

Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question

BY DAVID CHARLES LENNHOFF, CRE, MAI

INTRODUCTION

WHAT IS IT ABOUT THE WAY BIG-BOX RETAIL PROPERTY is being valued for tax assessment purposes that results in the wrong answer? Surprisingly, it can be traced to a misunderstanding of real estate appraisal fundamentals. These properties are never built speculatively, then put up for rent or sale. Instead, they are built to suit, and often built to suit, sold and leased back. The occupant never leaves the building. Also, they are custom built to capture a particular retailer's business image. The exterior design is intended to strike a familiar chord with the customer. A passerby sees the exterior of a Home Depot, for example, and instantly recognizes it. The interior similarly matches the tenant/occupant's brand standards.¹ Unfortunately, when the property is sold—for whatever reason—the new buyer often must endeavor as hard to remove the recognizable trade dress as the original occupant invested in building it. Recently, for instance, Englewood (Lemont, Ill.-based Englewood Construction) turned a former Circuit City store into an H. H. Gregg...the work involved gutting the interior and installing the new tenant's brand standards. The exterior was completely altered as well to make sure that customers see H. H. Gregg and not a former Circuit City.² This article reviews the fundamentals that are so frequently misunderstood—value in use vs. market value, leased fee interest vs. fee simple estate, market rent vs. contract rent, and real property vs. intangible personal property—and then discusses proper application of these concepts in the context of each of the three approaches to value. Finally, a review of relevant decisions from various jurisdictions, though not comprehensive, is included to help illustrate the concepts in a legal context. Armed with this information, both property owner and assessor alike will be better prepared to understand how these properties should be properly assessed.

About the Author



David Charles Lennhoff, CRE, MAI, is a principal with SC&H Appraisal Services, LLC, McLean, Virginia. His practice centers on litigation valuation and expert testimony relating to appraisal methodology, USPAP and allocating assets of a going concern. Lennhoff has taught nationally and internationally for the Appraisal Institute, recently in Tokyo, Japan and Beijing, China, Berlin, Germany and Seoul, South Korea. He has been a development team member for most of the Institute's income capitalization courses and served as editor of its Capitalization Theory and Techniques Study Guide (3rd Ed.). Lennhoff also was lead developer for the new asset allocation course, Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets, and editor of the two accompanying business enterprise value anthologies. He also authored the Institute's "Small Hotel/Motel Valuation" seminar. Lennhoff is a member of the Real Estate Counseling Group of America, a national organization of analysts and academicians. He is a past editor in chief of and frequent contributor to The Appraisal Journal.

THE EVOLUTION OF BIG-BOX REALTY

Prior to examining the valuation issues, it is useful to review the evolution of this real estate product and to study the trends that are influencing its future, and, in turn, the way it must be valued.

Big-box retail was born in 1962. That was the year Walmart, Kmart and Target all opened their first large discount stores. As they grew, the new big-boxes began offering a broad selection of merchandise and low prices to a growing population of suburbanites. These chains boomed in the early 1990s, and began expanding from the suburbs into small towns, fueled by a strong stock market and easy credit. The housing boom propelled the big-box retailers into the new millennium with increased

Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question

demand and further expansion. Then came the 2007–2009 recession and consumers pulled back.³ According to Sprague, with the recession came a dramatic shift in retail. Consumers began buying more products online. That shift of 18–25 percent of online purchases began to affect brick-and-mortar stores. There became a real case for downsizing stores. *Amazon.com* began as an online book retailer in 1993. By the late 90s it had expanded to other consumer goods and overnight delivery, forever changing the retail landscape. Most retail chains and “mom-and-pop” stores were not ready for this dramatic change in profit margins and access to quick delivery.

Other forces began working against the big-box model. Aging baby boomers no longer had kids at home and didn’t need to stock up on food and packaged goods or buy new appliances. Retail developers began to see both big and small retailers push back on renewal of leases and in many cases scaling down in size rather than renewing or expanding. By 2016, Richfield, Minnesota-based Best Buy plans to have as many as 800 Mobile Stores, up from 305 now. It’s part of a plan to generate revenue from warranties, accessories and connections between phones, tablets and other electronics.⁴ Other trends influencing big-box values include omnichannel retailing and ‘Social Curation,’ both of which involve retailers leveraging shopper social data and insights to curate product assortment online and in-store. Retailers looking to differentiate themselves with shoppers will invest in ‘recognizing’ or knowing shoppers across platforms and routes to market and providing individualized, customized messaging and content through each.⁵ Some see a risk the brick-and-mortar store will evolve into a ‘showroom’ for the e-commerce vendor. That is, the consumer will find what he or she wants to buy online, then visit a store to view it, then return home and purchase it online; or, more recently, visit the store and scan the item of interest on a smartphone, then order the item on the spot from an online merchant. All of this information will be helpful in understanding functional and external obsolescence in the cost approach; rent, vacancy and cap rates in the income approach; and adjustments in the sales comparison approach.

VALUATION TERMS AND CONCEPTS

Experience has shown that all three traditional approaches to value—cost, sales comparison and income capitalization—are being used in the valuation of big-box realty. Sometimes, however, the applications

are flawed by fundamental mistakes with respect to what is being appraised. That is, the valuations typically reflect either investment value, value in use or value of the wrong interest. These errors are largely a result of confusion about very basic valuation concepts. A review of key terminology is a logical beginning toward an understanding of the valuation issues involved.

