Dark Store Theory Discussion

Virginia Association of Assessing Officers

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How many of you wanted to become an assessor when you grew up?

I was gonna be a rock star...
Household name big-box retailers and home improvement stores such as Lowe’s, Home Depot, Sam’s Club, Wal-Mart, Target, and Kohl’s are using a controversial legal tactic to appeal their assessed valuations and reduce their property tax bills in several states across the U.S. Using what has been come to be called “dark store theory”, big-box stores have argued that their in-use stores should be valued equivalently to vacant or “dark” stores for taxing purposes. 

Standard & Poors, 2018

All taxpayers are entitled to appeal assessments they deem unfair,

But the sheer number of big-box appeals suggests a larger strategy to lower property taxes.
Scenario # 1
• Wal-Mart opens a new store in a rural town.
• Within 5 years sales exceed expectations, so Wal-Mart opens another larger store within two miles of the original store. The original store closes upon the new store opening.
• What happens with the original, relatively new store?

Scenario # 2
• Lowe’s and Home Depot are located directly across the street from each other. Demand can support one store, but not both. Home Depot closes.
• Is there an effect on the value of the Lowe’s store?

Scenario # 3
• Walgreen’s purchases Rite-Aid and announces the closing of hundreds of Rite-Aid stores, many of which are located directly across the street from a Walgreen’s or CVS.
• What is the affect on the market values of these properties?
Dark Store Theory – The Argument

• Originates from claims that big-box retail stores have been unfairly over-assessed by taxing jurisdictions.

• Occupied big-box stores should be valued as if vacant and available for sale or rent to a future hypothetical user – rather than in its current use as a functioning, occupied store.

Dark Store Theory – The Argument

• Costs associated with the construction of the property should be ignored as an indication of value because a significant portion of those costs must be considered as functional obsolescence.

• Assumes the property is already functionally obsolete as soon as constructed.

Dark Store Theory – The Argument

• Sale-leasebacks should be excluded from consideration as they are considered a form of 100% financing and do not represent value-in-exchange.

• Only generic properties can be used as market-based value-in-exchange sales as custom-built properties do not meet the test of value-in-exchange.
• The highest and best use of a successful operating store is no different than the highest and best use of a vacant, abandoned store.

• The current use of the property cannot be considered because it represents results in value-in-use, not value-in-exchange.

• Big-box stores are obsolete because consumers are shifting to on-line shopping and the large retailers are shifting to smaller store designs.

• Fee simple value is best reflected by sales of vacant big-box stores because those properties are not encumbered by leases.

• The assessor should:
  • Disregard the existence of the current property use; it's user; similar users; the market demand that supports the current use; the market activity of acquisition of land and the construction of improvements; and any property with an encumbrance.
Dark Store Theory – What Is It?

- Most of the discussion is centered on "big box" retail stores of 50,000 to 200,000 plus square feet.
- The concept can be applied to almost any size store.
- Another common feature is the stores appear to be originally built for a specific retailer.

Dark Store Theory

Former Walmart

New Walmart Nearby

Courtesy of Peter Korpacz

Operating Wal-Mart, Military Hwy, Norfolk, VA (under appeal)
Dark Store Theory

Closed Rite Aid
Norfolk, VA

Former Walmart
Military Hwy, Norfolk, VA
Closed Rite Aid
Norfolk, VA

Dark Store Theory

Walgreen’s across the street
Norfolk, VA

Operating CVS
Norfolk, VA
The Root of the Problem

Definition of the term “fee simple” or “fee simple absolute”

Fee simple is one of six freehold estates in real property

- Fee simple absolute
- Life estate
- Fee simple determinable
- Fee simple on condition subsequent
- Estate for years
- Estate at will

The term fee simple absolute dates back to the early 1300s in England. The legal definition, which remained constant over the years, is generally defined as an estate that has a potentially infinite duration and, if limited in favor of a person, would be inheritable by his heirs.

(Garner 2014, 2373-74; Wolf 2009, First Restatement of Property, section 14; section 13.01 - 02)
Dark Store Theory - Challenges

IAAO Definition of Fee Simple

Fee Simple – complete interest in a property subject only to governmental powers such as eminent domain. Also Fee Simple Absolute.

Glossary for Property Appraisal and Assessment, IAAO, 2nd Edition

Dark Store Theory – What Is It?

Other Appraisal Definitions of Fee Simple

The largest possible interest or estate in property, subject, however, to the limitations of Eminent Domain, Escheat, Police Power and Taxation; an inheritable estate.

Appraisal Terminology, American Institute of Real Estate Appraisers, 1938

Dark Store Theory – What Is It?

Other Appraisal Definitions of Fee Simple

Absolute ownership unencumbered by any other interest or estate; subject only to the limitations of eminent domain, escheat, police power, and taxation.

The Dictionary of Real Estate Appraisal, Appraisal Institute, 1984
Other Appraisal Definitions of Fee Simple

Note that the 1984 version of the Dictionary of Real Estate was the first publication to diverge from the previously established (1938) definition of fee simple.

Still in place in the 2015 version of the Dictionary of Real Estate.

- The concept that fee simple means the property is “unencumbered by any other interest or estate” is the point at which the appraisal definition digresses from the legal definition.
- Implies the existence of an encumbrance results in something other than fee simple ownership.
Dark Store Theory – What Is It?

**Black’s Law Dictionary Fee Simple Definition**

"An interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs; esp., a fee simple absolute. Often shortened to fee."

**The Law of Real Property Fee Simple Description**

"...the largest estate known to law. It denotes the maximum of legal ownership, the greatest possible aggregate of rights, powers, privileges, and immunities which a person may have in land. It is an estate of potentially infinite duration in the holder’s successors who acquire the holder’s interest in the property either by conveyance, devise, or inheritance. The three hallmarks of the estate are that it is alienable, devisable, and descendible."

(Moynihan and Kurtz 2002, 34)

Did either legal definition of fee simple mention estates or encumbrances?
Courts have noticed this discrepancy:
The distinction between 'fee simple' and 'leased fee' is one drawn in the context of appraisal practice. The appraisal industry uses the term 'fee simple' to refer to unencumbered property—or to property appraised as if it were unencumbered. This distinction is not one recognized by the law, however. A 'fee simple' may be absolute, conditional, or subject to defeasance, but the mere existence of encumbrances does not affect its status as fee simple. (Meijer Stores Ltd. Partnership v. Franklin Cnty. Bd. of Revision 2009; HIN, L.L.C. v. Cuyahoga Cnty. Bd. of Revision 2014)

Fee Simple

- Assertion is a Fee Simple valuation is the value unencumbered by any other interest or estate.
  - An estate is not an encumbrance.
  - A fee simple estate cannot be encumbered by another estate.
  - The existence of another estate simply means the estate is not fee simple.

Fee Simple, Leased Fee

- Assertion is a Fee Simple valuation is the value unencumbered by a lease—such as a vacant property.
  - A lease (or any other encumbrance such as mortgages, liens, deed restrictions) does not factor into the legal definition of Fee Simple.
  - Property may be held in Fee Simple subject to a lease.
Dark Store Theory – What Is It?

Fee Simple, Leased Fee
Stated simply, “fee simple” means the owner has full control of the disposition of the property.

Dark Store Theory – Legal Obligations of the Assessor

What Should the Assessor Do?
• Ad valorem valuation is a legal construct.
• Interpretation of the law is controlled by legal analysis, which may not be consistent with appraisal theory and practice.
• Note - The Virginia Code does not define “Market Value” or “Fair Market Value”

Virginia Fair Market Value Definition
"the price which it will bring when it is offered for sale by one who desires, but is not obliged, to sell it, and is bought by one who is under no necessity of having it.”
Tuckahoe Woman’s Club v. City of Richmond, 199 Va. 734, 737, 101 S.E.2d 571, 574 (1958).
Dictionary of Real Estate Appraisal Market Value Definition

“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, assuming that neither is under duress.”

