

# You can't get the value right if you get the rights wrong.

## Abstract

Market value opinions of the fee interest in custom-built commercial properties present challenging problems. In these assignments, appraisers must understand the nuances between value in use and market value, and fee simple estates and leased fees. These built-to-suit properties have rents, sale prices, and overall capitalization rates that are not representative of the market for second-generation users. The cost to build and worth to the initial owner or tenant well exceeds what the property would be able to command on the market for either lease or sale. This article reviews the three traditional valuation approaches and discusses the misconceptions that lead to the wrong value for the property fee interest.

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Single-tenant, built-to-suit commercial real estate presents difficult valuation problems. One of the most challenging of these valuation problems arises when the assignment involves developing an opinion of the market value of the fee interest in the real property. This assignment condition requires the appraiser to value the property as if it sold, available to be leased at market. However, these custom-built properties are always occupied by the owner or tenant for whom the improvements were built, with any lease structured to recoup the original cost of the custom construction. If the properties were sold, they would sell as leased fees with rents well above the market rent. So, an estimate of the market value of what would actually sell would be the market value of the leased fee, which is inconsistent with the value premise. Because the value premise is inconsistent with what would sell if the property were offered for sale, appraisers frequently end up answering the wrong question: rather than the market value of the fee, they provide an opinion of the value in use of the leased fee estate based on the original lease. To properly approach such assignments, appraisers must suspend reality-as these properties never sell as if vacant and available to be leased at market-and value the properties under the assumption they are vacant and available.

These are fundamental issues in appraisal of custom-built commercial properties, and it is important to explore the root causes for the problems that appraisers may have with them. This article reviews how to approach such an assignment, considering all three traditional appraisal methods, and exposes related misconceptions that should be avoided.

## Custom-Built Commercial Properties

Properties such as bank branches, fast food restaurants, freestanding pharmacies, and fitness clubs are frequently built by the owners to their specifications or built-to-suit for them. In either situation, the building is designed to conform to a particular business-model prototype. For example, Life Time Fitness health clubs are typically located in 110,000-square-foot buildings on about twelve acres, with a distinctive Federal-style architectural design. The buildings usually have two stories, three swimming pools, an expensive interior finish, and every imaginable type of fitness equipment. Walgreens' pharmacies are typically in single-story, freestanding 15,000-square-foot buildings on about two acres. These buildings also have a distinctive architectural design that features a glass entrance atrium.

For many reasons, it is often advantageous to lease the property rather than own it. This is accomplished with a build-to-suit sale/leaseback. Under these arrangements, the rental amount is based on the cost of construction. These properties are never built speculatively and then put on the market for rent or sale. Once the property is rented, the real property is often sold from investor to investor. The attractiveness of the purchase to investors, however, is more a function of the lease-rent amount, terms, and tenant-than the real estate. This is obvious from the fact that some buyers do not even bother to inspect the property before purchase.



## **The Appraisal Problem**

Although appraisals of commercial properties are sometimes obtained for purchase price purposes, more often they are for other uses such as condemnation and tax assessment. The question the appraiser is asked to answer when the use is related to a purchase is quite different from the question to be answered when the appraisal is for one of the other possible intended uses. The purchase-related appraisal involves an opinion of how much an informed purchaser would pay for the property as encumbered by the lease. The appraisal for condemnation or tax purposes, however, usually calls for an opinion of the market value of the fee interest. The specific question then is, if this property, which was custom built for this particular occupant's needs, were on the market for the typical exposure time and available to be leased or occupied, how much would an informed purchaser be willing to pay for it?

## **Market Value vs. Value in Use**

The primary difference between market value and value in use is that market value is couched in terms of the property's highest and best use, and is a value in exchange concept. Market value considers how much a knowledgeable buyer would pay for the defined interest as of a specified date if the property had been exposed on the market for a typical period of time. It requires the assumption of a transaction and a willing seller, regardless of whether the occupant has any intention of selling.

Value in use, on the other hand, is a function of the current use, regardless of the property's highest and best use; in its purest form it is not a value in exchange concept. (1) A property that has been custom built for the current occupant--be that an owner-occupant or tenant--will usually have a value in use that is higher than the property's market value. This is not surprising, as the improvements have been tailored to the wants and needs of the occupant, and those requirements are unlikely to be exactly the same as those of the market in general. A McDonald's restaurant, for example, is a perfect design for the McDonald's business plan, but largely undesirable for the market in general, even for another fast-food outlet.