The following terms are at the heart of big-box valuation methodology.

Market Value: *The most probable price, as of a specified date, in cash or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.*⁶

A number of different definitions of market value can be observed in various publications, courses and case law, and it is important that the appraisal be based on the one applicable in the property’s jurisdiction. Most, however, share the same basic characteristics: the assumption of a sale of defined rights occurring on the date of appraisal, willing and typically knowledgeable buyer and seller, and reasonable exposure. It is also implicit that the buyer and seller are aware of—and the price is based upon—the property’s highest and best use, which is not necessarily its current use. Critical are which rights are being valued and the fact that a transfer of those rights occurs. It is not possible to get the value right if the type of value and the rights appraised are wrong. Misunderstandings such as these are at the heart of the confusion relating to the valuation of big-box realty.

Investment Value: *The value of a property interest to a particular investor or class of investors based on the investor’s specific requirements.*⁷

In contrast to market value, investment value is value to an individual, not necessarily value in the marketplace.⁸ It is obvious how a misunderstanding of these terms can result in erroneous valuations. Consider a jurisdiction where real estate assessments are to be based on the market value of the fee interest in the property. Assume the property is currently owner-occupied by a Lowe’s store for which it was custom built. Market value would be the price the property would fetch had it been offered on the open market to a pool of knowledgeable buyers. It would not

Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question

be the value to Lowe's. Furthermore, the custom features that distinguish it as a Lowe's big-box, such as size of building and exterior appearance, and for which Lowe's was willing to pay above and beyond what it would have otherwise cost, carry little if any value to a buyer other than Lowe's. In fact, for reasons illustrated in the earlier Circuit City to H. H. Gregg transaction, the buyer may pay less because they will have to spend money to "de-Lowe's" the property.⁹ This is analogous to the resale of a custom built house. Take the case of a very expensive house in Potomac, Maryland, just outside of Washington, D.C. The owner for whom the house was built put an indoor racquetball court in the lower level, which added \$70,000 to the original cost. It was very professionally built and state of the art. The owner loved the court. Upon resale, however, the seller learned a hard lesson: The market did not want a racquetball court, regardless of how nice a court it was. In fact, not only would they not pay more because the court was there, they actually penalized the price in an amount equal to the cost to convert the space to more traditional living area. This classic case of functional obsolescence is exactly what occurs when you must assume a sale of the Lowe's property. The question becomes how much would the market pay for the property (market value), not how much would Lowe's pay for the property (investment value).

Value in Use: *The value of a property assuming a specific use, which may or may not be the property's highest and best use on the effective date of the appraisal. Value in use may or may not be equal to market value but is different conceptually.*

The confusion with this term and market value, which assumes highest and best use, is similar to the confusion between market value and investment value. What happens is the appraiser looks at the building and sees the occupant, often the entity for which the building was built. The appraiser then makes a leap of faith and assumes that occupant/use is the highest and best use. This leads to value in use rather than market value. Again the focus must be on the assumption of a transaction. What would the hypothetical new buyer desire? Another Washington, D.C. example may help illustrate the issue. A local big-box home-improvement chain, Hechinger, existed here from 1911 to 1999. One of its vacated stores was end-cap space in a community shopping center in Loudoun County, Virginia. Although the space had been perfect for Hechinger, the owner of the center tried in vain for several years to re-lease the space. Because it was so large

and deep there were no takers. Ultimately, what the owner had to do was carve the space into three more traditionally sized stores, then string curtains across the back 20 feet and just lease the front part. No one wanted, or was willing to pay rent for, the extra depth that was so suitable for Hechinger. An appraiser confusing value in use with market value would ignore the functional obsolescence associated with the extra depth and tax the property on the basis of its value in use to Hechinger.

Fee Simple: *Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat.*¹⁰

The owner of the fee interest retains the right to sell, lease, occupy, etc. Therefore, the fee refers to the building/property vacant and available to be leased. It does not refer to being leased at market rates. Any lease would compromise the interest, as the owner would no longer have the right to occupy. The problem related to the misunderstanding of this term frequently manifests itself in sale/leaseback transactions. A sale/leaseback is defined as a financing arrangement in which real property is sold by its owner/user, who simultaneously leases the property from the buyer for continued use.¹¹ The property is never on the market for rent and is never vacant. The lease does not represent market rent for the real property; in fact, it is usually simply amortized construction cost, often to include interior leasehold improvements.¹² Because it represents the amortization of cost that reflects the original occupant's preferences, usually it is above market. Imagine if the house with the racquetball court were leased on the basis of its cost new. The full fare for the functionally obsolete court would be reflected in the rent so calculated. An appraiser valuing a sale/leaseback property will often take the rent so developed and capitalize it as representative of market rent. Furthermore, he usually ignores the fact that the fee simple assumption requires consideration for time and expense of lease up.

Leased Fee: *A freehold (ownership interest) where the possessory interest has been granted to another party by creation of a contractual landlord-tenant relationship (i.e., a lease).*¹³

Note that the definition does not just refer to situations in which the property is leased at above or below market rates, or something other than market rent. It refers to any situation in which the occupancy has been given up in exchange for rent. The confusion between leased fee and

Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question

fee simple seems to be the fallacy in logic that if a property is leased at market rent it represents the fee interest. When this confusion occurs the appraiser ends up valuing the wrong interest; in other words, he answers the wrong question.