Appraisal Institute 2015

2018-19 USPAP Market Value Definition

“A type of value, stated as an opinion, that presumes the transfer of a property (i.e., a right of ownership or a bundle of such rights), as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal.”

2018-19 USPAP Market Value Definition

“Appraisers are cautioned to identify the exact definition of market value, and its authority, applicable in each appraisal complete for the purpose of market value.”
**Black’s Law Dictionary Fair Market Value Definition**

“The price a buyer will pay. All parties are willing and aware of the property and its value”

**Did any of these definitions of market value mention encumbrances such as leases, mortgages, liens, deed restrictions?**

Have you ever heard of an appraisal assignment – for property tax purposes or otherwise – that requests a value of an unencumbered estate?

**The Virginia Assessor’s duty is to determine the market value (as defined in re Tuckahoe) of the fee simple interest of property as of the assessment date.**
Dark Store Theory

This theory suggests that occupied big-box stores should be valued as if vacant and available for sale or rent to a future hypothetical user rather than in the current use, which is often as a functioning occupied store.

Valuing an occupied subject property as if vacant requires a hypothetical condition which must be disclosed as such.

Hypothetical Condition

A condition, directly related to a specific assignment, which is contrary to what is known by the appraiser to exist on the effective date of the assignment results, but is used for the purpose of analysis.

Contrary to known facts about physical, legal or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis.

2018-19 USPAP (TAF)

The assumption that the property must be appraised as if vacant and available for lease or sale to some other prospective user basically eliminates the current user from the pool of prospective buyers.

Could this thinking ignore the current use of the property even if that use is the highest and best use?
Build- to-Suit; Sale-Leaseback

- Asserted to be based on financing or costs of customized improvements plus a premium paid for land acquisition.
- These transitions usually involve first-generation space, a building designed and occupied by the original tenant.
  - Big-box stores are not typically built to be sold.

Build- to-Suit; Sale-Leaseback

- These transitions are not usually considered as arms-length as the rent is typically based on the underlying development costs.
  - Analyze the transaction to determine if it is reflective of the market value.
  - Determine if there is sufficient information available to make proper adjustments.

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.

Dictionary of Real Estate Appraisal, Appraisal Institute, 2013
Dark Store Theory - Challenges

Value In Use, Value In Exchange

• Assertion is appraising the subject property with a lease in place results in a value in use rather than value in exchange.
• If the lease terms including rent are reflective of the market, then contract rent is equal to market rent. In this case value in use is reflective of value in exchange.

Value In Use, Value In Exchange

• What is the highest and best use of the subject property?
  • If the highest and best use is defined as how the property currently exists in use, the value in exchange and is equivalent to the value in use.

Functional Obsolescence

• Assertion is the improvements are worth something only to the current user and would contribute little or no value in the open market.
  • Are big-box improvements really that unique?
• The value of the property is as of the valuation date, not a future date or to a hypothetical prospective user.
Dark Store Theory - Challenges

Functional Obsolescence?

Remodeled Lowe's, Charlotte, NC

Former Wal-Mart, Ahoskie, NC

Former K-Mart, Virginia Beach

Former K-Mart, Charlotte, NC
Abandoned, Vacant Stores

• Assertion is abandoned, vacant stores are evidence of functional obsolescence and lack of market demand.
  • Overbuilt retail, changing demand in the marketplace.
  • Deed restrictions are imposed to limit competition, which limit the number of prospective buyers.

Abandoned, Vacant Stores

• Rejection by market participants of a first-generation big box store may signal a change in the highest and best use of a property.
  • Are big-box retail stores built to be sold?

Abandoned, Vacant Stores

• Often occupied by furniture store, churches, medical facilities, libraries, etc.

  • The use of the property changes because the property is no longer suitable for its original purpose.
Restrictive Covenants
• Deed restrictions are imposed to limit competition, which limit the number of prospective buyers.
• May force a change in the highest and best use of the property.

Encumbrances
• Government – taxation, eminent domain, police power and escheat.
• Private – mortgages, deed restrictions, easements, covenants, liens.
  • Private encumbrances do not prevent the owner from holding property in fee simple;
  • Could affect the value of the property.

Leased Fee
• The term “leased fee” is an appraisal term; a better definition might be Fee Simple subject to a lease.
• Refers to the ownership interest held by the lessor, which includes the right to receive the contract rent specified in the lease plus the reversionary right when the lease expires.
Dark Store Theory – Challenges

Leasehold

- The possessory interest held by a tenant.
- If a lease reflects market characteristics (including market rent), the leasehold has no market value.
- If the tenant pays less than market rent, the difference between the contract rent and market rent would represent a positive leasehold value.

First-Generation Space

A building or space designed to be functionally and economically efficient for the original tenant or similar class of tenants over a period of time during which the space retains its original utility and desirability.

*Dictionary of Real Estate Appraisal, Appraisal Institute, 2015*

Second-Generation Space

A building or space used by a tenant other than the original tenant; often functionally obsolete before refurbishment but sometimes containing tenant improvements that can be reused by a new tenant.

*Dictionary of Real Estate Appraisal, Appraisal Institute, 2015*
**Second-Generation Space - Alternative**

A building or space whose design is no longer functionally and/or economically desirable for the original tenant or a similar class of tenants. The space may no longer retain its original utility and/or desirability for the original tenant but may be used by a tenant other than the original or similar class of tenant.

*Commercial Big Box Retail: a Guide to Market-Based Valuation, IAAO, 2017*

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**The Retail Apocalypse**

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**Is it Really an Apocalypse?**

- “It’s not a retail apocalypse. It’s a culling of weak, poorly run retailers which did not embrace the changing needs of consumers.” *The Motley Fool*

- “Retail is the business of delivering goods and services to the ultimate customer. It’s not dying at all. It’s reinventing itself.” *Amanda Nicholson, Syracuse University*
The Retail Apocalypse

"America was over-stored. Ten or fifteen years ago, the only way to grow your business was through opening stores...I think where it's moving is a much healthier place."

Gabriella Santaniello, A Line Partners

An apocalypse is the final destruction before the end of the world, so the popular phrase “retail apocalypse” would be the end of retail as we know it. It’s a ridiculous phrase, especially when stores closing isn’t something we should feel pessimistic about. Sure, we can’t go hang out in Wet Seal anymore, but no one was really doing that anyway, which is a large part of the reason the stores closed.

Blake Morgan, Contributor, Forbes

A report from Coresight Research found the retail apocalypse to be continuing, with 5,994 store closings announced in the US for 2019 compared with 5,864 in all of 2018.

Gap, Old Navy, Victoria’s Secret, Abercrombie & Fitch, Tesla, Payless, Family Dollar, J.C. Penney, Kmart, Sears, Nordstrom, Kohl’s, Macy’s, Lowe’s, Kay Jewelry, GNC, Office Depot, Foot Locker, ...

Note – many of these are located in malls....
The Retail Apocalypse

- "We literally took the linens department and built Bed Bath and Beyond. We took the electronics department and built Best Buy." Nick Egelanian, Siteworks Retail Real Estate

In the Hampton Roads Area:
- 5 (each) Home Depot, Lowes, Dick's, Best Buy, Kohl's, Target;
- 4 (each) Lowe's, JC Penney, Dillard's;
- 3 (each) Macy's
- 7 malls in Hampton Roads, 6 of which are within 10 miles of each other.

Do we really need all of these stores?