## **Fee Simple vs. Leased Fee**

The fee simple is perhaps one of the most misunderstood of fundamental appraisal principles. Simply put, the owner of the fee interest owns the entire bundle of rights that comes with property ownership, subject only to the four governmental powers of escheat, eminent domain, police power, and taxation. The bundle of rights includes the right to sell an interest, the right to lease an interest, the right to occupy the property, the right to mortgage an interest, and the right to give an interest away. Once the property has been leased--regardless of the terms of that lease--the owner no longer has the right of occupancy, the right to lease, or the right to give an interest away. Even if the lease is at market rent, the fee does not necessarily equal the leased fee.

## **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 custom-built commercial properties. Whether or not an approach can be used is a function of the availability of data and support for the elements of its application.

## **Sales Comparison Approach**

As noted, custom-built commercial properties frequently sell. Invariably, they are sold subject to the lease to the original occupant that outlined the construction specifications and is paying a rent structured on the cost to build the improvements. Therefore, the sales are most appropriately categorized as sales of the leased fee interest.

The rent for a custom-built commercial property is routinely higher than the rent for space that is not specifically designed for a tenant. Anyone who has purchased a custom home can appreciate this fact. A custom builder will build whatever you want and charge cost plus profit for it. When you sell the property,

however, the market will only pay for the features it wants, not for the special features you wanted built in. This is the foundation of the concept of functional obsolescence and superadequacy.

The transactions or sales of the leased fee interests for the custom properties are at prices that reflect the very high lease rate; typically the leases are net lease deals. The purchases are tantamount to a bond purchase, as the quantity, quality, and durability of the income streams being purchased are consistent with bonds. These are not arm's-length leases. The transactions are not representative of the amount for which the real property would sell if it were vacant and available to be leased (a fee interest) or leased in an arm's-length, open market transaction.

Sometimes, the only available comparable sales are net lease deals. In such circumstances, the appraiser has two choices: (1) find the evidence to support an adjustment for both rights appraised (the fee and the leased fee) and for an adjustment for the contribution of the above-market lease amount and terms; or (2) not apply the sales comparison approach. The only alternative would be to find sales of second-generation uses of these properties; for example, a reuse of a Walgreens as a local restaurant or a Kmart as a call center. If these sales are not distress sales and share the same highest and best use as the subject if vacant and available to be leased, then they will provide credible evidence of the subject's market value. More times than not, however, ample transactions of this kind are not available and the appraiser is not able to use the sales comparison technique.

### **Income Capitalization Approach**

Direct capitalization seems to be the preferred model to develop an opinion of value for custom commercial properties via the income capitalization approach. To apply this approach properly, support is needed for its three major ingredients: potential gross income, operating expenses, and overall capitalization rate. The same issues arise with its application as with the sales comparison approach when the appraisal problem involves estimating the market value of the fee simple interest of the custom-built property.

The first step in applying the income capitalization approach is to determine the market rent. In order to properly develop the market rent, sufficient market evidence must be found of the amount that a willing lessee would pay a willing lessor to occupy the space. A search of sources usually available to appraisers (such as CoStar, NNEx.com, or similar services) will quickly reveal many leases. When these leases are scrutinized, however, it will be apparent that almost every one is a lease to the original tenant based on a rate that was driven by that tenant's custom-construction specifications. As such these lease rents have little in common with the rent a second-generation tenant would be willing to pay for the space. Evidence of this is both obvious and available.

For example, when the fast-food franchise Roy Rogers Restaurants closed, many of its stores went to other fast-food franchises or to local restaurants. However, the buyers stripped the restaurants to their shells, removing all evidence of the prior user, and then rebuilt the restaurants to their own prototypical specifications. The buyers clearly did not want-nor were they willing to pay for-the sometimes expensive custom features of the original construction. So, it quickly becomes apparent that what may look like a substantial pool of potential leases that might be used as comparables in an estimate of market rent for the subject is really of no use whatsoever in determining how much a second-generation tenant would be willing to pay in rent for these custom-built properties.