Market Rent: *The most probable rent that a property should bring in a competitive and open market reflecting all conditions and restrictions of the lease agreement, including permitted uses, use restrictions, expense obligations, term, concessions, renewal and purchase options, and tenant improvements (TIs).*¹⁴

The keys to understanding the issues relating to this concept are “competitive and open market.” Just as with market value, market rent assumes exposure on the open market. The problem with many valuations of big-box realty involves a sale/leaseback or other prearranged financing arrangements in which the property is never exposed on the market. The rent was just a calculated number, based on the cost of construction to the occupant for whom the building was built. The fact that there are a lot of sale/leasebacks out there, and that they sell regularly, confuses many appraisers into thinking they must represent market rent.

Distress Sale: *A sale involving a seller acting under undue duress.*¹⁵

The way to establish that a sale was not distressed is verification that terms and conditions were conventional and under open competitive market conditions.¹⁶ Recall the issue with market value and the assumption of a transaction as integral to it. All first-generation big-box retail real estate is built to suit. That is, none is built speculatively, and then put on market for rent or sale. When valuing these properties under the assumption of a sale, the appraiser must assume the property was marketed for a reasonable exposure period to knowledgeable buyers. As a result, the hypothetical sales transaction would necessarily involve a second-generation buyer; that is, someone other than the current occupant. And there are a lot of second-generation transactions involving big-box retail real estate available. (Even if the appraiser were to include the current occupant as one of the pool of potential buyers, there is no reason the occupant should be willing to pay more than a dollar more than the rest of the pool. Why should he?) As described in the evolution of big-box realty section, trends indicate downsizing is prevalent, and a lot of the larger stores are either being sold or the occupant is looking for opportunities

to sublease space in the store. Walmart stores, whose Supercenters typically encompass over 185,000 square feet, has announced plans to build a number of 30,000–60,000 square foot stores.¹⁷ Target is planning smaller future stores because it is going into more urban locations where it is harder and more expensive to buy larger tracts of land. It is planning stores that will be 60,000 to 100,000 square feet, compared with 135,000 in a traditional Target. Office Depot could reduce store size from 24,000 square feet to about 15,000 to 17,000 square feet.¹⁸ Lowe’s recently experimented with a 50,000-square-foot Lowe’s Express model, which it premiered in Wall, New Jersey in June 2013.¹⁹ Lowe’s also recently purchased 72 Orchard Supply Hardware stores that average just 36,000 square feet of selling space compared to 112,000 square feet of selling space for an average Lowe’s store.

Another reason a big-box occupant might choose to move is to improve its productivity and increase profits.²⁰ This has nothing to do with the existing site being a bad location necessarily, rather it is simply a strategic decision based on a theory that tells us that the tenant will not immediately exercise this option (to relocate) until the net operating income exceeds the net operating income at the current store by an amount to compensate for the costs of moving, including possibly poorer sales at the new location.²¹

All of these are helpful in explaining why there is ample evidence of transactions of big-box stores in the second-generation market, and that these sales do not represent distressed property.

The problem occurs when the appraiser incorrectly classifies all second-generation sales as “distressed.” However, there is no distress to them. They receive a normal marketing time and typical exposure, and there is no undue duress involved with the seller. Ample evidence of this is found on the websites of most of the big-box retailers, (for example, [http://www.walmartrealty.com/Listings/#PropType\[\]=Buildings&Listings](http://www.walmartrealty.com/Listings/#PropType[]=Buildings&Listings) or <http://www.lowes-realty.com/search.aspx?t=buildingformerlowesstores>) where they list former stores being marketed for sale.

So, when the question is: what would the big-box store currently owner-occupied by a particular brand have sold for had it been offered on the open market for a typical exposure time—which is exactly the question being asked when market value of the fee interest is sought—these second-generation sales should not be viewed as distressed, but in fact are the best evidence of the correct

Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question

answer. Stated differently, the value of existing property must be based on the market for existing property...not on (the cost to future user of) 'to-be-built' properties.²²

Functional Obsolescence: *A loss in value due to something inside the property boundaries; it can be an overimprovement, an underimprovement, or something that is not there.*²³

A McDonald's store is one of the most easily recognizable pieces of real estate in the world. This is because they all exhibit the expensive trade dress that distinguishes them from other, usually freestanding retail food establishments. Both the exterior and interior are custom fit to McDonald's business image. If you were estimating the market value of the fee interest in the real property, however, none of these costly distinguishing features would be included. That is because, in answering the question of how much would this real estate have sold for on the open market had it been exposed for a typical exposure time—again, the question being answered when market value of the fee is asked—you would not be answering how much would McDonald's pay, but how much would a knowledgeable pool of informed buyers pay. As with the Circuit City example presented earlier, the answer is: a lot less than cost new. The expensive trade dress—so important to McDonald's—represents functional obsolescence when the property is put on the open market (either actually or hypothetically, as is required by the definition of market value).

