Valuation

Understanding the Basics

Define the Problem

IDENTIFY THE PROPERTY TO BE VALUED

STATE THE RIGHTS TO BE VALUED

WHAT IS THE VALUATION DATE

IDENTIFY THE INTENDED USE AND USERS

AGREE ON THE DEFINITION OF VALUE

DETERMINE NECESSARY EXTRAORDINARY ASSUMPTIONS AND HYPOTHETICALS

Value

- Causation: An item has value if it has scarcity, utility, and desirability and is backed by purchasing power.
- Different properties/items have a different value to different segments of the market.
- Value is set by the circumstances, influences and agreements of the supply (sellers) and demand (buyers) sides of the market.
- Value and Cost are not always equal

Economic Principles to Value

1. Principle of Anticipation – expected future benefits
2. Principle of Change - market value is never constant
3. Principle of Balance - state of equilibrium
4. Principle of Competition - Availability in harmony with demand
5. Principle of Conformity - reasonable similarity among improvements
6. Principle of Consistent Use - Entire property valued with a single use
7. Principle of Contribution - The value of a component depends on its contribution to the whole.
8. Principle of Increasing & Decreasing Returns - After some point, addition of more of something will decrease future incomes or amenities.

Economic Principles to Value

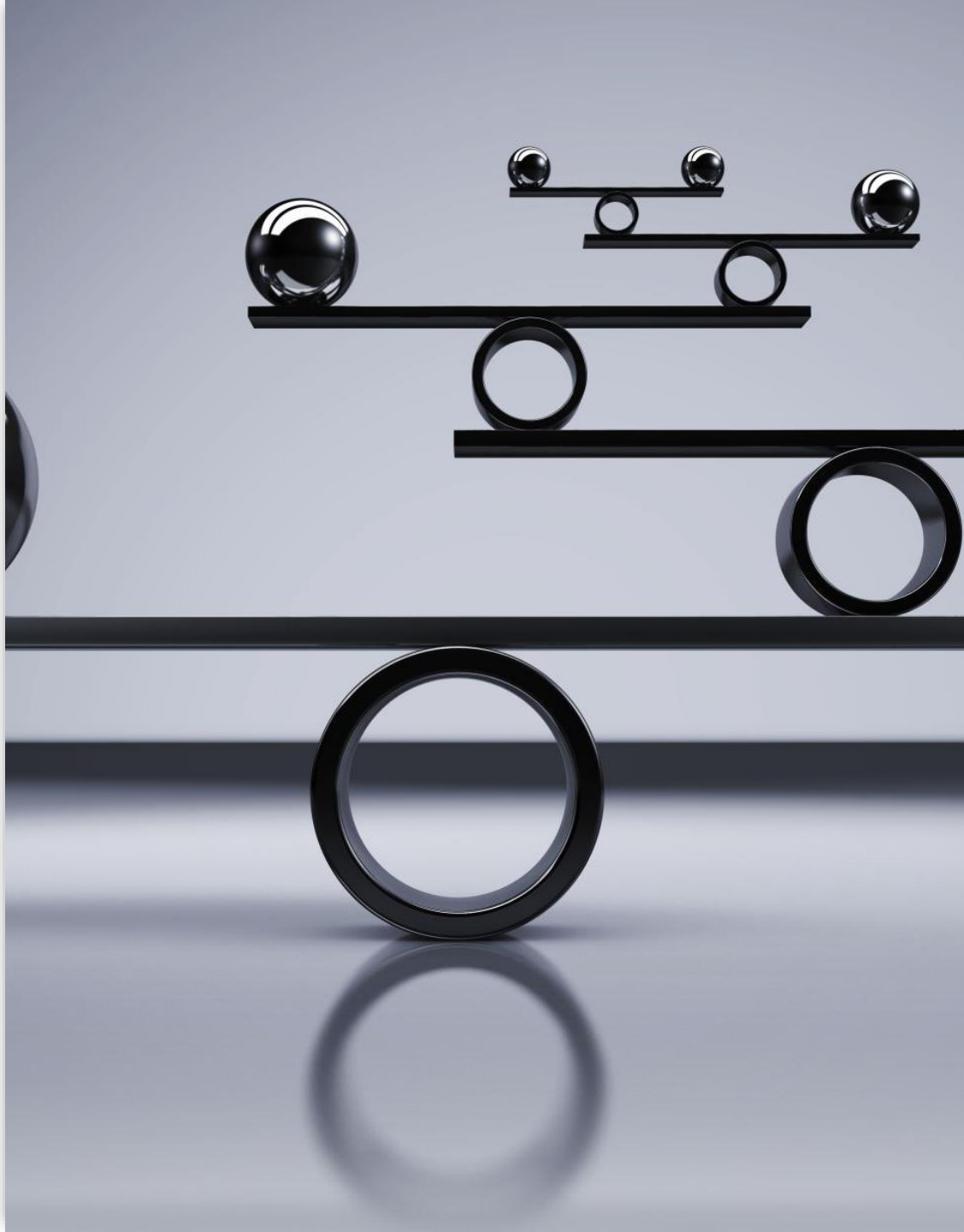
9. Principles of Progression and Regression - Value increased or decreased by association with higher or lower quality properties
10. Principle of Substitution - Market value set by cost of acquiring equally desirable and valuable substitute property
11. Principle of Surplus Productivity - Net income remaining after the costs of labor, management, and capital have been satisfied
12. Principle of Supply and Demand:
    - Supply - goods that producers are willing to sell at a given price
    - Demand - amount of a commodity that consumers buy at a given price