Alternatively, an appraiser might develop a market rental rate using percentage rent, a typical retail lease mechanism. Percentage rent is expressed as a certain percentage of the typical sales for the type of tenant best suited to the particular real estate. An indication of market rent can be developed if the appropriate percentage can be found, from a review of actual leases or from a secondary source such as Dollars and Cents of Shopping Centers, and the typical sales can be similarly established.

Support for the operating expenses is usually not a problem, so the next step is development of an overall

capitalization rate. The Appraisal of Real Estate, 13th edition, describes the methods for developing a capitalization rate, and it states that the preferred method is derivation from comparable sales. (2) However, the problem with derivation from comparables sales related to custom commercial buildings is the same as the problem encountered when trying to use the sales comparison approach: transaction prices for this type of property are based on the in-place lease to the original tenant and the rent being paid by that tenant, which is a function of the build-to-suit cost of construction. As a result, any capitalization rate extracted from these sales will be much lower than appropriate for an opinion of the market value of the fee interest.

Although substantial obstacles need to be overcome, application of the income capitalization approach is important to the solution of this type of appraisal problem. Careful analysis of second-generation lease transactions and overall capitalization rates extracted from these sales offers the best application. In the absence of sufficient data from second-generation deals, an option would be to estimate market rent using a percentage rent model and to develop an overall capitalization rate by an alternative method, such as a carefully vetted survey. Particular care would be needed, however, with the development of both the market rent and the overall capitalization rate.

### **The Cost Approach**

Initially, the cost approach seems to carry a lot of promise as a method for valuing custom-built commercial properties. The value of the fee simple interest is estimated by adding the value of the land to the cost of the improvements, minus depreciation. The three components of the cost approach—cost new, depreciation, and site value—are all capable of being supported by solid market evidence. There may be problems, however, with the way the depreciation component is developed.

The amount of depreciation is estimated using one or more of three fundamental methods: the economic age-life method, the market extraction method, and the breakdown method. The market extraction method has little application to custom-built commercial properties for the same reasons the sales comparison approach is not useable, i.e., the lack of similar sales. The breakdown method also is not particularly practical. The method used most often is the economic age-life method. The problem with the economic age-life method is that appraisers frequently select an effective age equal to or close to actual age, based solely on physical condition, and take the total economic life from a published source. For custom-built properties, this inevitably results in an understatement of the depreciation, as these properties almost by definition have features that the general market is not willing to pay for.

### **Feasibility Rent Analysis**

The key to the cost approach is the accurate measurement of functional and external obsolescence elements of depreciation. Often, even very new properties suffer substantial functional and external obsolescence.

Feasibility rent analysis is one of the very best tools available to show the magnitude of depreciation. It helps explain why cost new, even with a relatively new property, does not approximate market value. If the feasibility rent is above the market rent, then the property has obsolescence and cost new will exceed the market value.

The feasibility rent concept is taught in the Appraisal Institute's highest and best use courses, although there it is used to estimate the timing of a use rather than to quantify existing depreciation. Although some appraisers may be put off by the circularity that exists between feasibility rent analysis and direct capitalization, it is a methodology taught in the Advanced Cost and Sales Comparison course, which is currently a requirement for the MAI designation.

Feasibility rent analysis is, in effect, direct capitalization in reverse. Direct capitalization begins with an estimate of market rent from which appropriate vacancy and collection loss and operating expenses are

deducted. The resulting net operating income is then converted to an indication of value by dividing it by an overall capitalization rate ([R.sub.o]).

Feasibility rent, on the other hand, begins with the assumption that the cost new plus the site value equals value. Rearranging the relationship, value equals income divided by rate, allows the appraiser to calculate feasibility rent, or the net operating income necessary to support this assertion (net operating income equals cost new plus site value times the overall capitalization rate). The difference between this amount and the estimated net operating income developed in the income capitalization approach represents the net income shortfall, which when capitalized with the overall capitalization rate results in the total depreciation from all sources. Dividing the net income shortfall by the previously calculated feasibility rent results in the total percentage of depreciation in the improvements.

An example using a custom-built property helps illustrate why feasibility rent is a valuable tool in explaining why the cost new does not approximate market value for this type of property.

### Feasibility Rent Case Study

Assume that the subject is a two-year-old health club with 110,000 square feet of improvements on twelve acres. The site value, determined by the sales comparison approach, is \$3,500,000, and the all-inclusive cost new for the real property (personality excluded) is \$177.00 per square foot. This includes entrepreneurial incentive, which is a necessary cost in all market value estimates. (Unachieved profit would be reflected in the depreciation estimate.) The physical depreciation for the facility is \$500,000. Although only two years old, this facility has been operated on a 24-hour-a-day basis and shows minor physical depreciation as a result.