External Obsolescence: *A loss in value due to something outside the property boundaries. An improvement may have been built just right, but something outside the property causes a loss in value. External obsolescence is caused by problems having to do with the location or the market.*²⁴

Then e-commerce leveled some of their big-box tenants, hurt others and ignited a downsizing trend.²⁵ After 50 years of putting mom-and-pops out of business, big-box retail is having a mid-life crisis. A slow economy has hurt same-store sales, narrowing margins at big stores. Meanwhile, consumers, armed with price-comparison technology, are visiting more stores seeking deals or exclusive merchandise rather than making one-stop, fill-the-cart excursions.²⁶ We're undergoing a seismic shift. People are still cutting back. People are buying more products online so there is a real case for downsizing stores.²⁷ All of this, plus changes in the location, etc., represents external obsolescence, which often explains

why cost new does not equal value. After all, depreciation is, by definition, the difference between cost new and value.²⁸ Failure to recognize external obsolescence—although not unique to big-box retail valuation—results in an overstatement of the value.

Intangible Assets: *Nonphysical assets, including but not limited to franchises, trademarks, patents, copyrights, goodwill, equities, securities, and contracts as distinguished from physical assets such as facilities and equipment.*²⁹

Any contribution to value created by intangible assets must be removed from the equation when market value of the real property is sought. If only tangible assets are subject to property taxation, then the value of monetary and intangible assets must be extracted as a first step.³⁰ With respect to big-box retail, the cachet associated with Lowe's, Walmart and others known worldwide is undeniable. The exterior colors and façade design send a clear signal to passersby that the business is in place. Any increment these intangibles create in rent, occupancy, capitalization rates and comparable sales must be removed.

Net Lease Properties: *In general, income-producing property leased, often for 20 years or longer, to a national creditworthy tenant. Some real estate market studies treat net lease properties as a distinct property type.*³¹

More specifically, however, the reference here is to single-tenant, free-standing retail real estate. Such properties are not leased on a square-foot basis, as is multi-tenant real estate. Rather, the rents are a function of property construction cost and, therefore, must be acceptable to tenants on the basis of anticipated business earnings potential...real estate appraisals do not take into consideration tenant economics. They instead emphasize landlord economics. Single-tenant retail properties are not leased in an auction marketplace because they are not speculatively constructed. Instead, single-tenant retail property rents are a function of the cost to build the property and are affected by long-term interest rates and credit risk...Consequently, a lease becomes essentially a mortgage substitute and is part of a corporate strategic financing decision...the link between rents and tenant economics is undeniably direct.³² So, these transactions have not been exposed to the market—which is a criterion of market rent—and thus do not represent indications of market rent. They are abundant, however, and are often

Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question

inappropriately incorporated into direct capitalization analysis. (They are abundant indeed, to the extent that there are numerous websites devoted exclusively to net lease properties. *NNEX.com*, for example, is a popular net lease site.) To use them as indications of market rent for the purposes of estimating the market value of the fee interest in a big-box real property analysis is wrong on a couple of levels. First, inasmuch as they are not rented in an auction marketplace (exposed on the market for a typical period of time), they are not representative of market rent. Secondly, because they represent contracts in place they are not representative of the fee simple interest. Using net lease transactions as comparables results, at best, in providing an indication of value (probably use value rather than market value) of the leased fee interest in the assets, which potentially includes both intangible and tangible personal property.

Build to Suits: *An arrangement where a landlord builds or alters a property to the specifications of the tenant and recovers the cost of the improvements as part of the rent.*³³

The issue relating to big-box retail and build to suits has already been introduced. In effect, the properties are never built speculatively and then placed on the market for either sale or rent. Rather they are custom built to suit the needs of a particular entity. As such, whether or not they reflect the market is a function of whether or not functional obsolescence exists. However, if the product were for all intents and purposes generic, as some would suggest, then one would expect to see speculative construction. The fact that they are never built speculatively strongly indicates they are not one-size-fits-all. When the costs of the build to suit are used as a proxy for market value the appraiser inappropriately mixes value in use with market value. Referring again to the earlier example of the house with the racquetball court, were cost equal to value the sales price on the open market would have equaled not penalized the cost of construction.

THE THREE APPROACHES TO VALUE AND MARKET VALUE OF THE FEE INTEREST

All three of the traditional valuation approaches are potentially applicable in the market value estimate of the fee interest in big-box realty. Whether or not an approach can be used is a function of the availability of data and support for the elements of its application, as well as legal rules, regulation and precedent in the specific jurisdiction. As will be demonstrated, all of the terms and concepts

reviewed earlier factor into the correct methodology for each of the three approaches.

Sales Comparison

The definition of market value asks the question, what is the most probable price for which the subject property would have sold under specified conditions? As such, sales comparison becomes a compelling approach when it is market value that is sought. The key to correct application is identification of comparables that match the criteria of the definition. Recall, regardless of whether the occupant has any intention of selling, an opinion of market value demands the assumption of a willing seller. So, if Lowe's is occupying a building custom built by them for them, and an appraiser is asked to estimate its market value, the appraiser must assume the vacant building will be turned over willingly. It follows then that the very best comparable sales would be sales of vacant big-box buildings, and there is ample evidence of these transactions.

A study of multiple sales of both Lowe's and Target real property revealed surprisingly consistent sales prices per square foot of building. Of 11 transactions of Lowe's properties, the prices ranged between \$18.48 and \$39.34 per square foot. If the one high and one low extreme are excluded the range tightens to \$19.34 to \$29.00. These transactions occurred between March 2010 and December 2013, and across eight different states. If adjustments are considered for slight differences in store age and condition, building size, lot size, location, and market conditions, the range tightens even more. The Target sales are equally compelling. From the 20 transactions studied the unadjusted range was \$19.04 to \$45.52. When the two highest and two lowest transactions are removed the range tightens to \$19.47 to \$33.12, remarkably similar to the Lowe's sales range. The Target sales occurred between October 2011 and September 2013 and across ten states. In addition, on April 2, 2014, Walmart Realty publicly listed 25 big-box properties for sale on <http://www.walmartrealty.com>. Of these, 16 ranged between \$22.39 and \$33.74.