The Middle Class Squeeze

The middle-class squeeze is the situation where increases in wages fail to keep up with inflation for middle-income earners leading to a relative decline in real wages, while at the same time, the phenomenon fails to have a similar effect on the top wage earners. People belonging to the middle class find that inflation in consumer goods and the housing market prevent them from maintaining a middle-class lifestyle, undermining aspirations of upward mobility.
<table>
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<tr>
<th>Quarter</th>
<th>Total Retail Sales (millions of dollars)</th>
<th>E-commerce as a Percent of Total</th>
<th>Percent Change From Prior Quarter</th>
<th>Percent Change From Same Quarter of A Year Ago</th>
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<tr>
<td>Adjusted 4th quarter 2018(p)</td>
<td>1,345,243</td>
<td>132,830</td>
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<td>Adjusted 3rd quarter 2018(r)</td>
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<td>Adjusted 2nd quarter 2018</td>
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<td>Adjusted 1st quarter 2018</td>
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<table>
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<th>Quarter</th>
<th>Total Retail Sales (millions of dollars)</th>
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<th>Percent Change From Prior Quarter</th>
<th>Percent Change From Same Quarter of A Year Ago</th>
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<td>Not Adjusted 1st quarter 2018</td>
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<td>Not Adjusted 4th quarter 2017</td>
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<td>141,719</td>
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<td>7.7</td>
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</table>

Source: Retail Indicators Branch, U.S. Census Bureau

**Dark Store Theory – Challenges**

**The Retail Apocalypse**

- Even traditional brick-and-mortar retailers have an online presence.
- Shop and buy online, free shipping and in-store pickup.
The Retail Trifecta:

Changing shopping habits;
Overbuilt;
Growing impact of online sales

To correctly develop an assessment of any property, an accurate determination of highest and best use must be made, appropriate approaches to value selected, and proper adjustments applied.

Wilmeth and Alesandrini, 2015
**Highest and Best Use**

The use that generates the highest net return to the property owner over a reasonable period of time.

- **Legally Permissible**
- **Physically Possible**
- **Financially Feasible**
- **Maximally Productive**

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**The basis of Highest and Best Use is driven by economic principles (Anticipation, Substitution, Supply and Demand, and Contribution).**

**The disagreements regarding definitions and property rights will not change the highest and best use of a property.**

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**The highest and best use determination should identify:**

- **Use**
- **Timing (economic demand over a given time period)**
- **Market Participants**
  - Most probable users
  - Most probable buyer type (owner-operator, investor, developer, etc.)
Dark Store Theory – Highest and Best Use

- **Legal Restrictions** usually governmental in nature
  - Zoning, subdivision regulations, easements, building codes, environmental laws, etc.
  - Private restrictions in the form of a deed restriction are often present in the sale of a first generation big box retail store.
  - Basically the owners do not want to sell to a direct competitor – which eliminates the current use of the property.

Dark Store Theory – Valuation Techniques

**Three Approaches to Value**

- Cost
- Income
- Sales Comparison

All have strengths and weaknesses in the Dark Store debate!

Dark Store Theory – Valuation Techniques

**Sales Comparison Approach**

- Based on the concept of value-in exchange and Principle of Substitution.
- Comparison of the subject property with similar properties that have recently sold.
- Requires the analysis and application of adjustments to sold properties.
- Closely reflects how buyers and sellers in the marketplace engage in property transactions.
Sales Comparison Approach - Advantages
• Especially reliable when ample data is available to make appropriate adjustments.
• Widely understood and relied upon by the Courts.
• Reflects the actions of buyers and sellers in the marketplace.

Sales Comparison Approach - Disadvantages
• Usually only two types of sales are available:
  • Sale-leaseback (first generation users)
  • Rent is usually based upon development costs
  • As vacant after a big-box chain has abandoned a location (second-generation users)
Dark Store Theory – Valuation Techniques

Income Approach
• Present worth of future benefits.
• Based upon the Principle of Anticipation.
• Big-box retail are mostly owner-occupied, but can be owned by investors and occupied by retailers under a long-term lease.

Income Approach - Strengths
• Income and expense information may be available through services such as CoStar and Trepp.
• Likely the fee-simple owner is an investor drawn to the property due to the quality of the income stream.
• Arguably, income capitalization is the most accepted approach utilized by market participants.

Income Approach - Weaknesses
• Selection of the capitalization rate!
  • Overall capitalization rates may be difficult to develop due to a lack of information.
• Sale-leaseback rents are usually based upon development costs (first-generation users)
• Second-generation rents are usually a derivative of a change in highest and best use.
Cost Approach

- Estimate of the value of the land;
- Estimated cost new of the improvements;
- Adjustments for depreciation caused by age, utility or external factors;
- Land Value + Depreciated Value of Improvements = Total Value

Cost Approach - Strengths

- Inherently values the fee simple property rights
- Eliminates the debate about leases and deed restrictions
- Useful when comparable sales and rental data are not available
- Replacement cost typically excludes functional obsolescence issues.
Dark Store Theory – Valuation Techniques

**Cost Approach - Strengths**
- Serve as a test of reasonableness against claims that build-to-suit costs exceed the market value of new improvements.
- A prudent investor would consider land and improvement costs when determining the financial feasibility of a project.
- Data is almost always readily available.

**Cost Approach - Weaknesses**
- Estimating depreciation and entrepreneurial profit
- Effective age is based upon an appraiser's opinion.
- Remaining economic life can be supported by a study of the typical economic lives of similar buildings – but is usually based on the appraiser’s judgment.

Dark Store Theory – Parting Thoughts

In big box appeals, look for:
- Definitions of market value and fee simple;
  - Magic words are "encumbrances" and "unencumbered"
- **Value in Use versus Value in Exchange**
- Highest and Best Use
  - Not highest and best user
Dark Store Theory – Parting Thoughts

In big box appeals, look for:

• In the Cost Approach:
  • Physical depreciation calculation
  • Actual Age, Effective Age, Remaining Economic Life
  • Economic obsolescence
  • Online sales, store closings (retail apocalypse)
  • Functional Obsolescence
  • Stores built for a specific user

• In the Sales Comparison Approach:
  • First Generation and Second Generation Properties
    • Appellants tend to use second generation sales as comparables for first generation properties
    • Highest and Best Use should be the same for the subject and the comparable sales

• In the Income Approach:
  • First Generation and Second Generation Properties
    • Appellants tend to use second generation I&E as comparables for first generation properties
    • Highest and Best Use should be the same for the subject and the comparable sales
Dark Store Theory – References

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- Retail Indicators Branch, U.S Census Bureau, March, 2019
- Commercial Big-Box Retail: Guide to Market-Based Valuation, International Association of Assessing Officers, September 2017
- Thinking Outside the Big Box, Tim Wilmath and Pat Alesandrini, CAE, IAAO Fair and Equitable, November 2015
- Peter F. Korpacz, MAI, CRE, FRICS, Korpacz Realty Advisors, Inc.
- Mark T. Kenney, MAI, SRPA, MRICS, MBA, American Valuation Group, Inc.

Still wanna be a rock star....
Dark Store Theory Discussion
Virginia Association of Assessing Officers

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Real Estate Assessor
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I. PURPOSE

This IAAO position paper provides guidance for the valuation of big-box retail properties. Over the last several years, issues involving these properties and theories about how to value them, such as the dark store theory, have resulted in great debate within both the appraisal and legal communities. Even though this paper concentrates on arriving at the market value of the fee simple interest of these properties, it provides guidance regardless of the specific law of a jurisdiction.

This analysis focuses on big-box retail stores from 50,000 to 200,000-plus square feet; however, the market trend for big-box retail is shifting to both smaller and larger stores. For example, one major retailer has six different prototype stores varying from 15,000 to 260,000 square feet, depending on the characteristics of the trade area. The concepts discussed in this paper apply to single-tenant retail stores of any size and also to other property types.

This paper does not explain how to mass appraise; rather, it describes the process that will help an appraiser support a market value estimate for big-box retail properties. The theories and methodologies discussed in this paper reflect market behavior. The paper identifies recurring issues in this controversy, clarifies the fundamental concepts used in appraisal practice, and explains the methodologies developed in arriving at the appropriate value required by the jurisdiction for assessment purposes.