Economic Theory -

- Economics builds on a combination of theory and empirical evidence
- Theory provides a conceptual framework - assumptions
- Theory is key to the understanding of the data
- Each economic theory comes with its own set of assumptions that are made to explain how and why an economy functions
- No theory in economics is ever exactly true
- The important question is not whether or not a theory is true but whether it offers a useful insight in explaining an economic phenomenon.

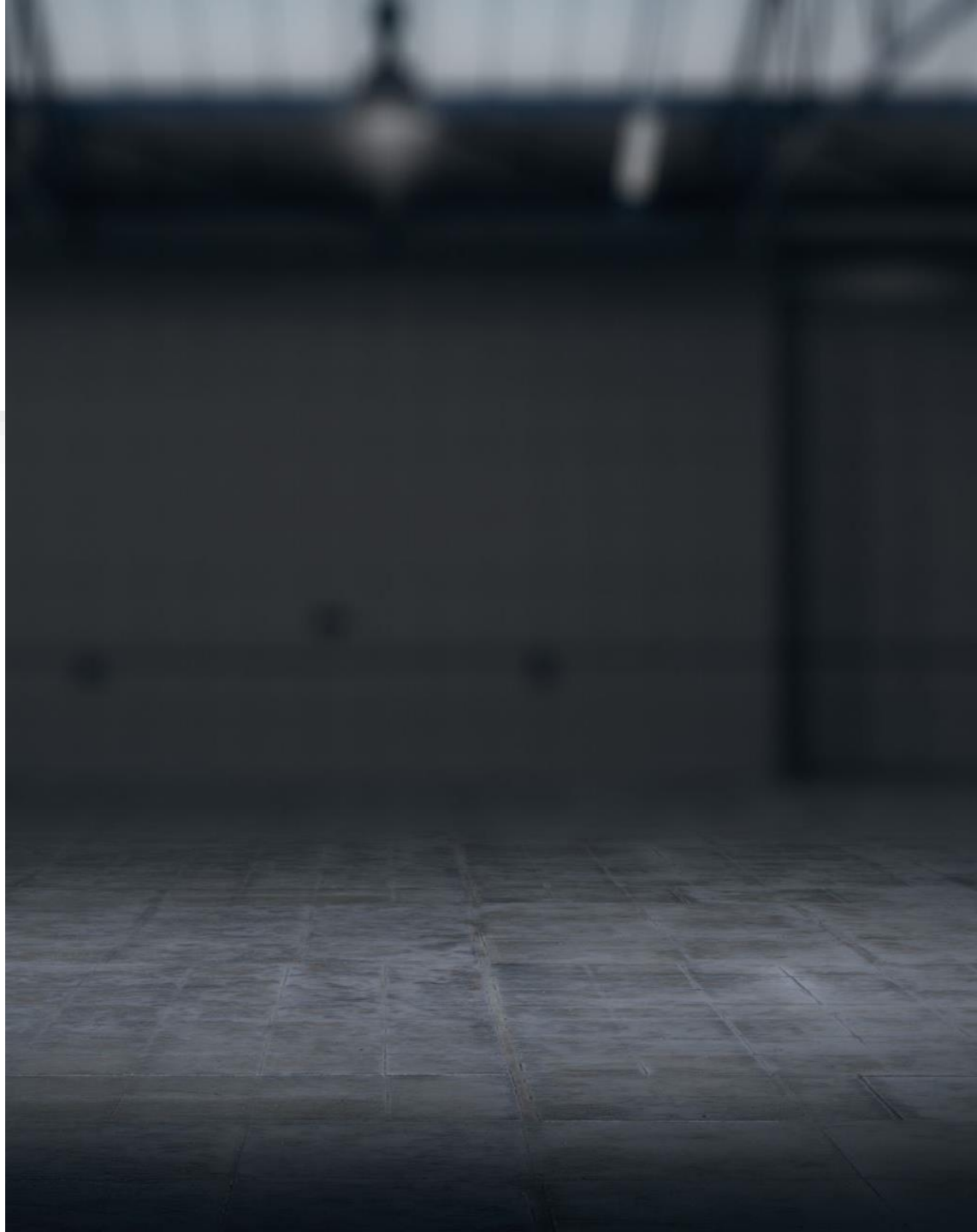
What is Motivating the Theory?

- There are Monetarist and Keynesians theorists
  - Monetarists believe that the market, if left alone, will function and typically bring itself back to equilibrium
  - Keynesians believe that the government should monitor and direct the economy to keep it in equilibrium
- In honesty, neither is either completely right or completely wrong and that discussion is best left to the bar after class
- But in valuation, what is driving the theories that are being employed by the valuer???
- Beware of absolutes



What is Motivating the Valuer?