These are very convincing sales data. So, where do appraisers go wrong when applying sales comparison? There are a couple of mistakes made regularly. First, instead of using properties such as those summarized, which reflect the type of value being sought and the correct rights to be appraised, uninformed appraisers rely exclusively on sale/leaseback transactions, which

Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question

more closely reflect value in use for the leased fee interest. In other words, the appraiser answers the wrong question. Furthermore, recognizing how a sale/leaseback transaction develops reveals how unrepresentative of the market value of the fee it is. Using an example: suppose Walmart buys a site and has a big-box custom built to its business standard. Once occupied, Walmart sells the property to an investor and leases it back, never vacating the building. The rent, of course, was never exposed to the market and is simply a function of Walmart's cost to acquire and construct. However, by selling then leasing back, in effect, Walmart gets back what it invested and is able to replicate the process on another site. In other words, it achieves 100 percent construction financing for its developments. Now suppose the investor turns around and sells the leased fee interest he/she holds to a second investor. The buyer is buying the very secure—bond-like— income stream from Walmart that usually extends 20 years. Notice, the income stream that is bought is the same one the first investor purchased, the income stream that was never exposed on the market. So, it should be obvious that using such a sale would hardly represent the market value of the fee interest. In summary, sale/leaseback transactions present difficulties as comparable sales. Such transactions are frequently financing arrangements in which the seller often agrees to an above-market lease rate in return for an above-market sale price. Due to the problems in deriving accurate market based adjustments for such factors, the sale may not provide a reliable indication of value. The appraiser may consider avoiding the comparable altogether or at least using extreme caution.³⁴

A second problem is the use of property-purchase decisions that are affected by tax considerations, such as Section 1031 tax-deferred property exchanges.³⁵ These transactions, in simple terms, (involve) a trade of real estate and/or other considerations, such as cash, between two or more investors to accrue tax benefits. The name, Section 1031 exchange, relates to the IRS Tax Code section, which permits and governs such transactions. The 1031 exchange could involve one or more parcels from each investor being traded for other properties. As with sale/leasebacks, there are benefits and considerations beyond just real estate in making these transactions.³⁶ A further issue with 1031 sales is the necessity to complete the transaction within an often tight window of time.

Income Capitalization

Income-producing real estate is typically purchased as an investment, and from an investor's point of view earning power is the critical element affecting property value.³⁷ As such, as a valuation method that explicitly incorporates the income generating potential of the property it is particularly well suited to the valuation of these properties. While big-box retail real estate is frequently owner-occupied, much is leased. (Target and Lowe's, for example, want to own, not rent. Although they are willing to lease land and construct their leasehold improvements on it, they prefer not to rent improvements.) As such, careful consideration of the income approach in the valuation of these properties is essential. Almost always direct capitalization (rather than yield capitalization, which includes discounted cash flow analysis) is the income capitalization method used for assessment valuations. In fact, several courts will not allow discounted cash flow analysis as they consider it too speculative.

There are four primary components to correct application of direct capitalization: Potential gross income, vacancy and collection loss, operating expenses and an overall capitalization rate. However, given the characteristics of these big-boxes, a direct capitalization model most likely would involve a single tenant and a net lease. Therefore, vacancy—at least as a stabilized matter—and expenses can be eliminated from this discussion. So, one might consider potential gross income and the capitalization rate, as these are the two components that cause the most problems in the faulty valuations.

Potential Gross Income

The problem with estimating the market rent is the same problem that occurs in the sales comparison approach with comparable selection: it must be based on comparables that represent an amount a willing landlord and willing tenant agreed to after typical exposure on the open market. In other words, it must meet the definition of market rent. As with the second generation sales, there are lots of second generation rentals. Walmart Realty, for example, provides lists of available rentals on its website, and includes professional marketing brochures that detail building, site and area demographics. Similar information is readily available from other big-box owners as well. These are not "fire-sale" opportunities, but represent professionally marketed real estate transactions. As such, these rates represent the best answer to the question, for

Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question

how much would the subject have rented had it been exposed on the market for a typical exposure period? Faulty appraisals, on the other hand, use the build to suits and sale/leasebacks as their comparables. These rental rates, however, were not based on market rent criteria. Instead they represent amortization of custom built construction costs.