II. BIG BOX RETAIL ISSUES AND THE DARK STORE THEORY

The dark store theory originates from claims that big-box retail stores have been unfairly over-assessed by taxing jurisdictions. This viewpoint maintains that real property assessments should not be based on what the property is worth to the current user, purported to be value-in-use or use value, but on what the property would be worth to another prospective (hypothetical) user in the open market. The argument alleges that the latter is a true reflection of value-in-exchange and market value. Advocates of this position assert that any costs associated with the property’s construction must be ignored as an indication of value, and that a significant portion of those costs must be considered functional obsolescence. By this argument, a property is already functionally obsolete as soon as it is constructed. Leases-in-place must also be ignored, because they too are a reflection of use value or value-in-use, in that the rents are typically based on costs to cover construction.

The term *dark store* generally describes vacant stores (as in dark because they are without electricity). The term is used to identify the types of sales that dark store theorists claim are appropriate comparables for the subject property, regardless of whether the subject is a vacant property or an occupied property. Vacant subject properties are rarely identified in this contentious debate, because there is generally less disagreement that vacant stores have less value. However, the debate escalates when vacant, blighted, abandoned, deed-restricted sales are used as comparisons to functioning, occupied stores. While it is often true that big-box stores may close their doors after they have operated and made profits, and also true that these stores sometimes sit vacant for months or years before retrofit or demolition, critics of the dark store theory argue that vacant big-box stores have a highest and best use different from those of occupied ones.
For tax assessment purposes, the date of value is established and value is based on what actually physically exists—not what is hypothetical. Critics of the dark store theory also believe the value of the property in its current use, if rents-in-place are shown to be in line with market rents, is reflective of market value, and that leased-fee value is equal to fee simple value. Further, an occupied property is evidence that demand for the property exists, and valuing an occupied property as if it is a vacant property would require the appraiser to disclose a hypothetical condition. Hence the debate. This paper seeks to address these issues and provide the assessor with guidance on valuing these property types.

III. EXECUTIVE SUMMARY

During the research process, the following arguments were identified as repeatedly arising in the appeal of big-box retail ad valorem valuations. The following list summarizes some significant and recurring issues.

- **Dark store theory.** This theory suggests that occupied big-box stores should be valued as-if-vacant and available for sale or rent to a future hypothetical user rather than in the current use, which is often a functioning, occupied store.

  Valuing an occupied subject property as-if-vacant requires a hypothetical condition that the appraiser would be required to disclose. This is not to say that when the subject property itself is vacant as of the valuation date, the use of vacant comparables is inappropriate.

- **Build-to-suit and sale-leaseback transactions.** It is asserted that these transactions are based either on financing or on costs of customized improvements plus a premium paid for land acquisition. Thus, the rents reflect inflated costs. These transactions are non-arm’s-length and should be excluded as comparisons for the subject property.

  Sales of first-generation transactions are scarce in the market, and an appraiser should examine whatever data are available. Neither build-to-suit nor sale-leaseback transactions should be automatically disregarded as improper comparables. As with all sales, the appraiser must carefully analyze the transaction to determine whether it is reflective of the market value of the fee simple estate, and if not, determine whether sufficient information is available to make the proper adjustments.

- **Value-in-use versus value-in-exchange.** Valuing the subject property with a lease-in-place sometimes raises the concern that the appraiser is arriving at value-in-use rather than value-in-exchange.

  If the appraiser determines the lease terms, including rent, are reflective of the market, then contract rent is equal to market rent and value-in-use is reflective of value-in-exchange.
• *Functional obsolescence in improvements designed for a specific user.* Improvements made for a specific big-box retailer are claimed to be functionally obsolete as soon as they are built, because they are worth something only to the current user and would contribute little or no value in the open market. In other words, improvements may cost $15,000,000 to build but are worth only a fraction of that amount to another user.

Most big-box improvements are in fact not unique (with the likely exception of signage). Further, the value of the property is as of the date of valuation, not as of a future date, to a hypothetical prospective buyer. It will be for the market to determine whether the improvements are in demand, and it will be for the future buyer to make the economic decision to purchase the property and retrofit, demolish, or continue to use the improvements.

• *Abandoned, vacant stores.* The assertion is that abandoned, vacant stores are evidence of functional obsolescence and lack of market demand.

Abandoned stores may or may not be evidence of functional obsolescence. Moreover, subsequent sale prices for those properties are often the result of the detrimental impact of deed restrictions or of changing demand in the marketplace on the pool of potential buyers.

• *Impact of restrictive covenants.* Big-box retailers often assert that deed restrictions have no significant impact on property value.

The impact of deed restrictions on value is difficult to quantify, because it is virtually impossible to determine the number of potential buyers who walked away from a deed-restricted sale. It is certain that deed restrictions, by design, are imposed to limit competition and force a change in highest and best use.

• *Fee simple is not unencumbered.* This notion suggests a fee simple valuation assignment (whether big-box or other types of property such as a corporate office center, office building, industrial property, among others) is the value unencumbered by a lease, i.e. a vacant property.

A lease does not factor into the definition of fee simple absolute. A lease is a possessory right, and a property may be held in fee simple, subject to a lease. In a jurisdiction where market rent is the criterion for the calculation of rental income in an appraisal (market rent jurisdiction), sales of leased properties can and should be used as comparables, if adjustments are made for above- and below-market rents. In a jurisdiction where contract rent is the criterion for the calculation of rental income in an appraisal (contract rent jurisdiction), sales of leased properties can and should be used as comparables, with no rental adjustments required.

• *Highest and best use of big-box properties.* If a property is a certain size, regardless of investment class, occupancy, or deed restriction, it serves as an appropriate comparable for a subject property that is occupied and is not burdened with such a restriction.
The appraiser should be wary of arriving at an overly broad highest and best use conclusion of *general retail*. Market segmentation analysis indicates the existence of multiple investment classes of retail properties, similar to other property types such as offices, apartments, hotels, and other commercial properties. Simply because a property is similar in size to the subject property does not alone make it an appropriate comparable. Also, the appraiser is highly encouraged not to use a deed-restricted comparable if the subject property does not have a similar restriction.

IV. REAL PROPERTY RIGHTS IN REAL ESTATE

Ad valorem tax valuation is a legal construct. The specific laws, regulations, and case law of a jurisdiction control what is valued and how it is valued. This is one reason there is a jurisdictional exception in the *Uniform Standards of Professional Appraisal Practice* (TAF 2016). Because ad valorem tax valuation is a legal construct, interpretation of the law and regulations is controlled by legal analysis, not by appraisal analysis; thus, in some jurisdictions, what is required for ad valorem valuation may not be consistent with fee appraisal theory and practice. The appraiser must know exactly what a jurisdiction means by fee simple estate and what encumbrances must be taken in account.

A. Fee Simple Absolute

Many jurisdictions require a valuation of the fee simple absolute estate (or *fee simple*). *Black’s Law Dictionary* defines fee simple as,

> An interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs; esp., a fee simple absolute. Often shortened to fee. (Garner 2014)

Alternatively, the *First Restatement of Property* §14 defines an estate in fee simple as follows: An estate in fee simple is an estate which

(a) has a duration
   (i) potentially infinite; or
   (ii) terminable upon an event which is certain to occur but is not certain to occur within a fixed or computable period of time or within the duration of any specified life or lives; or
   (iii) terminable upon an event which is certain to occur, provided such estate is one left in the conveyor, subject to defeat upon the occurrence of the stated event in favor of a person other than the conveyor; and
(b) if limited in favor of a natural person, would be inheritable by his collateral as well as by his lineal heirs.”

The important aspect to note is that “fee simple” has absolutely nothing to do with leases/mortgages/liens/deed restrictions or any other encumbrance or distribution of any of the property rights to others. It simply means that the current owner has full control of the
disposition of the property. The fact that a property may have a deed restriction, lease, lien, or easement does not diminish or defeat the fee simple absolute property rights.

