

The Infamous Price-Per-Square-Foot Measure of Value

The gold standard for many buyers is to try to determine the value of a home in terms of price per square foot. It is human nature to seek out this type of simplicity and hang onto a single quantitative figure of merit. For example, we have the controversial Body Mass Index to tell us we are overweight. We have a credit score to tell us we are credit worthy. We have a GPA in school to tell us how smart we are. So it is natural to seek a figure of merit to easily tell us we are getting a good deal on a home. But like all Figures of Merit, they aren't very accurate and are subject to misinterpretation.

Experienced Realtors and appraisers will both quickly point out that price per square foot is a very poor indicator of predicted sales price and should not be used to determine value. In fact, the quoted square footage only refers to the living space of a property. What about the non living space, and the quality of what is contained in that living space? You would have to assume the homes are otherwise identical (both in condition and quality) and that all lots are the same in order for price per square foot to be meaningful. Most people would agree that a big box builder would have a lower cost per square foot than a elegant custom home builder. It's not the square footage that makes the difference; it's the quality of what's inside. In other words, when people decide which home they fall in love, which one they can afford, and which one they choose to write an offer on, the price per square foot is not a consideration. It's only when Buyers try to analyze whether or not they are getting a good deal that price per square foot comes into play. But is it wise to use such a crude measuring stick when deciding to buy or walk on your dream home?

Origin of this Technique

It is hard to say exactly why the price per square foot standard became so popular among buyers, but it is probably due to a combination of creative advertising from the big box builders who advertise more square footage for the price, the dominance of production builders in general who build similar houses within a neighborhood, and its historical use by builders, insurance adjusters, and appraisers for estimating new construction costs. A lack of available data within the public domain probably drives some of this "go with what you know" approach, and it may also be further propagated by new and inexperienced real estate agents who have not yet figured out the correct way to evaluate comps. Inexperienced agents often don't possess the knowledge they should of the local market and therefore have no better way of assisting their clients in determining fair market value except to use this technique and bounce it off of the original purchase price. The successful Realtors know there is a direct correlation between price, location, and condition. The style on the outside, quality and features on the inside as well as the desirability of the neighborhood, schools, curb appeal, view, etc. all come into play.

Errors in Square Footage Quotes

Quoted square footage values aren't even that accurate. We have seen cases where the same exact floor plan within the same neighborhood varied 200-400 square feet. Realtors and assessors often copy those misquoted numbers across many homes rather than measure on their own, or obtain the correct info from the builders. In some cases it may be a mistake (such as using the square footage from another listing with the same floor plan but that had a bonus room while the current home does not), but in other cases there seems to be a pattern to suggest some fluffing may be occurring to make the Buyer feel like they are getting a better deal. Sellers often overestimate their square footage when providing it to the agent. It is best to verify consistency where identical floor plans are available.

Statistical Errors

Without delving into statistics too much, be aware that if you take the highest and lowest sales price within a neighborhood and convert that to price per square foot, the variation can be great. Averaging several homes smoothes things over, but the data can be skewed to one side or the other depending on the types of homes that have sold recently. Also, you can have an average price per square foot and there be no homes that sold at or significantly close to that average price per square foot. Think about the height of the starters for a basketball team. If you had two 7' players and three 6' players, the average height would be 6'4". There are no players on the team at 6'4". Is it fair to say that the 7' players are too tall or that the 6' players are too short? The same applies for price per square foot.

Statisticians use standard deviation, alpha and beta error minimization schemes, etc. to pull more reflective data of the population in question. Also the population of homes you choose for your evaluation must be true comps. All homes in the neighborhood are not comps. Think of a Buyer looking at homes on a lake. If the homes he likes are waterfront property, then the homes across the street that are not water front are not comps. In a production neighborhood, if you are looking at the premier series home on an interior lot, then a lower series home backing up to a road is not a comp either. These issues and the errors mentioned earlier are just part of many reasons price per square foot is a bad technique for valuing a home.

What is the Proper Use of Price Per Square Foot?

Price per square foot does have its place in real estate, but not in the determination of re-sale value. Average sales price per square foot taken over time can be a useful tool in determining if the prices of homes in the local area are rising or falling and by how much. The median price per square foot can be useful in determining if the affordability of existing homes or new construction is rising or falling. However, land prices could also be the real culprit and have nothing to do with the structural cost per square foot.

Price per square foot is used by insurance adjusters to determine the replacement cost of homes in case of a fire or tornado. It can be useful when evaluating builders in estimating construction costs for specific sized homes (i.e. when you are providing the lot). However, there can be a wide variation in construction costs, particularly between production builders and custom builders. Most custom neighborhoods command a higher resale price, thus justifying the higher construction price per square foot initially. Their costs are reflective of several factors including differences in quality, uniqueness' in design, additional gables or more complex blue prints as well as they do not enjoy the economy of scale savings that production builders have. Even in production neighborhoods there are wide variations in price from floor plan to floor plan and between elevations and options within that same floor plan. These are typically due to layout and material quality.