Overall Capitalization Rates

An overall capitalization rate is simply that metric that equates one year's net operating income to value. Market value of the fee interest is equal to one year's net operating income, based on market rent, divided by a market derived overall capitalization rate, less any necessary costs associated with lease up. If an ex-Walmart property sold for \$30 per square foot and was rented at a market rate of \$3.00 at the time, then the indicated overall capitalization rate that could be extracted from it would be 10 percent ($\$3/\30). The best evidence of an appropriate capitalization rate to apply to an estimate of the subject market rent would be extraction from market sales that were rented at market rates at the time of sale. Instead, however, faulty appraisals are based on capitalization rates that are either extracted from sale/leaseback transactions or taken from websites and publications, such as PricewaterhouseCoopers quarterly *Real Estate Investor Survey*, using the "national net lease market" section. These rates, however, answer the question of how much should an investor pay for the right to receive the bond-like income stream generated from the sale/leaseback? For the same reasons that sale/leaseback rent isn't equal to market rent and sale/leaseback sales prices are not equal to market value of the fee interest, sale/leaseback capitalization rates are not applicable to the answering the question asked in a real estate assessment of big-box property. Even when the correct comparables are used to develop market rent and the correct evidence is used to develop the overall capitalization rate, the appraiser (still) must account for an absorption period to achieve occupancy by a tenant.³⁸ This is because, by definition, fee simple means vacant and available to be leased, not as if already leased at market rates.

Cost Approach

The cost approach is most applicable in valuing new or proposed construction when the improvements represent the highest and best use of the land as though vacant and the land value is well supported.³⁹ The method comprises three parts: site value as if vacant, cost new of improvements, and depreciation. Almost all problems

with this approach emerge from a mishandling of the latter, depreciation, with much of the error due to a confusion of value in use with market value. As with the other two approaches reviewed, the objective of a properly applied cost approach is an estimate of market value. As a result, those features—whether building size, custom finishes, ceiling heights, building depth, etc.—for which the market would not be willing to pay are deducted as obsolescence. It is important to emphasize that the approach is *not* seeking to identify how much the entity for which it was built would be willing to pay, but how much the *market* would be willing to pay. Correctly calculating depreciation is how cost-new is distinguished from value and how value in use is converted to market value.

Site Value

The site value estimate is usually straightforward. Keys to proper application are using comparables that are similar in size, location, highest and best use, and market conditions. Traffic, access and demographics are critical to location, and excess land can be an issue with size. Two other truisms: larger sites usually sell for a lower unit price than otherwise equal smaller sites. So, a 20-acre site might sell for \$2.00 per square foot while an otherwise equal 10-acre site might sell for \$2.50 per square foot. Surplus land often has a lower unit rate than the primary site, although not always. So, if 12 acres were needed to accommodate the improvements, and the site comprised 18 acres, the six acres of extra land would probably command a lower unit rate, all else equal. The exception would be when the extra land had a separate highest and best use and could be sold off for that purpose.

Cost New of Improvements

The cost to construct an improvement on the effective appraisal date may be developed as either the estimated reproduction cost or estimated replacement cost of the improvement.⁴⁰ If applied correctly, both reproduction cost and replacement cost will result in the same value; however, there is an important and germane difference between the two. Reproduction cost represents the cost to construct a replica of what exists; while replacement cost is cost of a substitute of what exists, using contemporary materials, standards, design and layout. So, suppose one was estimating the cost new of a Costco store that had 30-foot ceiling heights—10 feet higher than market standard. The additional cost of building the extra 10 feet plus the excess utilities expense it creates is functional obsolescence—superadequacy. The entire 30 feet would be

Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question

included in the *reproduction* cost new estimate, and then the value loss represented by the excess would be deducted as depreciation. Only the market standard 20 feet would be included in the *replacement* cost new estimate, but no depreciation for this item would be deducted, other than that for the excess utilities expense. Errors occur when an appraiser uses replacement cost new, and then deducts depreciation for the excess ceiling height. That would be double counting the obsolescence. Or, more likely, the appraiser uses reproduction cost of the 30 feet and makes no deduction for the superadequacy. Again, while he/she may be correctly estimating the value to Costco (value in use), it would represent an incorrect estimate of market value.

Depreciation

Depreciation is simply the difference between cost new plus site and market value. If cost new plus site equals market value, then there is no depreciation. There are three primary categories of depreciation and three primary methods of measuring it.

The three categories of depreciation are physical deterioration, functional obsolescence and external obsolescence. Physical deterioration refers to simply aging, the wearing out process. Functional obsolescence, on the other hand, refers to a flaw in the structure, materials or design of the improvements. It can occur when the subject does not have a feature the market demands (air conditioning, for example), or when it has a feature for which the market is unwilling to pay (the excess ceiling height). External obsolescence is a loss in value caused by factors outside a property. Examples include effects of the 2008 financial crisis (which would be properly labeled external obsolescence—economic) and location on a highway that only allows right turn in and right turn out (which would be labeled external obsolescence—locational).

The three methods of measuring depreciation are economic age/life, market extraction and breakdown. The latter is not particularly practical for these assignments so it will not be discussed further. Suffice it to say, the difference between it and the other two methods is that the breakdown method is much more comprehensive and treats each of the elements of depreciation separately, while the other two are limited in that they require that lump-sum depreciation from all causes be expressed in an overall estimate, which is rarely accurate if obsolescence is present.⁴¹

Economic age-life is used most frequently because of its apparent simplicity. It will work, but only if the appraiser accurately identifies the property’s effective age and total economic life—often both are quite different than chronological age and total physical life. Furthermore, the more obsolescence that exists, the less likely this method will accurately capture total depreciation. And given the issues that have been described earlier, it is obsolescence that distinguishes value in use from market value.

A better method is market extraction. It is realistic and efficient as long as market sales exist, and as has been explained, they are abundant with this property type. To use an example to illustrate how it works, consider the following comparable transaction (ideally, depreciation would be extracted from more than one transaction).