- It is assumed that the valuer is always impartial and unbiased
  - But what if they are not
- Theories can be used to alter the value of a property with ease, in the skilled hands of a charlatan or a cheat
- On the next few slides we will review actual cases that I have come across in trials where I have been an expert witness



Intentional Manipulation of Theory #1

- This case involved a 160,0000 square foot light manufacturing facility on a five acre site. In the appraisal for the taxpayer, the valuer provided five lands sales of various sizes and made the following statement.

"Given economies of scale, we all know that as size increases, the value per unit decreases. The value for one acre, based on the sales information provided, is $100,000 and since the subject is 5.25 acres, the market value for the lot is significantly less." He placed a value of $75,000 per acre on the site or $393,750, rounded to $400,000.

Looks reasonable, but wait, there's more…

Taxpayer's Appraiser's Opinion of Land Value

Intentional Manipulation of Theory #1

- Let's look at the data
  - Sale #1 sold for $ 750,000 – 5.00 acre site
  - Sale #2 sold for $ 965,600 – 6.80 acre site
  - Sale #3 sold for $ 420,000 – 3.00 acre site
  - Sale #4 sold for $ 100,000 – 1.00 acre site
  - Sale #5 sold for $ 281,250 – 2.25 acre site
  - Sale #6 sold for $1,485,000 – 11.00 acre site

The valuer's assumption that the economies of scale didn't make any sense, so I presented the information graphically to show my opinions.


Sale Price per Acre
$160,000
$140,000
$120,000
$100,000
$80,000
$60,000
$40,000
$20,000
$0
0
2
4
6
8
10
12
$100,000
$124,889
$140,000
$150,000
$142,059
$125,000

Intentional Manipulation of Theory #1

The appraiser's own data shows that he improperly applied the data to the economic principle of Demand:

Consumer Taste and Preference

Diminishing marginal utility:

- The greatest satisfaction is delivered by the first unit consumed and each additional unit consumed brings less and less satisfaction

When in fact the economic principle of Increasing and Decreasing Returns was clearly displayed.

None of the economic principles operate in a void and are not absolutes

Intentional Manipulation of Theory #2

- Whenever I receive an appraisal report on an income producing property that seems questionable, I immediately start to check on several areas that are easy to manipulate:
    a. Vacancy and credit loss
    b. Expense Ratio
    c. Rate of Capitalization
- The reasoning, is that if someone wished to exaggerate the value, these are easy and common areas to do so.
- We will look at one area of concern, which is making sure that the rate of capitalization matches the income stream

Intentional Manipulation of Theory #2

There are two properties that each sold for six million dollars ($6,000,000) and both have an Effective Gross Income of $475,000. In the first example, we will utilize a twenty percent expense ratio (20%) and the second example will utilize a forty percent (40%) expense ratio:

Sale Price	$6,000,000			Sale Price	$6,000,000	
EGI	$475,000			EGI	$475,000	
Exp Ratio	-$95,000	20%		Exp Ratio	-$190,000	40%
NOI	$570,000			NOI	$665,000	
÷	$6,000,000			÷	$6,000,000	
OAR	9.50%			OAR	11.08%	

Intentional Manipulation of Theory #2

The subject property has an effective gross income of $500,000 and expenses of $100,000. The appraiser has documented the expenses and provided comparable data to support a value of:

EGI	500,000	
Exp Ratio	-200000	40%
NOI	$300,000	
÷	6.33%	
Ind Value	$4,736,842	
Say	$4,750,000	