The legal concept of fee simple merely states that the owner has a fee simple estate, rather than another lesser estate, such as a life estate, fee simple determinable, or other various estates. It does not address government limitations or private encumbrances on the property.

**B. Encumbrances**

Although the legal definition of fee simple implies the fee owner retains all rights in the property, all private property has limitations imposed by the government powers of taxation, eminent domain, police power, and escheat. These government restrictions on property are encumbrances.

In addition to government encumbrances, there may be private encumbrances placed on property, such as mortgages, deed restrictions, easements, covenants, and liens, to name a few. While none of these private encumbrances result in the owner not holding the property in fee simple, they can raise or lower the value of the real property.

*Black’s Law Dictionary* defines encumbrance in part as follows:

A claim or liability that is attached to property or some other right and that may lessen its value, such as a lien or mortgage; any property right that is not an ownership interest. (Garner 2014)

The Uniform Commercial Code defines encumbrance as follows:

Encumbrance means a right, other than an ownership interest, in real property. The term includes mortgages and other liens on real property. (Legal Information Institute n.d.)

As noted above, the existence of these governmental and private encumbrances on real estate does not affect the fee simple estate.

It is critical that jurisdictions, courts and the property tax community specify what encumbrances the appraiser should and should not recognize when performing a property tax appraisal. Simply using the phrase “fee simple” is insufficient.

Sometimes the phrase “fee simple” is appended with the term “unencumbered”. The problem with the word “unencumbered” from an appraisal standpoint is that the term is inconsistently applied and subject to misinterpretation. An appraisal of the fee simple unencumbered interest would mean the appraiser would ignore governmental restrictions, utility easements and the like – an unlikely assignment in property tax or any other appraisal assignment.

Because of this confusion, a primary debate in big-box valuation is whether stores should be valued based on the sale prices of vacant stores or on the sale prices of leased and owner-
This debate arises in part when the appraiser reads the term “unencumbered” (or appends the term to the phrase “fee simple”) and concludes that the appraisal assignment must ignore the existence of a lease. The appraiser then takes the further step of determining that the property must then be valued as-if-vacant, even if the subject property is occupied. This same logic is then extended to sales of leased stores, which are also excluded because they too are encumbered. Excluding sales of leased properties leaves only vacant ones as potential comparables. To take this logic to the end assumes that all commercial property should be valued as-if-vacant. This erroneous conclusion is addressed below in Section V. Definitions of Value.

How jurisdictions treat encumbrances is a public policy issue. One overriding principle in ad valorem property taxation is that a parcel of property is typically assessed to one owner. Thus, regardless of whether the fee simple owner has transferred interests in the property, the holder of the fee simple estate is assessed for all of the property rights.

Jurisdictions may ignore the transfer of rights associated with liens, leases, and mortgages. However, not all jurisdictions treat easements and restrictive covenants similarly, and some jurisdictions continue to struggle with the issue.

C. Leased Fee (Fee simple subject to a lease)

The term leased fee is an appraisal term defined in The Dictionary of Real Estate (Appraisal Institute 2015). It is not a legal term and is rarely used by market participants in the sale transaction market. Leasehold is a legally defined term as well as an appraisal term. Black’s Law Dictionary (Garner 2014) defines leasehold as, “a tenant’s possessory estate in land or premises… .” The terms are used as follows:

- **Leased fee.** The ownership interest held by the lessor, which includes the right to receive the contract rent specified in a lease plus the reversionary right when the lease expires. (Appraisal Institute 2015, 128). The term is used by appraisers as a basis to estimate the lessor’s value subject to a lease. It is based usually on the capitalization of net operating income (NOI) or the sum of the present value of the forecast NOI over a holding period and the present value of the reversion. In reality, leased fee is synonymous with fee simple, subject to a lease when possession but not the ownership is temporarily transferred to another.

- **Leasehold.** This is the possessory interest held by a tenant. The term is used by appraisers as a basis to estimate the value of the lessee’s interest, usually calculated by capitalizing the difference between market rent and contract rent. If a lease exists that reflects market characteristics, including market rent, then the leasehold has no market value. However, if the tenant pays less than market, the difference between the present value of what is paid and the present value of market rents would be a positive leasehold value in the real estate for the tenant.
D. The Fee Simple and Leased-Fee Issue

Technically what is being referred to is a fee simple interest subject to a lease. However, the term leased fee is common appraisal terminology and is used throughout this document.

When arriving at a fee simple valuation value for ad valorem taxation, the appraiser must recognize that leases, easements, and estates other than fee simple exist in the real world of comparables the appraiser considers. A lease fulfills the basic wish of an owner to receive rent. It is not an encumbrance to ownership of real property rights—it is a contract for the use of the property to provide rental income to the owner. The appraiser must be able to make any necessary market-based adjustments to those comparables in order for them to be useful in arriving at the appropriate valuation goal required by the law of the jurisdiction.

If the appraiser is considering using leased-fee sales, then it must be determined whether the contract terms and contract rents are equivalent to market terms and market rents as of the valuation date or whether supportable adjustments can be made to the leased-fee sales.

V. DEFINITIONS OF VALUE

A. Jurisdictional Requirements

Most jurisdictions require a market value estimate; however, a jurisdiction may also use the terms market value, fair market value, cash value, or true cash value, among others. An appraiser should identify the applicable value as it is defined by the jurisdiction and carefully follow that definition. Usually the term market value is defined by statute or the courts and constitutes a willing seller and a willing buyer acting in full knowledge without duress in an open-market, arm’s-length transaction. In general, the market value will be the *as-is* market value. If other value-related terms apply, they also should be examined for possible application in the assessment valuation.

B. Market Value

1. Definition

*The Dictionary of Real Estate Appraisal* defines market value as follows:

*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.* (Appraisal Institute 2015, 141)
2. Market Value and Big-Box Retail

An appraiser’s conclusion of the market value of a big-box property should reflect the actual condition of the property on the date of valuation, including whether the property is occupied or vacant. If the property is occupied, whether by an owner or a tenant, the property should be valued as occupied. If the property is vacant as of the date of valuation, then the market value conclusion should arrive at a value as vacant.

This issue frequently arises in the sales comparison approach, in which an appraiser uses vacant comparables to value an occupied property without applying an appropriate adjustment to the vacant comparables. In fact, valuing the subject property as vacant when the subject property was occupied as of the date of valuation requires a hypothetical condition that the appraiser would be obliged to disclose.

Hypothetical condition is defined as follows:

1. A condition that is presumed to be true when it is known to be false.
2. A condition, directly related to a specific assignment, which is contrary to what is known by the appraiser to exist on the effective date of the assignment results, but is used for the purpose of analysis. Comment: Hypothetical conditions are contrary to known facts about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis. (TAF 2016)

The issue is clarified when the appraiser considers the other two approaches to value. Quite obviously, in an income approach, the appraiser is valuing the subject property as occupied, using market income and expense data. Less obviously, the cost approach also arrives at a value of the subject property as occupied (stabilized). As noted in *The Appraisal of Real Estate*,

*The value of a property indicated by the cost approach is the value of a fee simple estate. For properties that are leased, the cost approach assumes stabilized occupancy and income.* (Appraisal Institute 2013, 565–566)

Thus, it now becomes clear that using vacant sale comparables (without adjustment) to value an occupied property is not proper appraisal practice.

If the subject property is vacant as of the date of valuation, lease-up costs should be considered when the comparables are leased at market terms, including the time it takes to lease the space. However, because of the speculative variables in these unknown lease-up assumptions, the appraiser is encouraged to use similarly comparable properties, that is, vacant with vacant and occupied with occupied.

C. Value-in-Use

*The Dictionary of Real Estate Appraisal* defines value-in-use as follows:
When the highest and best use of a property is defined as how the property currently exists in use, the value-in-exchange of the property is equivalent to the value-in-use of the property.