Figure 1

Sales Price (adjusted for all transactional elements of comparison):	\$3,750,000
<i>Less Site Value</i> by sales comparison	(\$750,000)
Value of the improvements:	\$3,000,000
Cost-new of improvements (as of date of value)	\$5,000,000
(125,000 sf x \$40/sf)	
Depreciation	
In dollars	\$2,000,000
In percent	40%
Percent good	60%
Age	13 yrs
Percent per year (assumes straight line)	3.08%
So, if the subject cost new was \$5,400,000, and it was 10 years old and the site value was \$950,000, the indicated market value would be calculated as follows:	
Subject Cost-new of Improvements	\$5,400,000
Less Depreciation from all causes (3% x 10 years)	\$1,620,000
Indicated Improvement Value	\$3,780,000
Estimated Site Value	\$950,000
Total Indicated Value by Cost Approach (fee simple)	\$4,730,000
Source: David Lennhoff	

Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question

An appraiser might erroneously use the *Marshall Valuation Service* depreciation tables to calculate depreciation with, say, an effective age of eight years and a total life of 40 years, and conclude eight percent total depreciation, and thus overvalue the property, all else being equal, by 25 percent ($\$5,400,000 \times .92 + \$950,000 = \$5,918,000$). As emphasized in standards for federal land acquisitions, the estimating of depreciation by use of published tables or age-life computation is to be avoided.⁴²

Reconciliation

This somewhat overlooked step in the valuation process requires the appraiser to evaluate the strengths and weaknesses of each approach applied and explain how he/she got from them to the final opinion of value. It is not an averaging process. So, when an appraiser uses sale/leaseback transactions as indications of subject market rent and an overall capitalization rate, and sale/leaseback transactions as sales comparables, an explanation will be needed as to how the indications by them apply to a fee simple conclusion. A cost approach—without adjustment—provides an indication of the fee interest; however, without proper treatment of depreciation, especially obsolescence, it is likely an indication of value in use of the fee interest. As with other approaches, perhaps a right answer, but to the wrong question.

A FEW RECENT DECISIONS RELATING TO BIG-BOX ISSUES

A comprehensive survey of case law relating to this topic is better left to an attorney; however, this discussion will summarize a few decisions that address the issues explicated in this white paper. Although obviously not exhaustive, these decisions report an understanding of the concepts presented, and the erroneous results obtained when these concepts are violated.

Lowe's Home Centers, Inc., v. Township of Marquette

Home Depot USA, Inc. v. Township of Breitung

State of Michigan Court of Appeals of Michigan
Tax Tribunal Decision

LC No. 00-385768 April 2014

LC No. 00-366428 April 2014

The Lowe's decision arises out of taxpayer consolidated appeals of ad valorem property tax assessments for two big-box retail stores located in the Upper Peninsula. The tribunal found in favor of the taxpayers in both cases and rejected the townships' assessments of the subject

properties. The key issue was the use of second generation sales by the taxpayer's appraiser. All of his comparables were sales of vacant and available big-box properties, instead of sale/leaseback comparables of occupied properties, which were used by the jurisdiction's appraiser. The appeals court decided the taxpayer's appraiser "properly valued the TCV of the fee simple interest in the subject properties."

CVS v. City of Richmond

Michigan Tax Tribunal

Docket 425425 October 2012

The City of Richmond opinion dealt with the appeal of the real estate tax assessment for a CVS Pharmacy store in Macomb County, Michigan. The Petitioner's appraiser relied primarily on sales comparison while the Respondent's appraiser relied on a cost approach. The tribunal concluded sales comparison was the most useful valuation method in determining true cash value of the subject property. The Petitioner's appraiser successfully established that pharmacy retailers are not motivated by the resale value of the stores and that secondary uses of such properties "result in a lower market value than the original construction cost." The tribunal continued: "like big-box stores, modern pharmacies and drugstores are specifically constructed to meet the design, location, and physical requirements of one major retailer's business needs. The build-to-suit nature of these properties creates a certain degree of functional and economic obsolescence." The Respondent's appraiser selected comparables of sale/leaseback transactions. The Petitioner's appraiser relied only on sales that were vacant and available at time of sale. The tribunal concluded: "sale/leasebacks are not true sales, but are more in the nature of a financing tool similar to a mortgage" [and] "finds that sales (the sales of vacant and available properties) best represent the fee simple interest in the subject property."

Meijer Stores Limited Partnership v. Franklin County Board of Revision and Marvin J. & Ursula F. Siesel, Shops at Waggoner LLC, and Fifth Third Bank

Supreme Court of Ohio Appeal from the Ohio
Board of Tax Appeals

BTA Case Nos. 205-T-441 & 443 February 2009

This review of a decision by the Ohio Board of Tax Appeals concerning a Meijer's big-box property embraces all of the issues presented in a 2009 article that Lennhoff wrote for *The Appraisal Journal*, which the court

Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question

cites repeatedly.⁴³ Specifically, the court concludes: “it is clear from the report and the testimony before the Board that [Respondent’s appraiser] focuses on the value in use of the subject property to the occupant for which it was originally designed and built...and intertwines the non-real estate business value of the owner occupant with that of the real estate.” [The Petitioner’s appraiser’s] “opinion is of the value at which the fee simple interest in the subject property would sell for in the open market while [the Respondent’s appraiser] indicated the value to the current owner/occupant and not what it would sell for on the open market.”