Assessor's Copy

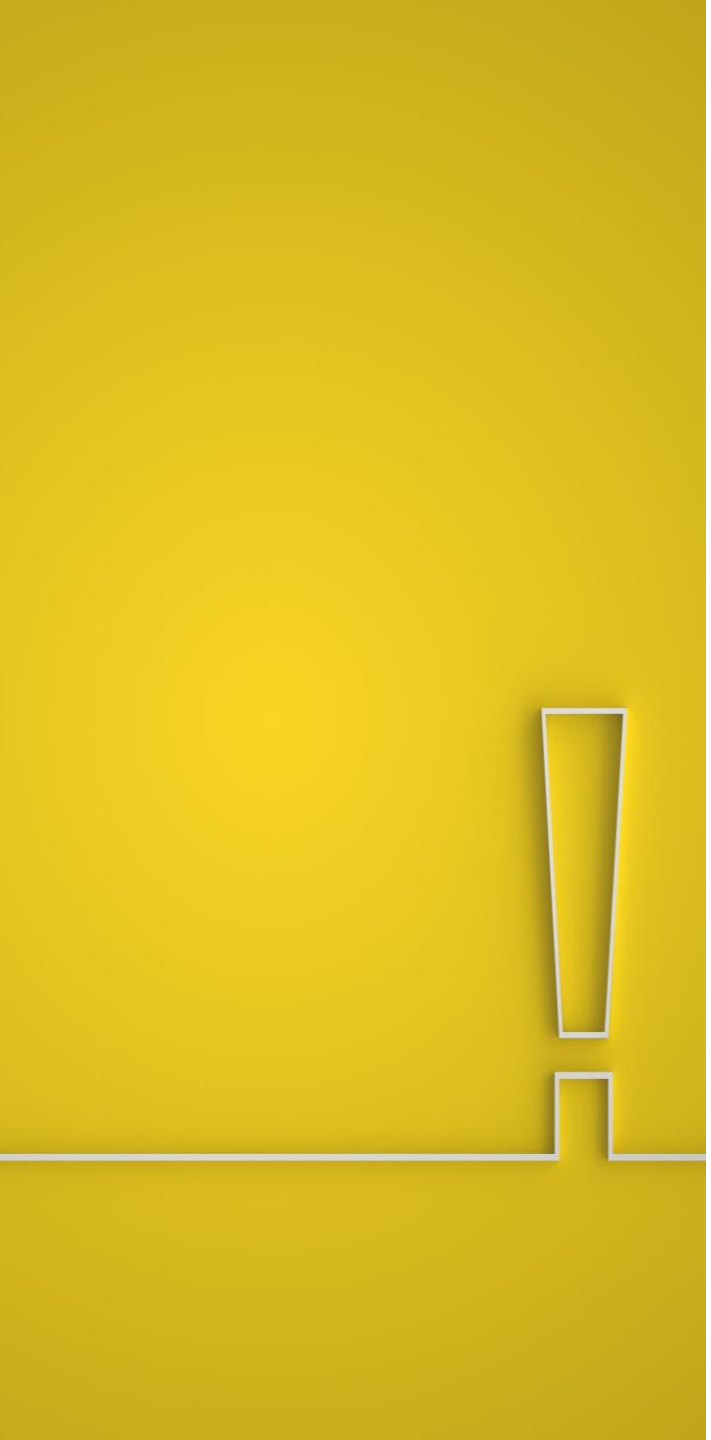
EGI	500000	
Exp Ratio	-100000	20%
NOI	400000	
÷	4.75%	
Ind Value	$8,421,053	
Say	$8,400,000	

Lender's Copy

Intentional Manipulation of Theory #2

The correct value

EGI	$500,000	
Exp Ratio	-$100,000	20%
NOI	$400,000	
÷	6.33%	
Ind Value	$6,319,115	
Say	$6,300,000	



Intentional Manipulation of Theory #2

- It is imperative that the capitalization rate matches the income stream!
- As you read the report, other items to look for are that the adjustments to the various approaches to value are consistent.
  - If there is obsolescence taken in the cost approach, is it described in the body of the report, more specifically in the highest and best use
  - If there is obsolescence taken in the cost approach, where has it been accounted for in the sales comparison and income approaches
  - Does the report adhere to the principle of Consistent Use

Highest and Best Use

- Defined: The use that generates the highest net return (value) to the property over time

- The highest and best use should be considered both as currently improved and as if vacant and available to be developed
  - This allows the valuer to understand which use will produce the highest net return
  - This is a critical investigation of the property's potentials to generate value
  - In mass valuation, this is typically considered to be its current use, until such time the land value of the property exceeds its value as improved

Highest and Best Use – The Four Tests

- The highest and best use is determined by applying four tests to the property, once as vacant and once as improved

- Four Tests
  1. What is the legal uses to which the property can be put?
  2. What is the physically possible uses to which the property can be put?
  3. What uses are economically feasible for the property?
  4. What is the maximally productive use of the property

Highest and Best Use Characteristics

A. Not an exhaustive analysis

B. Many alternatives are tested to select the optimal use under current market conditions

C. Tells the assessor what data must be analyzed to estimate market value

D. Not an isolated concept, rather it is one step in the appraisal process

Highest and Best Use Characteristics

E. Analysis of a vacant property's highest and best use reflects consumer preferences

F. Appraisers identify characteristics of improvements that would result in optimum improvement

G. Highest and best use considers the contribution of a specific use to the community as well as the benefit of that use to the owner

H. Assessor's highest and best use conclusion determines what comparable sales are applicable and what other data is used to arrive at market value

Highest and Best Use – Assumptions

I. It should be a Complimentary use when compared to the surrounding properties or neighborhood

J. It is a function of the twelve economic principles

K. It shouldn’t be too broad or too concise

L. It can have an Interim Use for lands in transition

M. Don’t forget Legal Non-conforming and its role

PEGS

- Physical
  - Physical factors are both natural and man-made physical circumstances that affect the highest and best of a property
- Economic
  - Influence supply and demand and the buying public's economic ability to satisfy its wants and needs through property purchases
- Governmental
  - Regulations, services, and facilities instituted or provided by federal, state, and local governments that affect land use patterns
- Social
  - Demographic (population) attitudes, characteristics, and trends