Also assume that the estimated market rent by percent typical for similar retail is 8%; the typical sales level is \$120 per square foot; and the market rent is \$9.60 per square foot. The overall capitalization rate is 9%, based on analysis of the subject relative to alternative retail investment opportunities such as strip centers, power centers, and hotels.

We can now calculate the feasibility rent, which is the rent necessary for the property to be worth what it cost to construct at the effective date of value.

Cost new of improvements	\$19,470,000
Site value	+ 3 500 000
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Total cost new	\$22,970,000
Capitalization rate	x 9%
	-----
Feasibility rent	\$2,067,300

We can now compare the market rent estimate to the feasibility rent (both on a net basis). The difference between the two serves as a market-extracted measure of total depreciation in the subject real property. The depreciation calculation using feasibility rent analysis is as follows:

Total development cost new	\$22,970,000
Capitalization rate	x 9%
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Feasibility rent	\$2,067,300
Less net market rent	- 1,056,000
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(\$9.60 x 110,000 sq. 1%)	
Income loss due to depreciation,	

all sources	\$1,011,300
Value of loss, capitalized at 9%	\$11,236,666
(\$1,011,300/.09)	

Of the total loss in value, \$500,000 is physical depreciation, so the property suffers the balance \$10,736,666 in functional or external obsolescence. It is not particularly important in this situation to identify how much of this amount is functional obsolescence and how much is external obsolescence. A reconstructed cost approach would look as follows:

Cost new	\$19,470,000
Less depreciation	
Physical deterioration	\$500,000
Functional/external obsolescence	\$10,736,666
Total depreciation	- 11 236 666
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Depreciated value of improvements	\$8,233,334
Site value	+ 3,500,000
	-----
Total market value of fee by cost approach	\$11,733,334

It is important to emphasize that the cost approach did not produce an independent indication of value. However, it did provide a very useful way of demonstrating that, although only two years old, this property suffers substantial functional or external obsolescence and its market value is significantly less than its value in use would be.

### Summary and Conclusions

Estimating the market value of the fee interest in the real property component of a single-tenant, built-to-suit or custom-built commercial property is a difficult assignment. The reason it is so difficult is that no one builds these properties on a speculative basis and then offers them for sale or rent on the open market. Instead, they are built-to-suit, and if they sell, they trade on a sale/leaseback arrangement. The rent, sale price, and overall capitalization rate are not arm's-length and not equivalent to market rent, value, or capitalization rates. As a result, it is very difficult to find support for market rent, market sales comparables, and market overall capitalization rates. However, the value in use to a specific tenant or owner does not become market value just because support for the latter is hard to find. The best support for the components of both the sales comparison approach (the comparables) and the components of the income capitalization approach (rental and capitalization rate comparables) is second-generation space that has leased or sold and that enjoys the same highest and best use as the subject would if it were available for lease or sale on the open market. The key to the cost approach is the accurate quantification of the functional and external obsolescence. Feasibility rent analysis is an excellent tool for such quantification in these situations.

Appraisers often respond to these types of appraisal assignments by asking, why would an intelligent and sophisticated national corporation pay an amount well above the market value or market rent for these custom-built properties? The answer is simply this. The cost of the real estate might not make sense on a stand-alone basis, but makes complete sense as a part of the overall business operation of the owner or tenant. When a nationally known fast-food establishment was asked why it had paid what was seemingly well above the market value for land for one of its restaurants, the response was,

"We're not in the real estate business, we're in the hamburger business. The land price is completely acceptable as a part of the overall business plan, and that is all we care about" However, no one else would be willing to pay either rent or a sale price for custom-built improvements that fit perfectly into someone

else's business plan, but not their own. The price a buyer is willing to pay would be well below the cost-based amounts, and this represents the very crux of this valuation issue.

(1.) Some jurisdictions have assessment criteria that mandate a market value in use estimate, which usually means the exchange value of the property assuming the current use is the highest and best use.

(2.) Appraisal institute, *The Appraisal of Real Estate*, 13th ed. (Chicago: Appraisal Institute, 2008), 501.

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