SUMMARY AND CONCLUSIONS

The key issues at stake in the estimation of market value of the fee interest in big-box real property are value in use vs. market value, leased fee vs. fee simple, second generation transactions vs. build to suits and market rents and sales vs. sale/leaseback rent and prices. All of these are interrelated to a point, and when misunderstood, result in an appraiser at best providing the right answer to the wrong question. The credibility of the assessment is compromised when value in use of the leased fee interest is substituted for market value of the fee interest. On the other hand, with a firm understanding of these fundamental concepts, an appraiser is able to correctly value the mandated basis of ad valorem tax, which is usually the market value of the fee interest. ■

ENDNOTES

1. Michael Fickes, “Re-inventing Power Centers,” <http://www.chainstoreage.com>, (October 2013), p. 46.
2. Ibid.
3. Mark Sprague, “The Era of Big Box Retail Dominance is Coming to an End,” <http://independencetitle.com/the-era-of-big-box-retail-dominance-is-coming-to-an-end>, (November 2012).
4. Ibid.
5. Justin Honaman, “Top 6 Retail Trends to Watch in 2014,” <http://risnews.edgl.com/print>, (January 2014).
6. Appraisal Institute, *The Appraisal of Real Estate*, 14th ed. (Chicago: Appraisal Institute, 2013), p. 58.
7. Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 5th ed. (Chicago: Appraisal Institute, 2010), p. 105.
8. *The Appraisal of Real Estate*, op. cit., p. 63.
9. Martin A. Skolnik and Gary E. Heiland, “Big Box Retail Properties: Pitfalls of Valuation,” Working Paper, p. 366.
10. *The Dictionary of Real Estate Appraisal*, op. cit., p. 78.
11. Ibid., p. 175.
12. Skolnik and Heiland, op. cit., p. 368.
13. *The Dictionary of Real Estate Appraisal*, op. cit., p. 111.
14. Ibid., p. 121-122.
15. Ibid., p. 60.
16. Interagency Land Acquisition Conference, *Uniform Appraisal Standards for Federal Land Acquisitions* (Chicago: Appraisal Institute, 2000), p. 38.
17. David Kaplan, “Stores Reversing Big-box Trend,” <http://www.chron.com/business/article/Stores-reversing-big-box-trend>, (*Houston Chronicle*, April 2014).
18. Ibid.
19. Michael L. Diamond, “Smaller Lowe’s Express in Wall is First in the Nation,” <http://www.tmcnet.com/usubmit-smaller-lowes-express-wall-first-the-nation>, (*Asbury Park Press*, June 2013).
20. James D. Shilling, Tammie X. Simons-Mosley, and Stephen F. Thode, “Stand-Alone Centers Occupied by Big-Box Retailers,” *The Journal of Portfolio Management* (Special Issue 2005), p. 125.
21. Ibid., p. 127.
22. Michael B. Shapiro, “Big-box Retailers Beware How Assessors Overvalue Your Property,” <http://www.NREOnline.com>, (September 2000), p. 52.
23. E. Nelson Bowes, *In Defense of the Cost Approach* (Chicago: Appraisal Institute, 2011), p. 20.
24. Ibid., p. 21.
25. Fickes, op. cit., p. 44.
26. David Welch, Chris Burritt, and Lauren Coleman-Lochner, “The Era of Big Box Retail Dominance is Coming to an End,” <http://www.bloomberg.com>, (March 2012).
27. Natalie Berg, <http://www.topics.bloomberg.com/london/>.
28. *The Appraisal of Real Estate*, op. cit., p. 576.
29. Appraisal Foundation, *Uniform Standards of Professional Appraisal Practice*, 2014–2015 ed. (Washington, D.C.: Appraisal Foundation, 2014), p. U-3.
30. Gordon V. Smith and Russell L. Parr, *Valuation of Intellectual Property and Intangible Assets*, 3rd ed. (New York: John Wiley & Sons, Inc., 2000), p. 443.
31. *The Dictionary of Real Estate Appraisal*, op. cit., p. 134.

Valuation of Big-Box Retail for Assessment Purposes: Right Answer to the Wrong Question

32. Christopher H. Volk, "Single-Tenant Retail Real Estate Valuation and Financing: An Enterprise Approach," *The Real Estate Finance Journal* (Spring 1997), pp. 49–51.
33. Henry S. Harrison and Julie S. Harrison, *Illustrated Dictionary of Real Estate and Appraisal* (Reston: Reston Publishing Company, Inc., 1983), p. 35.
34. The Appraisal Foundation, "APB Valuation Advisory #2: *Adjusting Comparable Sales For Seller Concessions*" (Washington, D.C.: Appraisal Foundation, March 2012), p. 15.
35. Christopher Volk, op. cit., p. 53.
36. Skolnik and Heiland, op. cit., p. 369.
37. *The Appraisal of Real Estate*, op. cit., p. 439.
38. Skolnik and Heiland, op. cit., p. 364.
39. *The Appraisal of Real Estate*, op. cit., p. 566.
40. *Ibid.*, p. 569.
41. *Ibid.*, p. 598.
42. Interagency Land Acquisition Conference, op. cit., p. 20.
43. David C. Lennhoff, "You Can't Get the Value Right If You Get the Rights Wrong," *The Appraisal Journal* (Winter 2009), pp. 60–65.