VI. THE HYPOTHETICAL SALE

As noted above, the classic definition of market value as arriving at an estimate of what the real property interest would sell for between a willing buyer and willing seller requires that the appraiser create a hypothetical sale of the property as of the date of valuation.

Although the appraiser is hypothesizing a sale of the property, what should not be hypothetical are the physical aspects of the subject property and the economic conditions surrounding the subject property. The appraiser cannot ignore the subject property’s physical depreciation or functional obsolescence in the hypothetical sale. Nor can the property’s location, market demand, or economic conditions be ignored.

While this seems obvious, appraisers sometimes erroneously attribute negative aspects of a comparable sale (such as a poor location with weak market demand, functionally obsolete features, and the like) to the subject property by failing to make adjustments for those differences.

A. Hypothetical Seller

When there is an actual sale of a property, the appraiser knows the identity of the seller of the property. However, in a hypothetical sale of the subject property as of the date of valuation, the actual owner of the property is not the hypothetical seller. Instead, the identity of the hypothetical seller is both unknown and not relevant. However, as the definition of market value requires, that unknown seller is knowledgeable and acts prudently and with self-interest.

B. Hypothetical Buyer

In a hypothetical sale, the appraiser does not have to identify an actual buyer of the property. As long as the appraiser identifies demand for the property, the market will supply a buyer. However, if the subject property is functionally obsolete, even a hypothetical buyer would take that obsolescence into account.

When determining demand for the subject property, the appraiser should not ignore the current owner/user as a part of that demand. If the current owner/user is ignored as part of the market demand, then the appraiser is improperly analyzing the market demand for the property.
VII. HIGHEST AND BEST USE

Highest and best use analysis must be conducted for both the subject property and other properties the appraiser is considering using as income or sales comparables.

*Highest and best use is a theoretical concept that underlies valuation analysis. An appraiser must first perform general market analysis in order to then analyze the characteristics of the market that cause the subject property to have value. ... Highest and best use is the use that generates the highest net return to the property over a reasonable period of time.* (Thimgan 2010)

The highest and best use of the land as-if-vacant and available for use may be the same as the existing use or may differ from the highest and best use as-improved. It is different when existing improvements are either an interim use or are approaching the end of their economic life but still contribute value to the real property in excess of the value of the land.

Analysis of highest and best use for as-if-vacant requires four tests done in the order listed below.

A. As-if-Vacant

   1. Legally Permissible

   Legally permissible uses considered first in a highest and best use analysis include legal limitations, such as zoning regulations or deed conditions and restrictions, that may have an impact on development potential. These constraints may be attributable to zoning, private restrictions, easements, historic districts, building codes, and environmental regulations.

   2. Physically Possible

   Factors such as site size, shape, frontage, topography, soil composition, flood zone, and access to utilities may limit use of the site to its fullest potential. A use may be legally permissible but only realized if the physical characteristics of the land support the use. Thus, a proposed property may or may not be a viable development on the site.

   3. Financially Feasible

   The determination of financial feasibility is largely dependent on supply and demand for the legally permitted and physically possible uses and the costs associated with the future development. Recent construction of other big-box properties in the market is evidence that a big-box use is financially feasible and shows that demand for such big-box properties exists.

   4. Maximally Productive

   The highest and best use for as-if-vacant is the use that produces the highest residual land value.
B. As-Improved

The same four criteria for the highest and best use analysis for as-if-vacant should be considered in the highest and best use analysis for as-improved.

1. Legally Permissible

The appraiser should determine whether the current use is a legally conforming use. If zoning has changed or if the improvements were built under a conditional use permit, reconstruction of the same type of building may not be allowed if the improvements are destroyed. When a first-generation big-box retailer vacates, it often places deed restrictions on the property to prohibit competition. This forces a change in highest and best use to something other than the property’s original design.

The following is an example of such a deed restriction:

TO HAVE AND TO HOLD said Land unto Grantee, and its successors and assigns, forever, with all tenements, appurtenances and hereditaments thereunto belonging, subject to easements and other matters of record, and subject to the following restrictions: For a period of TWENTY-FIVE (25) years from the date hereof, said Land may not be used as a discount department store whose overall retail concept is based on a discounting price structure, a wholesale membership club or warehouse store, a grocery or supermarket or similar type store, or a pharmacy (collectively, the "Use Restrictions"). Those portions of the building leased to (intentionally omitted for confidentiality) (collectively, the "Leases") shall be exempt from the Use Restrictions for those periods the Leases shall be in effect, however, in no instance shall the exemption for the building area leased by (ABC retailer) last beyond May 31, 2018. The aforesaid restrictions shall run with and bind said Land and shall inure to the benefit of and be enforceable by Grantor or an affiliated company or its successors, by any appropriate proceedings at law or in equity to prevent violations of such conditions and restriction and/or to recover damages for such violations from the then current owner of the Land. However, such conditions and restrictions shall remain in effect for Twenty-Five (25) years from the date hereof.

2. Physically Possible

Consider the land-to-building ratio. If the land-to-building ratio is greater than what is typical for the current use, the improvements may be an underutilization of the site, suggesting that a larger building may be developed. Underutilization may indicate the current improvements are not the highest and best use as-improved.
3. Financially Feasible

The third step in a highest and best use analysis is financial feasibility. This analysis requires consideration of the demand for the property. This step typically incorporates some degree of a marketability study. When considering market demand, the appraiser considers the likely users of the property, which include likely buyers/tenants. The result of this analysis in the consideration of operating properties versus vacant properties is often that the operating property is still financially feasible for its current use, whereas the vacant store is vacant because of a diminishing or absent demand. If the property is occupied, this is evidence that demand for the property exists.

For most properties with big-box stores and related improvements, one of the following four possible highest and best use conclusions is likely:

- Retain existing improvements for their current use.
- Renovate to address physical and functional items that need to be cured and/or convert to a different use to recognize changing trade area demand trends.
- Demolish existing improvements and redevelop the site with a different use that represents the highest and best use of the site.
- Demolish existing improvements and hold the site for future development.

Techniques such as the land residual, feasibility rent analysis, and the use of profitability index are methods that may be used to test financial feasibility. Another practical method that may be considered is a simple analysis showing that an improved property should not be worth less than vacant land. This methodology is particularly useful for big-box stores. Consider the following hypothetical:

An occupied store of 150,000 square feet has a typical land-to-building ratio of 5:1 or land area of approximately 750,000 square feet. Purportedly the building is worth $20/square foot based on comparable sales of deed-restricted, converted stores, and/or vacant properties. This value implies the subject property is worth $20 \times 150,000\text{ square feet}, or $3,000,000. This $3,000,000 for 750,000 square feet of land area also indicates that land must be worth less than $4/square foot. If comparable land sales indicate a value for land greater than $4/square foot, then the market value of the subject property is either greater than $3,000,000 or the occupied property has reached the end of its economic life because the improvements offer no contributory value.

From this example, the comparable properties are not appropriate for comparison to the occupied property or the current use is not the highest and best use. If continued use of the operating store is financially feasible, then the comparable properties are inappropriate because the resulting value is less than the land value.
The same test may also be used with rents. The $3,000,000 value implies that net operating income for the subject property would be approximately $270,000 annually using a market-based capitalization rate of 9 percent as an example. An annual net rent of $270,000 for 150,000 square feet implies a net rental rate of $1.80/square foot. If comparable leased properties in the subject’s market reflect net income significantly higher than $1.80/square foot, then either the comparable leased properties are inappropriate or the property is approaching or has reached the end of its economic life. Again, the test reveals that the value of the land exceeds what is proposed as the contributory value of the improvements.

Comparable land sales provide the benchmark for the lowest value a property can be as-if-vacant; thus, the proper identification of land sales is an important step in determining the correct highest and best use.