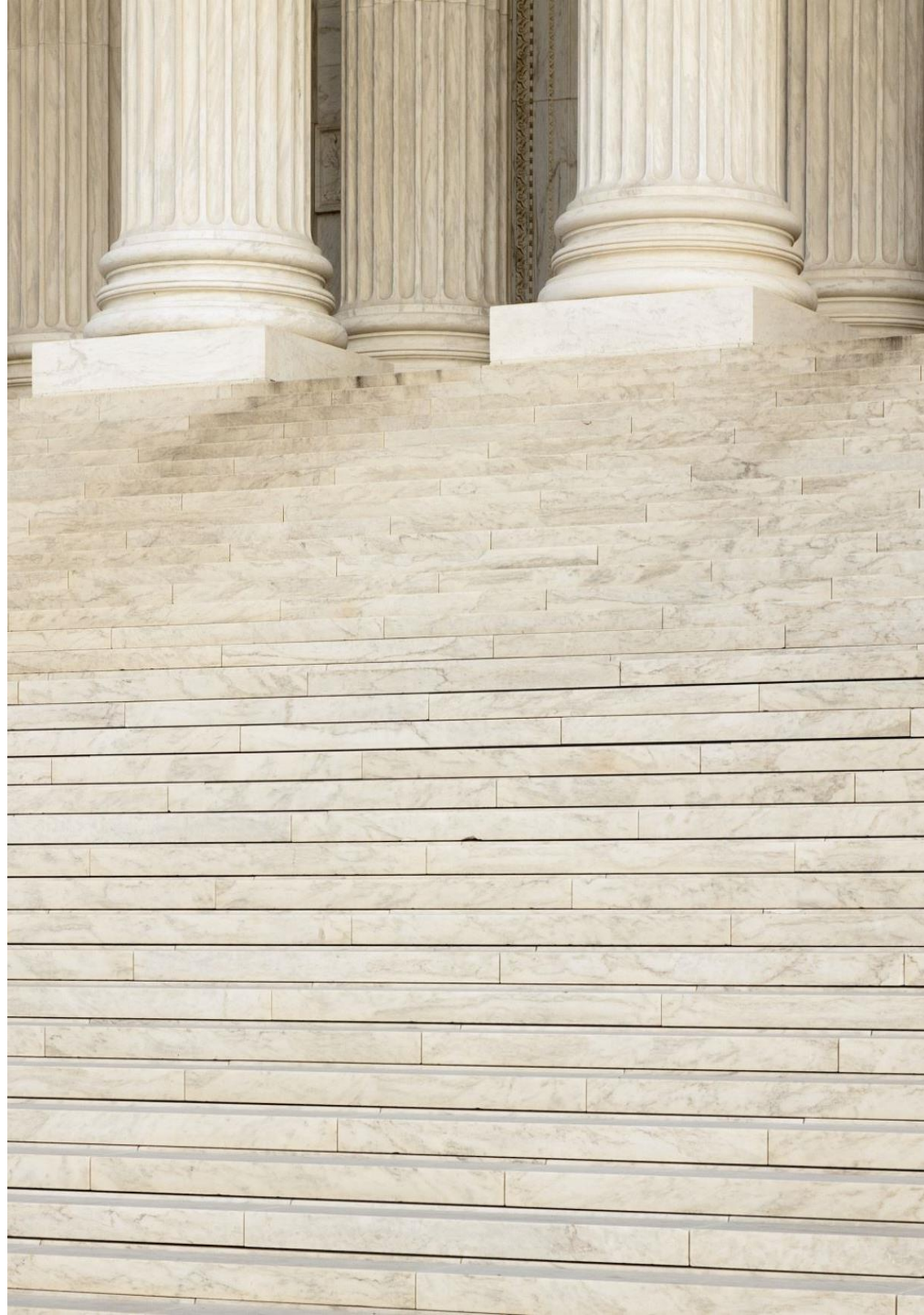
CVS vs Rob Turner, as Property Appraiser for Hillsborough County, FL

Before Dark Story Theory, in Hillsborough County Florida, CVS filed valuation appeals on all forty of their stores.

- The county was successful at the county Property Tax Appeal Board
- The county was successful at the circuit court level
- The county prevailed at the appellate court level

But why??

Highest and Best Use!



CVS Appellate Court Decision

- CVS contended that the highest and best use was only for a general commercial use, which the court found to be too broad
- HCPA contended that the highest and best use of newer existing national drugstores was as a national drugstore. The court agreed with this decision after hearing the facts
- The following are some of the rationale for why the highest and best use of a going national chain drugstore is as a national chain drugstore (note: it is a generic national chain store)

CVS Appellate Court Decision

- The acreage of a contemporary national drugstore is significantly greater than most stand-alone retail stores, because of the need for a drive-through
  - Therefore, the value of the site becomes less, because of the inability to fully utilize the excess land required for a drive-through
- The footprint of a contemporary national drugstore is greater than most of the secondary market users of that space, because they have become small grocery stores, stocking larger amount of goods than just for health care.
  - Because of this size, most other businesses, banks, auto-parts stores, and other retailers don’t need that much space
- The values paid for land by these national chains is significantly greater than market. This is because of the demographics that have changed at these old locations and necessitated a move to a new location. Therefore, the highest and best use of the old location has changed.

CVS Appellate Court Decision

- Almost without exception, all of these former national drugstore properties sell with deed restrictions placed on them
  - These restrictions commonly do not allow for the retail sale of any forms of pharmaceuticals or retail (groceries) in competition to the new store.
  - This prohibits the property to be utilized to its full potential
    - Most other retailers who purchase these properties do not use the full square footage of the building, so they are being underutilized

Dark Store Theory

- This process started in a small township in the State of Michigan.
- Upon contacting the former deputy (the assessor had been let go) I inquired about their defense against Menards, which was the organization that brought the appeal
- What I found was a lack of understanding of the questions to be asked and of the issues to make in the trial
  - They didn’t know to ask about the deed restrictions on the former box stores
  - They didn’t understand the core principles of highest and best use
  - They didn’t question or research the demographics of the closed or newly opened stores
- They were a small jurisdiction, with little resources, little experience, and little training.

