

A Better Approach in the Assessment and Valuation of Free-Standing, Single-User, Retail Properties

By Rich R. Correll

Professionals in taxation, appraisal, and law have struggled to find common ground in the resolution of real estate tax appeal cases involving single-occupant, free-standing, retail properties. Such properties include free-standing drugstores, restaurants, and big-box retail assets.

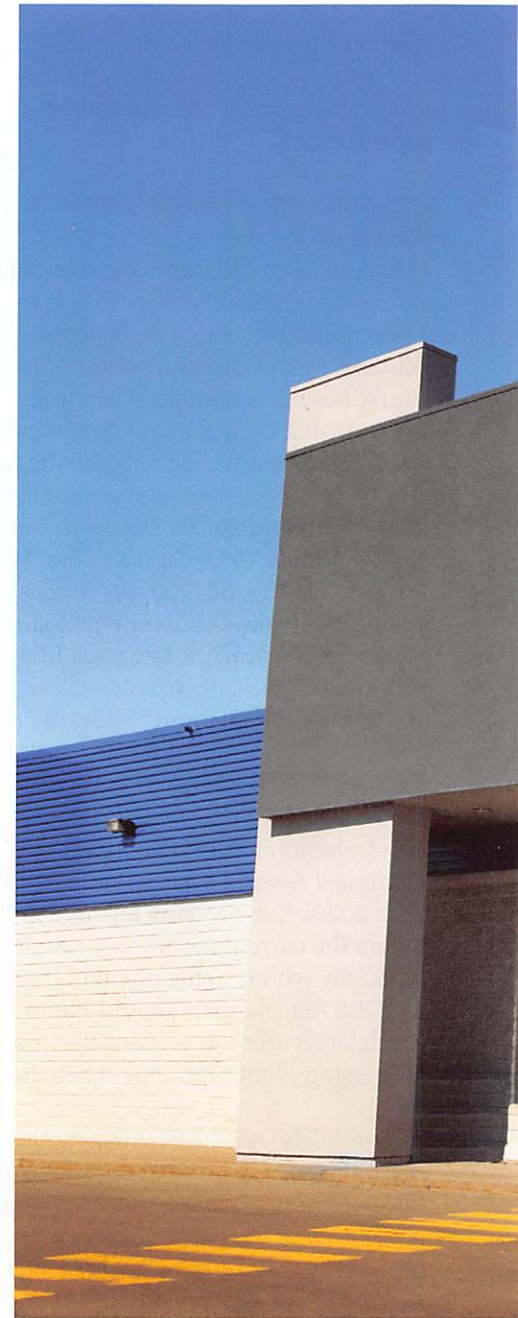
The sophistication of investment markets centered on triple-net leased retail properties, consolidation of retail categories, and evolution of the “Big Box” retailer as the dominant player in many major retail categories has given rise to confusion in government on how to handle these assessments. Each state or jurisdiction has sought to develop criteria or explain how it approaches the assessment of these types of properties.

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Professional organizations such as the International Association of Assessing Officers (IAAO) and the Appraisal Institute (AI) have published detailed white papers on methodology and practice standards. Much has been written on the concepts, techniques, and definitions that are appropriate in the valuation of the property interests involved in these cases, but disagreements remain.

The most attention has been garnered by the use of the sale of vacant retail properties as a basis for the value or assessment of their occupied counterparts. Both government entities and the tax-paying public have voiced opposition to the concept of using vacant property sales as a basis for occupied property assessed values.

The birth of the term “Dark Box Theory,” an ominous-sounding description of vacant retail stores, has given rise to increased disagreement among all parties. On the private property ownership



side, the use of sales of vacant properties as a basis for assessments leans toward the low side of values. On the government or assessor side, the use of leased fee sales provides the highest basis for assessment, and those investment transactions are regularly selected as a basis for assessments.

The IAAO’s *Glossary for Property Appraisal and Assessment* defines



“assessed value” for real estate as “[a] value set on real estate by a government as a basis for levying taxes.”