4. Maximally Productive

According to Property Assessment Valuation,

*In mass appraisal, the current highest and best use is usually considered to be the current use; that is, buildings will not be immediately demolished or replaced* (Thimgan 2010, 44).

If the subject property is occupied, that fact supports the premise that there is demand for the use for which the property was originally designed. Highest and best use is likely for the continued use of the property in its current use.

VIII. MARKET SEGMENTATION AND HIGHEST AND BEST USE

For retail properties, value is affected by size, age, condition, access, traffic counts, proximity to major employment centers, the concentration of surrounding properties, population size, and household purchasing power, to name just a few considerations. The competitive advantage of a property determines its relative position within the market. A property that has significant advantages over other properties of the same use because of location, demographics, and economic forces will command a higher price and rent. As such, stratifying properties into investment classes creates a logical hierarchy that reflects potential market participants’ actions. This method assists the appraiser in identifying the highest and best use of the subject property and in selecting appropriate comparables.

A. Investment Class A

Investment class A big-box retail properties sell at the highest prices and lowest capitalization rates. The first-generation user generally occupies these properties. Buyers of investment class A big-box retail properties typically are national investors, such as real estate investment trusts, insurance companies, and retirement funds, looking for newer improvements with a creditworthy national or regional retail chain tenant under a long-term, generally triple-net, lease. These properties often have locations that generate high retail sales per square foot, usually above the
chain’s nationwide average. The locations typically have greater visibility, such as a corner lot and high traffic counts. Leased class A properties generally are subject to long-term leases and are purchased with significant years remaining on the lease.

B. Investment Class B

Investment class B big-box retail properties are usually slightly older properties that sell in the mid-range price level at mid-range capitalization rates. These first-generation properties are in good locations but not as well located as class A properties. The retail sales per square foot usually meet or may exceed the chain’s nationwide average sales per square foot. These properties may still attract national and regional investors. Remaining lease terms on these properties, while not as long as for investment class A properties, generally exceed 10 years.

C. Investment Class C

Investment class C big-box properties are nearing the end of their economic life for first-generation use and may be classified as second-generation space. These locations do not meet the minimum requirements for a new improvement of the same use or renovation of the current improvements by the first-generation user. Retail sales at these properties are usually below the chain’s nationwide average. These properties sell toward the low end of prices and high end of capitalization rates. The continued use of the current use is likely an interim use. Remaining lease terms are relatively short, usually less than 10 years.

D. Investment Class D

Investment class D big-box retail properties sell at low prices and, when leased, indicate high capitalization rates. They are often vacant or soon-to-be-vacant properties with a highest and best use for a second-generation use. The original market demand for these properties has moved to more desirable retail locations. These vacant properties possibly are ready for redevelopment for a different use (e.g., low-end retail, office, or warehouse). The original design is no longer valuable or viable in the marketplace except by second-generation users at low prices or rents.

IX. THE THREE APPROACHES TO VALUE OF FEE SIMPLE PROPERTY RIGHTS

A. The Cost Approach

*The cost approach to value provides a value indication that is the sum of estimated land value and the estimated depreciated cost of the building and other improvements* (Thimgan 2010).

The cost approach is a two-step process that provides a value indication of the land and an estimate of value for the cost to build a new or substitute property. Adjustments for depreciation caused by age, utility, or external factors are applied to the improvements, and the depreciated value of the improvements is added to the land value to arrive at a total value. The approach is premised on the Principle of Substitution, which asserts that,
[A] rational, informed purchaser will pay no more for a property than the cost of acquiring an acceptable substitute with like utility, assuming that no costly delay is encountered in making the substitution (Thimgan 2010).

This approach reflects market behavior, especially in the valuations of new properties, well-maintained properties, proposed construction or renovations, and special-purpose properties or, in the case of big-box properties, when comparable sales and unrestricted-use sales are scarce.

1. Strengths of the Cost Approach

Courts frequently rely on the cost approach because it inherently values the fee simple property rights and eliminates the debate about leases and deed restrictions. The cost approach is useful when comparable sales and rental data are insufficient or lacking. Replacement cost new, rather than reproduction cost new, typically excludes any functional obsolescence relating to design and utility, such as superadequacies, for example. The cost approach can serve as a test of reasonableness against claims that build-to-suit costs exceed the market value of new improvements. For these reasons, the cost approach is especially useful for investment class A and class B properties that tend to be newer, well-maintained buildings. Big-box retailers consider land and improvement costs when determining financial feasibility for a project, so the application of the cost approach directly replicates market behavior.

2. Weaknesses of the Cost Approach

Limitations in the cost approach are attributed generally to estimating depreciation and entrepreneurial profit/incentive. The economic age-life and market extraction methods are widely used by appraisers to estimate depreciation because of their simplicity in application. However, lump-sum deductions and straight-line depreciation are often criticized for being oversimplified approximations. Effective age is based on an appraiser’s opinion. Remaining economic life is based on the appraiser’s judgment but can also be supported by a study of typical economic lives of similar buildings. Both tend to be less reliable as the property ages. Although the breakdown method is more detailed in measuring depreciation, many forms of depreciation are difficult to support with market evidence. In these cases there is a greater likelihood of a methodology’s misapplication. With regard to big-box retail properties, some of these shortcomings are diminished, because these properties typically tend to be well-maintained and generally have minimal functional obsolescence.

3. Land Valuation

An accurate land value estimate is critical to the development of a reliable cost approach. Comparable land sales should have the same highest and best use as the subject property and should be similar in location, traffic count, demographics, zoning, size, visibility, access, and any other attributes deemed important by buyers and sellers. Often, investment classes C and D big-box properties may be approaching the end of their economic lives, and while depreciation and functional obsolescence may be difficult estimates to quantify, a reliable valuation of land may reveal whether the subject property is approaching or has reached the end of its economic
life. If the value of the land is close to the value of the property as-improved, this may indicate that the property is ready to be torn down or possibly redeveloped.

4. Entrepreneurial Profit/Incentive

Entrepreneurial profit is defined as,

[A] market-derived figure that represents the amount an entrepreneur receives for his or her contribution to a project and risk; the difference between the total cost of a property (cost of development) and its market value (property value after completion), represents the entrepreneur’s compensation for the risk and expertise associated with development (Appraisal Institute 2015, 76).

Entrepreneurial incentive is defined as,

The amount an entrepreneur expects to receive for his or her contribution to a project. Entrepreneurial incentive may be distinguished from entrepreneurial profit (often called developer’s profit) in that it is the expectation of future profit as opposed to the profit actually earned on a development or improvement. The amount of entrepreneurial incentive required for a project represents the economic reward sufficient to motivate an entrepreneur to accept the risk of the project and to invest the time and money necessary in seeing the project through to completion (Appraisal Institute 2015, 76).

Entrepreneurial profit/incentive, based on analysis of recent sales of similar properties and/or interviews with developers of similar improvements, is often difficult to support because of the lack of sufficient market evidence. It is often calculated as a percentage of direct and indirect costs and included in the total replacement cost of the improvements.

5. Functional Obsolescence

The issue of functional obsolescence often arises in the valuation of big-box retail properties in the context of whether the properties are in fact special purpose. A special-purpose property is defined as follows:

A property with a unique physical design, special construction materials, or a layout that particularly adapts its utility to the use for which it was built; also called a special-design property (Appraisal Institute 2015).

The functional utility of a special-purpose building depends on whether or not there is continued demand for the use for which the building was designed. When there is demand, functional utility depends on whether or not the building conforms to competitive standards. (Appraisal Institute 2013)
If the appraiser finds there is still demand for the uses served by the subject property that are similar to those for other newly constructed properties in the market, the property is probably not special purpose and there is likely no or limited functional obsolescence.

6. Signage/Facade

Some modification and level of customization are expected when a new tenant takes over a space. This does not make the property functionally obsolete. The appraiser may find that the signage and/or facade may be minimal and easily removed without significant damage to the underlying real estate.