Dark Store Theory

- This entire theory is based on the highest and best use of the property in question
- Those wanting to use Dark Store Theory will want to use the income and sales comparison approaches to value
  - Because they will introduce the income and sales per unit for all these properties, that are on their second or third lives
  - These rents and values are below market because they are not the highest and best use of the design of the properties they are occupying
- They typically won't want to utilize the cost approach, as they would have to heavily depreciate the cost new for physical deterioration or try and justify some form of obsolescence that isn't present in the property

Dark Store Theory

- When a big-box chain abandons a store, its actions indicate there may no longer be market support for that use at that location
- Dark stores are typically closed because they were poorly located, had functional issues, or were part of a company bankruptcy or downsizing.

- The following is a deed restriction on a deed from Target
  - *For a period of 10 years following the date of this conveyance, no portion of the subject property shall be used for the operation of a discount department store containing more than fifty thousand square feet of floor area. No portion of the subject property shall be used as a grocery store, containing more than 25,000 square feet of floor area for use in connection with the sale of food, groceries, fruit, produce, dairy products, vegetables, bakery products, meats, or delicatessen products.* (Bexar County Clerk 2007, 1918)

Dark Store Theory

- The most overlooked market participant in big-box property tax appeals is actually the most obvious: the big-box chains themselves.
  - They build, occupy, own, and sell more stores than any other market participant.
- Big-box chains are overlooked as potential buyers because of a common mistake in contemplating a hypothetical sale. That mistake is that many assume a hypothetical sale must be to *someone else*.
- There is no accepted appraisal theory that suggests an appraiser or assessor should exclude the present occupant, or a similar occupant, as a potential purchaser in a hypothetical big-box sale.

Dark Store Theory

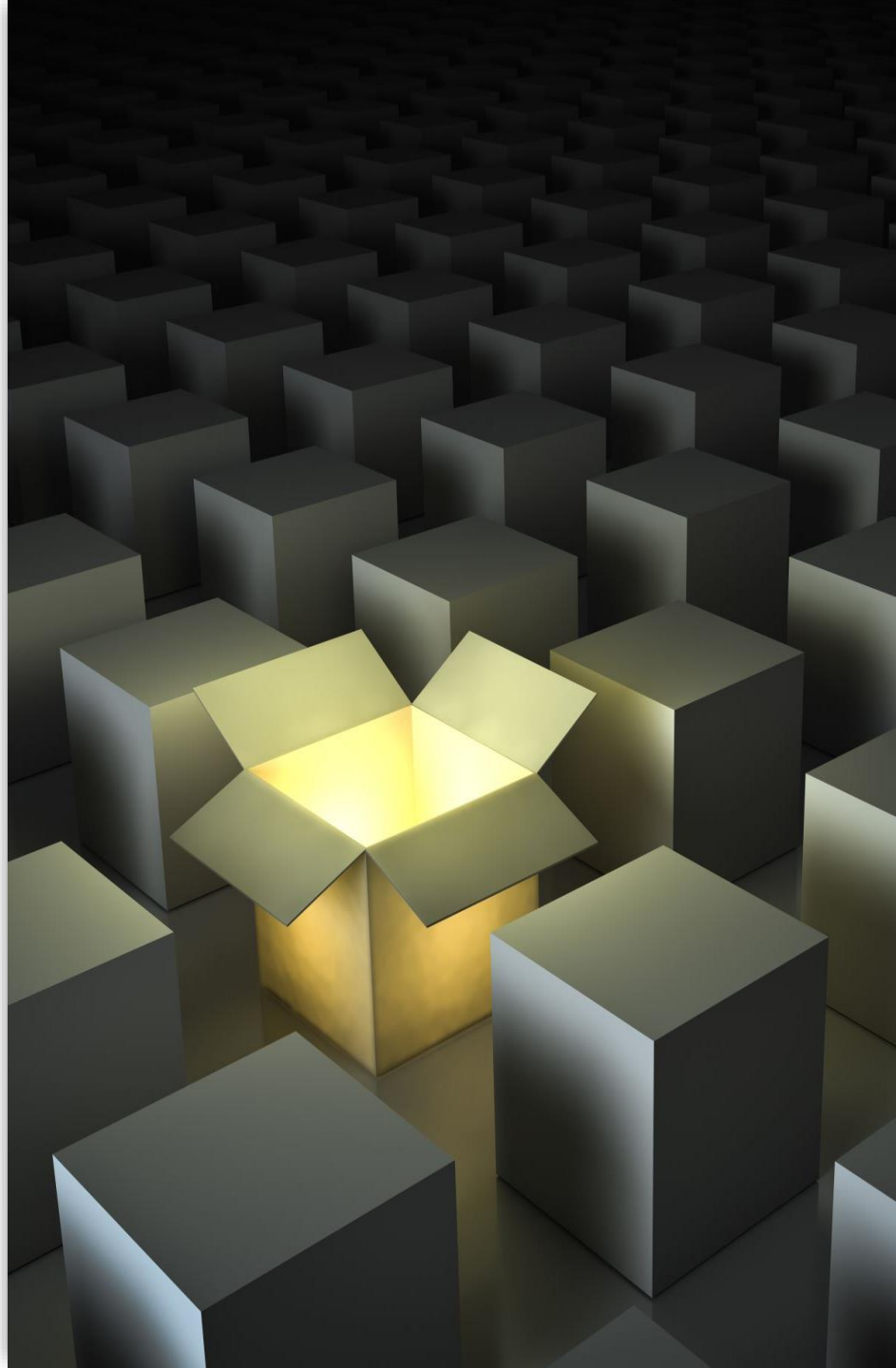
- Where many assessors go wrong is that, instead of identifying a *typical* user for a big-box store, they point to a *specific* user, such as Walmart, Target, Home Depot, or Lowe's.