When considering comps, looking at initial sales price can be an important factor in determining value. Couple that with a comparison of the average price per square foot in the neighborhood to determine direction and magnitude of price movement. You should also consider the median home price delta in the local area to determine increased or decreased competition. You should also have an understanding of what is driving the increase or decrease in average and median price per square foot; is it material cost, building restrictions, inflation, deflation, economic collapse, or some other important factor? Finally, there is no substitute for years of experience working within the market to recognize which homes will command a premium vs those that will not, so Buyers should work with an experienced agent who services their area of interest.

Price Per Square Foot Ignores Features that Affect Price the Most

Below are a list of items that significantly affect price and **ARE NOT** captured in a price per square foot Figure of Merit. Unless the buyer or Realtor has seen the comps personally, the pictures or a drive by only tell part of the story, so leave some padding in your estimate.

- Elevation of the home (even production builders have significant cost variation)
- Floorplan, such as an open floorplan vs closed
- Two-Story rooms and vaulted ceilings vs All Single Story flat ceilings
- Interior and Exterior Condition (i.e. shows like a model vs looks worn and needs paint and carpet)
- Three-car vs two-car or attached vs detached garage vs no garage (some condos)
- Professionally finished basement vs owner finished basement, vs unfinished
- Walkout basement vs Daylight basement vs Scape-Well window basement vs No Window basement, vs Partial Basement, vs No Basement
- Lot condition such as preferred interior lot on cul-de-sac, vs corner lot, or backing up to road, vs backing up to pond, vs mature trees, etc.. This variation can be amplified on lakefront or beachfront properties vs those on the opposite side of the road. The identical house on the non-preferred side of the road can cost a fraction of those on the water.
- Lot Size or acreage 1 acre vs ½ acre vs 1/3 acre (lot premium can significantly affect price)
- Home placement (nice backyard vs no backyard)
- Number of gables vs big box home (affects actual construction price per square foot)
- Side-load garage vs front load vs rear load
- Overhead power lines or intrusive easements
- Vinyl Siding vs Hardi-Plank vs all Brick
- Pool vs No Pool
- Hardwoods and Tile vs Vinyl
- Granite Countertops vs Solid Surface vs Formica
- Limited counter space or cabinets
- 8' ceilings vs 9' ceilings
- Functional obsolescence (limited number of bathrooms, small closets, little or no insulation, etc.)
- 3 bedrooms vs 4 bedrooms
- Downstairs Master vs Upstairs Master in certain neighborhoods
- Neighborhood to Neighborhood Variations
- Well manicured lawns with sprinkler system, fence, and privacy from other homes or public access will greatly be appreciated by buyers over unkempt or hard to maintain lawns backing up to other homes and without any privacy.
- Landscaping
- Builder brass vs updated lighting and fixtures
- Proximity to a busy road, railroad, or public buildings vs quiet interior neighborhood setting.
- Financial predicaments such as divorce or foreclosure.
- Builder still in neighborhood vs closeout phase, vs builder out
- Paint and Carpet Colors or wallpaper
- Mold
- Age of Home
- Property Taxes and Schools
- Stigmatized Property
- Poorly maintained property next door

Inconsistencies in Buyer Thinking

As you can see in the list above, there are numerous factors that get overlooked when using price per square foot. Nevertheless buyers often remain blind to these factors, particularly in production neighborhoods... ***that is until it is time to write an offer.*** At that time they will pick the home within their price range that is in the best condition or has the best lot, or inevitably some other factor that is not considered in the price per square foot calculation. It won't be price per square foot driving their initial selection.

So it is not uncommon for Buyers to try to derive a price per square foot of the homes selling at lower prices that they wouldn't buy and then want to negotiate on the pristine homes that they would buy using the same price per square foot. Often their Realtor, if they have one, will steer them on the right path. But if their Realtor falls into that trap as well, then the deal is going to be a hard sell. Seasoned Realtors know that Buyers in this market are very particular and somewhat reluctant to take on a "Project" house. They know Buyers tend to overestimate the cost of repairs and in general have no interest in a fixer-upper. The ones that do take on these fixer-uppers then put several thousand dollars back into the house shortly after moving in. In an ideal world that cost should be considered as well, but the info is not available. In many cases it falls on the Listing Agent to steer everyone back on the right path to save a sale.

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The banner features a background image of a city skyline with several skyscrapers. On the left, there is a gold trophy icon and a blue 'R' logo with 'Team Century REALTOR' text below it. On the right, the Century 21 Scheetz logo is prominently displayed in a black oval. At the bottom, a grey bar contains the text 'LICENSED PROFESSIONAL REALTORS SERVING THE ENTIRE METROPOLITAN INDIANAPOLIS AREA'.