you just have a single car garage, that won't work either. You need to consider both proportion and balance.

Change ~ (Today only)

No one can tell the future! Things change, and so do real estate values. If there are significant changes in the economy, then the value may change too. This can be either positive or negative news. The fact that a new manufacturing plant is coming to town, can be a real plus to a small area with limited housing stock. How many new people will require houses. The existing housing market can shoot up overnight. Look at Vancouver in anticipation of the Olympics coming to town. And, also think about small resort communities like Whistler.

Then, there could be plant closings. Think about Brampton losing 900 positions at the Chrysler plant. But, Brampton has a population of about 500,000 people. So, 900 positions really isn't that much! According to Statistics Canada, all those job losses in the manufacturing sector have been made up in the construction sector.

In addition, to the local area, there are other factors that affect the entire economy including mortgage rates, the stock market, the level of employment,

inflation etc. A very significant change could influence the housing market in relative short order.

So, the simple point here, is that value is a value for today, and tomorrow is tomorrow.

Competition ~ (one more builder)

Once you have a profitable opportunity to build and sell houses, you are likely to see more builders attracted to the business. At the outset and in a rising market both builders will do well. They will both be able to raise their prices and make a profit. Oddly enough, the mere fact that they are able to raise their prices will attract more business. Buyers will perceive that the area is “hot” and that prices are going up. If the values rise faster than inflation, then the cycle continues.

However, the third builder just cannot sit on the sidelines forever. As soon as he enters the marketplace, there is more competition. The prices cannot continue to rise as fast, due to the potential increased supply. But, this concept is slightly different than supply and demand. It’s just about more competition. A third builder will force all three builders to sharpen their pencils to attract business. Profit margins will decrease somewhat with competition.

Conformity ~ (residences away from industry)

Buyers like to see that an area is relatively stable and similar for a significant distance. You come to expect that Dofasco and Stelco will have fairly industrial areas surrounding them. If you had a heavy industry, it would be safe to locate around them. How messy can your business be? But, your heavy industry will not fit well in picturesque equestrian areas in Caledon and King that are subject to the Oak Ridges Moraine, various Conservation authorities and the Niagara Escarpment Commission.

So, most municipalities zone areas to have similar types of uses, and buyers often prefer to be in the centre and not along the edge. If you have an commercial area abutting a residential area, the preferred residential lots will be a considerable distance from the commercial plaza.

Consistent Use ~ (residential OR commercial)

The value of a property is to be calculated using one method and one method alone. Often you will come across a redevelopment area. Three houses all in a row on 50 foot lots are relatively similar but over the years, the owners have maintained them somewhat differently and improved, renovated and added-on. Today, they are now worth \$500,000, \$550,000 and \$600,000. Those valuations are all based upon the houses as houses.

However, let's consider the developer. He wants the three houses because he plans to tear them down and build a high rise condominium apartment. He is not interested in who has the nicest kitchen, or that someone added a sunroom. He wants the 50 by 150 foot lots. Furthermore, he is prepared to pay \$1.5 million for each property. So, if you were planning to value these properties based on their commercial development potential, you would assess them all at \$1.5 million.

What you can't do, is value them at \$1.5 million for commercial purposes and then come back and add an additional \$50,000 or \$100,000 in residential improvements. It's one method, or the other, not both.

Contribution ~ (the added value)

Kitchens, bathrooms, sunrooms, swimming pools and tennis courts.... what are they worth? Well, if you don't have one, they are worth what they cost to construct. Safely, kitchens and bathrooms seem to add about 70% of their cost to the value of the home. This means that a \$30,000 kitchen renovation might only add \$21,000 to the house value.

Sunrooms and swimming pools add about 50% and tennis courts add very little. So, when you come to think about it, all these "improvements" are poor financial investments, although some are better than others. Actually, the only improvement that adds value over its cost is landscaping, as long as the money is spent on trees.

The important issue here is to separate the objective value of the kitchen (\$30,000) from its subjective value (\$21,000) which is of course the additional amount that a buyer will pay for the house.

That's seven, and there are eight additional principles to consider that affect value. The first seven are the ABC's of value.

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