- Use value and exchange value are different only when the current use is not the highest and best use. If an appraiser concludes that the current use (***not the specific user***) of a big-box store is also the highest and best use, then use value and market value are the same.

Dark Store Theory

- The courts have sent mixed messages about the proper way to value big-box stores.
  - Some past cases from Michigan, Indiana, and Ohio indicate that assessors should embrace dark stores as a comparable, while other decisions, sometimes from the same states, suggest the opposite.
  - These seemingly conflicting opinions could be attributed to state law nuances, presented evidence (or lack thereof), confusion in the courts, or all of the above.
  - A number of states have passed legislation or regulations that restrict the use of Dark Story Theory in valuation appeals
- But at the end of the day,

Highest and Best Use Matters Most



Assemblage and Plottage

1. You are analyzing two separate parcels that are currently valued at $35,000 each. If they are combined into one parcel, you estimate that the value of the new parcel would equal the value of the two individual parcels combined.
   - **What action has occurred?**
   - **What is the value of the new combined lot?**

2. Suppose one lot valued at $60,000 is combined with a second lot valued at $40,000. The resulting value of the combined lot is 20% higher than the value of the separate lots on their own.
   - **What type of value has been created?**
   - **What is the value of the new combined lot?**

Assemblage and Plottage

1. You are analyzing two separate parcels that are currently valued at $35,000 each. If they are combined into one parcel, you estimate that the value of the new parcel would equal the value of the two individual parcels combined.
   - **What action has occurred?** **Assemblege**
   - **What is the value of the new combined lot?** **$70,000**

2. Suppose one lot valued at $60,000 is combined with a second lot valued at $40,000. The resulting value of the combined lot is 20% higher than the value of the separate lots on their own.
   - **What type of value has been created?** **Plottage**
   - **What is the value of the new combined lot?** **$120,000**

Highest and Best Use Analysis

- The subject property is an irregularly shaped lot containing approximately 40,000 square feet of land. The back one-third of the lot is low and will require a considerable amount of fill before it can be used.
- There is enough level land to handle most types of structures. The main problem with the lot, because of the area in the back, is the lack of potential parking space. Also, due to the shape of the lot there are ingress and egress problems.
- Potential uses of the site have been determined as follows:
  - Retail store
  - Convenience Store
  - Restaurant
  - Small office building
- The site is adequate size to handle any of these types of structures. A retail store and a restaurant would require a substantial amount of parking area. A convenience store requires adequate ingress and egress. The parking requirement for an office building is minimal.
- **Based on the physical data given, what is the highest and best use of the subject property?**

Highest and Best Use Analysis

- **Based on the physical data given, what is the highest and best use of the subject property?**

The highest and best use appears to be the small office building. It requires a minimal amount of parking. The ingress and egress into the site should not be a problem with an office building. The other uses would be hampered by both the lack of parking and the ingress and egress.

Highest and Best Use Analysis

- **Discussion Question 1**

- What factors must be considered by the assessor/appraiser who is valuing a property ripe for development or redevelopment?

Discussion Question 2

If the highest and best use of an improved site is determined to be different from the current use, how long should the assessor/appraiser continue to use the current use in valuing the property?

Highest and Best Use Analysis

- **Discussion Question 1:** What factors must be considered by the assessor/appraiser who is valuing a property ripe for development or redevelopment?

Legal factors - zoning and other restrictions

Physical factors – site data

Financially feasible – market demand

Maximum productivity

Discussion Question 2: If the highest and best use of an improved site is determined to be different from the current use, how long should the assessor/ appraiser continue to use the current use in valuing the property?

The current use will remain the highest and best use until the value of the land as if vacant and available for the proposed use minus the cost of removing the existing improvements is greater than the value of the current use.

Valuing Vacant Parcels

- A vacant parcel can accommodate a triplex or a four-plex unit. The triplex is projected to have a market value of $380,000 and the construction cost is estimated to be $280,000. The four-plex could be built for $400,000 and the market value is projected to be $490,000. The land value for both uses is $70,000.
- **What is the highest and best use?**

	Triplex	Four-plex
Market value	$38,000	$490,000
Cost to construct new	$280,000	$400,000
Land value	$70,000	$70,000
Total cost	$350.000	$470.000
Profit	**$30,000**	**$20,000**

The highest and best use is the triplex.