There are varying types of value, including insurable value, use value, market value, fair cash value, and market value in use. There are also varying interests in real estate, including fee simple, leased fee, and leasehold, among others. And there are varying approaches in the appraisal of real

estate interests, including the use of replacement costs, income benefits, and sales analysis.

This variation can be confusing, especially when combined with the reality that a free-standing occupied retail property has various and differing values, depending on the type of value being considered and the interest that is being valued. The arguments relating to methodology for assessment have been

heated, and one of the primary sticking points is the concept that the value of an occupied property is not the same as that of a similar vacant property.

In a *USA Today* article it was reported that a local Appleton, Wisconsin, government passed a resolution to ensure that “occupied commercial properties are valued differently than vacant commercial properties.” The article states: “An onslaught of retailers such

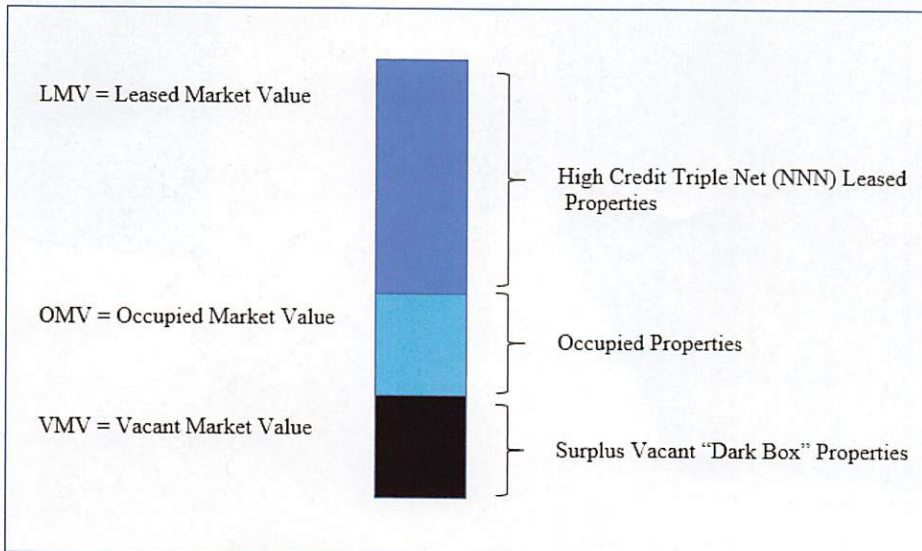
Occupied Walgreens



Vacant Walgreens



VALUE CHART 01



as CVS or Target want to have the city assess their occupied property values like vacant storefronts and city officials are poised to take a stand against the practice." Madeleine Behr, *Appleton Takes on "Dark Store" Loophole*, USA Today (Mar. 2, 2017).

The public, politicians, and local governments are often unwilling to accept that a vacant property value can be the basis for the assessment of an occupied similar property. This makes sense in basic terms, as "occupancy" suggests that a property is serving its designed purpose and value is perceived.

By February 2019, the issue remained heated and unresolved, as described in a TV news report: "The loophole is designed to give big-box retailers a break by allowing an operational store to be assessed based on the value of a closed property." Jason

Zimmerman, *Area Communities Reveal How Much They're Losing under Wisconsin's Dark Store Loophole*, WBAY.com (Feb. 6, 2019, 6:55 PM CST).

Within the United States, major chain retailers in both big- and small-box categories are in fierce competition and in a constant cycle of expansion for market share, realignment within established markets, and disposition of older or nonperforming assets. To recover capital costs and maintain capital liquidity, many retailers structure triple-net leases to create credit-based leased fee investments, adding another value to the mix of choices for assessment.

In March 2019, the Appraisal Institute released an Exposure Draft of a Proposed Guide Note that deals with appraising interests in real property with various applications. One of the key points of the Guide Note, as it

relates to free-standing retail properties, is the following:

"Fee simple" may or may not mean a leased property is valued as though unleased and available for lease. Whether the property is, or is presumed to be, leased, unleased, available for lease, vacant, etc., is a premise of the valuation that must be clearly identified and disclosed.

In essence, the Guide Note is saying that sales of vacant free-standing retail properties may or may not provide a basis for the value of a leased similar property.