Highest and Best Use as Though Vacant

- A developer is considering two potential structures for a site that can be purchased for $175,000. The first structure would be a 5,000 square foot office building with an estimated cost of $100 per square foot.
- The second structure would be a 6,000 square foot retail building with an estimated cost of $75 per square foot. The net operating income for both properties is estimated at $68,000. The lot is zoned commercial. It is physically capable of handling either structure.
- **What is the highest and best use of the site?**

Highest and Best Use as Though Vacant

- First structure:
- 5,000 SF × $100/SF = $500,000
- $500,000 + $175,000 (land value) = $675,000
- $68,000 (NOI) ÷ $675,000 = **0.101 or 10.1%**

Second structure:

6,000 SF x $75/SF = $450,000

$450,000 + $175,000 (land value) = $625,000

$68,000 (NOI) ÷ $625,000 = **0.109 or 10.9%**

The second structure is the highest and best use of the site.

Highest and Best Use as Though Vacant

- A vacant parcel can accommodate a large single-family residence or a duplex. The single-family residence would have a market value of $250,000 and the construction cost would be $160,000. The duplex could be built for $230,000 and the market value would be $300,000. In both cases, the land value is $40,000.
- **What is the highest and best use of the property?**

Highest and Best Use as Though Vacant

	Single-family residence	Duplex
Market value	$250,000	$300,000
Cost to construct new	$160,000	$230,000
Land value	$40,000	$40,000
Total cost	$200,000	$270,000
Profit	**$50,000**	**$30,000**

The highest and best use is the single-family residence.

Highest and Best Use as Though Vacant

- A vacant site is being considered by a potential developer who is deciding what type of improvement to build if he acquires the property. He has come to you to see what type of improvement is best for the site.
- You have determined the construction cost and the estimated net operating income for the two types of properties being considered, an office building and a retail building. The market capitalization rates for both proposed uses are 12.5% for the building and 11% for the land.
- The construction cost for the office building is $2,700,000 with a projected net operating income of $370,000. The retail building has an estimated construction cost of $1,700,000 with a projected net operating income of $255,000.
- **What is the highest and best use for the site?**

Highest and Best Use as Though Vacant

	Office Building	Retail Building
Cost to Construct	$2,700,000	$1,700,000
Net Operating Income	$370,000	$255,000
Return on Improvement (12.5%)	$337,500	$212,500
Income to Land	$32,500	$42,500
Indicated Land Value (11%)	**$295,455**	**$386,365**

The highest and best use is a retail building.

Highest and Best Use as Though Vacant

- A tract of land is currently improved with a 4,000 square foot building that is being used as a construction company's office. You estimate the building to be at the end of its economic life.
- The approximate value of the property is $90,000 (land and building). The area around the subject property is currently being developed with small industrial structures. The typical size of these structures is 8,000 to 12,000 square feet.
- An industrial building containing 10,000 square feet can be constructed for $12.00 per square foot and will have a value when completed of between $220,000 to $240,000 (land and building).
- **What is the highest and best use of the land as though vacant?**

Highest and Best Use as Though Vacant

Current Value	$90,000 (using small office market indicators)	
Industrial Use	Building cost = 10,000 SF × $12.00 = $120,000	
Estimated Value Range	$220,000	$240,000
Building Value	-120,000	-120,000
Estimated Land Value	**$100,000**	**$120,000**

The highest and best use is industrial.

The value of the vacant land as an industrial property is more than its current use.

Note: You would also need to consider the demolition costs for removing the small office building.

Highest and Best Use: Interim Use

The subject property is a 25-year-old single-family residence situated on a 7,800 square foot lot. The area in recent years has seen an influx of commercial businesses.

Recently, the city governing body has changed the zoning for the area, including the subject property, to commercial. A review of vacant lot sales in comparable commercially zoned areas indicate that the land would sell for approximately $8.75 per square foot.

The cost to demolish the structure would be $5,000. Your analysis of the neighborhood also indicates that sales of comparable residential properties in commercially zoned areas would range from $75,000 to $85,000.

1. **What would be the highest and best use of the subject property?**

2. **What type of use is indicated?**

3. **How should the value of the subject property be allocated between land and building va**

Highest and Best Use: Interim Use

1. What would be the highest and best use of the subject property?

The highest and best use of the subject property remains its current use, improved residential property. The improvements represent the highest and best use as long as they continue to contribute increments of value over the value of the vacant land.

Land value:	$8.75/sf x 7,800 = $68,250
Land value minus demolition cost:	$68,250 - $5,000 = $63,250
Comparable sales range:	$75,000 to $85,000

2. What type of use is indicated?

Interim use. The owner should continue using the property as residential until the improvements no longer contribute value. Then the improvements should be demolished or converted to an alternative use.

Highest and Best Use: Interim Use

3. How should the value of the subject property be allocated between land and building value?

   - **Land value:** **$68,250**
   - **Improvement value:** **$6,750 to $16,750**

Valuation: Understanding the Basics

Questions

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