In September 2017, the IAAO published *Commercial Big-Box Retail: A Guide to Market-Based Valuation*. One of its key points is the following: "A lease is a possessory right, and a property may be held in fee simple, subject to a lease." *Id.* at 6.

Both of these contentions lean toward occupancy as a factor in valuation, which opens the door to lease influence. Simply put, when a property is occupied, it is not to have an assessed value that is based upon the sale prices of vacant "Dark Box" properties.

The problem with these contentions is that the sale price of a vacant commercial property is the purest form of fee simple interest transaction that can be found to prove the cash value of a real estate interest. Even though this is true, the public, government, and related parties may not accept that "vacant property" has the same value as "occupied property." It is true that

perception matters in decision-making and dispute.

One way to bridge the gap is by using standard appraisal methodology, along with some concepts that are useful in communicating how markets function. The following chart shows how typical free-standing retail properties can be profiled.

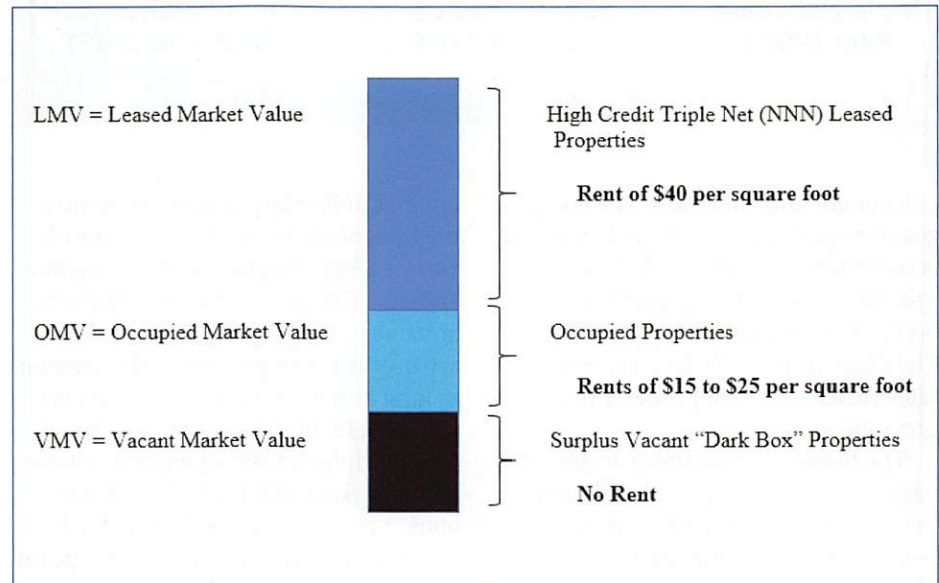
At the top of the chart on page 38 are triple-net (NNN) leased retail properties. These interests in property are backed by the credit of the tenants and are actively traded in the national investment market. These prices, *for the leased fee interest in these properties*, will be at the highest value, as these investments are commingled with specific credit lease agreements. It is not a “sticks and bricks” value but more akin to the bond market. We will call the values in this class of prices the leased market value (LMV).

At the bottom of the chart are the vacant “Dark Box” retail properties. These may be surplus assets of major retailers or vacant assets resulting from failure. This type of real estate may be purchased for retail use or alternative uses. These prices are likely to be the lowest of the group, but this is not always true, and these sales are the purest in the valuation of just “fee simple real estate for some use.” The use could continue as a retail property or be converted to another use. These surplus “Dark Box” type properties we will identify as vacant market value (VMV).

In the middle of the group are occupied properties. This group consists of properties that are free-standing, range in size, and are occupied by retailers within different business categories. Within the United States, a large number of free-standing retail properties are occupied by national chains. They frequently engage in the sale-leaseback strategy so they can remain competitive to companies within their category. Examples include Walgreens and CVS, Advanced Auto and Auto Zone, Pop-eye’s and KFC, and Lowe’s and Home Depot. These transactions represent the LMV category.

Both the public and those in government finance struggle with a solution

VALUE CHART 02



| | LMV | OMV | VMV |
|---------------------------------|--------------|--------------|--------------|
| Property Size/SF: | 10,000 | 10,000 | 10,000 |
| Rent per SF (NNN): | \$40 | \$20 | N/A |
| Gross Potential Income: | \$400,000 | \$200,000 | N/A |
| - Market Vacancy Factor: | <u>-5.0%</u> | <u>-5.0%</u> | |
| Effective Gross Income: | \$380,000 | \$190,000 | N/A |
| CAP Rates: | <u>6.00%</u> | <u>8.50%</u> | N/A |
| Valuation: | \$6,333,333 | \$2,235,294 | \$1,000,000 |
| Value per SF: | \$633 | \$224 | N/A |
| Dark Box Sales per SF: | N/A | N/A | \$100 |

for occupied real estate assessment and value that aligns with fairness and established appraisal methodology and that can be applied uniformly across markets and property types.

The author’s proposed solution bridges the gap with a foundation in established appraisal methodology and a commonsense application

to give recognition to occupancy as an influencer on value without the commingling of credit-based, long-term lease contracts.

Valuation—Street Retail Model

This article has established that occupancy matters in the analysis of free-standing retail properties for

| Triple-Net Lease Rent (PSF) | Street Retail Leased Low End (PSF) | Street Retail Leased High End (PSF) |
|-----------------------------|------------------------------------|-------------------------------------|
| \$40 | \$15 | \$25 |

assessment and valuation. The author's goal is to provide a framework that both is consistent with established appraisal principles and gives recognition to occupancy and its influence on value. The chart on page 39 displays rental rates for each class of property from the previous example.

The highest rent in the example on page 39 is \$40 per square foot; this is the rate for a high-credit, triple-net, long-term leased property. It is probable that this rent was developed under a build-to-suit contract and is a part of a sale-leaseback contract that is backed by the credit of the tenant. The reason this rent, and a value based upon a credit-based triple-net lease transaction, is not a good basis for assessment is the existence of commingling of non-real estate elements. An investor in these types of properties is mostly concerned about the risk related to the

tenant's ability to pay on the contract; the level of the rent, whether it is \$30, \$40, or \$50 per square foot is not really an issue. Further, the location, age, size, or value of the property to a secondary user is not important to the investor as long as it is confident that it can get paid a yield on the long-term contract.

The triple-net leased property investment market is a multibillion-dollar market that is financeable and much more active than the comparable vacant property market, but those investment transactions are not reliable for real property assessments.

Besides the high rent of the triple-net investment property, we show retail market rents "along the street," or within the market area. These range from \$15 to \$25 per square foot.

Valuation Example

With these rents, we can apply the

following assumptions: a 10,000 SF free-standing retail property, market rent of \$20 per square foot triple-net, deductions for vacancy at 5 percent, and cap rates of 6 percent (for the net leased value) and 8.5 percent (for the fee simple occupied market value).

The three columns in the example on page 39 show the concepts of leased market value (LMV), occupied market value (OMV), and vacant market value (VMV). For the VMV, we have not renovated the property and estimated a market rent, so the value is based on sales prices of comparable vacant properties. The LMV is based on the long-term credit lease that is in place, and the cap rate reflects that high credit investment market. In the middle is the OMV, which is derived from local market data, including local retail rents. The resulting values are \$6.3 million for the LMV, \$2.2 million for the OMV, and \$1 million for the VMV. The example shows the vast disparity of values that can be measured for varying interests in a single property. The goals of this methodology are to account for occupancy as an influencer of value, thus satisfying the dispute between "Dark Box" values and the value of an occupied property, and to show the weakness of credit-based investment transactions as a basis for assessments.

Summary

The methodologies that have been used by appraisers and assessors in the valuation and assessment of occupied free-standing retail properties have resulted in disagreement and a public outcry for fairness. The attempt by professional associations and government to add clarity and find common ground via discussion papers and policy has led to more confusion. Within these arguments, the concept of occupied property value versus vacant property value resonates loudly. This article provides a solution that has a strong foundation within established appraisal practice and adds some terminology—LMV, OMV, and VMV—to better communicate concepts that can otherwise remain elusive. ■

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