B. The Sales Comparison Approach

Based on the concept of value-in-exchange, the sales comparison approach to value compares the property being appraised with similar properties that have recently sold. The characteristics of the sold property are analyzed for their similarity to those of the subject of the appraisal (Thimgan 2010).

The sales comparison approach to value is commonly employed in the appraisal process because it closely reflects how buyers and sellers in the marketplace engage in property transactions. The sales comparison approach is also heavily influenced by the economic Principle of Substitution, which holds that properties demonstrating similar economic utility command similar prices. Hence, the value of a property or highest price a property will likely obtain is determined by the cost of purchasing a substitute property of similar design, function, and utility. This is a straightforward approach that studies the market’s reaction to similar properties and is especially reliable when there are ample data available in the market from which to make appropriate comparisons.

1. Strengths of the Sales Comparison Approach

The sales comparison approach is a well-founded methodology when there are abundant, truly comparable properties in the market that serve as appropriate substitutes to the subject in terms of functional utility and other relevant market characteristics. This straightforward approach is widely understood and relied upon by the courts. It reflects the actions of buyers and sellers and is used to estimate market value. For big-box properties, the appraiser will likely be able to find sales in the marketplace of such properties if he or she is willing to broaden the search area for other similar investment class sales that have a similar highest and best use.

2. Weaknesses of the Sales Comparison Approach

Properties that are not true comparables can lead to unreliable conclusions. For example, simply because a property is similar in size does not make it an appropriate comparison for another property. Closed sales transactions are historic and may not reflect current market value. There are generally few first-generation sales that convey to users, and sale-leasebacks and build-to-suit transactions may be the only first-generation sales available to an appraiser who is valuing investment class A properties.
3. Sales in the Big-Box Market

Some appraisers reject a comparable sale as a valid, open-market transaction if the property exchanged is a build-to-suit property, a sale-leaseback transaction, or a private sale. As indicated in the IAAO Standard on Verification and Adjustment of Sales (IAAO 2010, 12, 31), it is up to the appraiser to verify the transaction details. The standard suggests that during the sale verification process the appraiser ask first whether the sale was a sale-leaseback and then whether this influenced the sale price.

For big-box and single-property retailers overall, the current practice for financing construction of a new improvement is through a build-to-suit arrangement. This arrangement is as common, if not more so, than traditional mortgage financing. The developer obtains the financing to build the improvements for the occupant, and the occupant opts to make lease payments instead of mortgage payments to a bank. This is an economic decision of the user. It does not mean the transaction does not represent market value. While sale-leasebacks often relate to new construction, these types of transactions may also involve existing properties. In either scenario, subject to verification of the above facts, these may be regarded as potential open-market transactions.

Build-to-suit rents, sales of properties with a build-to-suit lease, sale-leasebacks, and private sales should not be automatically dismissed. Unless there is evidence to the contrary that is inconsistent with the applicable market value definition, these types of sale transactions may be used as comparable sales if they are arm’s-length and verified to be reflective of market rent and price.

a. Build-to-Suit

To illustrate a market-driven transaction in a build-to-suit arrangement, consider the following. ABC Retail wishes to enter a new market location as part of its overall plans for expansion. ABC Retail is a creditworthy, regional player in its retail segment and has been making strides to expand nationwide. ABC Retail makes a business decision that the best way for it to continue a steady expansion is to not finance the new development with its own capital, for which it has sufficient funds available, and to forgo traditional lender financing.

ABC Retail sends invitations to bid to various developers and negotiates with Developer Jones to purchase the land and build the improvements as ABC Retail specifies, and on completion ABC Retail will lease the property from Developer Jones. Developer Jones obtains mortgage financing for the development. The lease rate is based on a negotiated rate to cover all of Developer Jones’s soft and hard costs for the development (return of capital) and to provide Developer Jones with a profit margin (return on capital).

On the reverse side, ABC Retail knows its cost of capital for mortgage financing if it owned the subject. ABC Retail also knows its cost of capital for financing the purchase of personal property and inventory. It also has calculated expected sales at the new location and the associated costs of owning the subject rather than leasing it. In the negotiation of the lease rate, it too has
negotiated a rent that, when amortized over the life of the lease term, will be comparable to its cost of capital through other financing mechanisms.

ABC Retail and Developer Jones are not related. Both are knowledgeable, sophisticated parties. Neither party is forced into this arrangement. Both parties act in their own self-interest. Either party can walk away if the arrangement is not mutually beneficial. Developer Jones will not undertake a project that it does not think will be profitable. ABC Retail will not use Developer Jones if it cannot get what it needs for no more than its costs of capital from another developer or other sources. This build-to-suit arrangement, when both parties agree that the rental reflects market rent, is potentially an open-market transaction and may be used as a comparable rental.

b. Sale-Leasebacks

Now consider the same facts as above but in a sale-leaseback context. ABC Retail finances the project with its own capital or by mortgage financing because it allows for faster development than a build-to-suit plan. While the project is in development, ABC Retail markets the property on the triple-net lease market through a broker and negotiates with NNN Investments to purchase the subject from ABC Retail on completion and to lease the subject back from NNN Investments. Subject to verification, the purchase price and the rental rate are usually set at market, as agreed to by the parties.

ABC Retail and NNN Investments are not related parties. ABC Retail and NNN Investments are fully knowledgeable, sophisticated parties who negotiate an agreement that meets NNN Investments’ required return on its purchase price, and ABC Retail has negotiated an agreement with NNN Investments for a market rental rate. ABC Retail is not paying more or less than what it would pay in rent through a direct lease with a developer. NNN Investments is not engaged in usury nor has it colluded with ABC Retail so that ABC Retail receives more benefit than it would have received by any other store development arrangement.

It is essential that each sale is verified to ensure it meets the necessary requirements of an arm’s-length transaction between a willing buyer and a willing seller. Any sale that is not a valid market transaction should be disqualified. Especially in the case of sale-leaseback transactions, the appraiser should verify the sales, rather than simply rely on information provided by data services. It is important to determine whether the circumstances meet the market value criteria that would allow the transaction to be used in a sales comparison approach. If the sale is verified and qualified as arm’s-length, additional consideration should then be given to the sale to determine whether it is reflective of market.

c. Private Sales

Now consider both scenarios in which Developer Jones or NNN Investments puts the property on the market and sells it to Retirement Fund subject to ABC Retail’s leasehold. The transaction is not between related parties. All parties are knowledgeable and acting in their own self-interest and without duress. ABC Retail’s prior business relationships with Developer Jones or NNN Investments are not relevant. This transaction is not a build-to-suit or a sale-leaseback transaction. This is an open-market transaction.
Given the uniqueness, size, and location of the property, the broker knows that there is a specific group of market participants who would be interested and financially capable. One in this group buys the property. This may be termed a private sale, but it is a valid market transaction. None of the parties are related; no one was under duress; and all parties acted in their own self-interest. The broker used segmentation marketing to target the most likely buyers. This is an arm’s-length transaction.

4. Market Segmentation

In general, big-box properties are configured as single-tenant properties that may be modified to accommodate a variety of users. While it is ideal to narrow the property’s highest and best use and those of the comparable sales as much as possible, care must be taken not to identify a specific user, because this may be interpreted as a value-in-use. Characteristics such as size, age, condition of the property, access, traffic counts, proximity to major employment centers, the concentration cluster of surrounding properties, and population size are among factors that influence a big-box retail property’s competitive position in the market. These determinants contribute to establishing the appropriate trade area and also the suitable comparisons to use in the sales comparison approach. As such, differentiating the subject property and comparable properties into segments such as investment classes or retail types creates a logical hierarchy.

The proper selection of comparable sales is essential for the sales comparison approach to reach a reliable conclusion of value. Narrowing the highest and best use of the comparables assists an appraiser in identifying those properties most similar to the subject. Once the highest and best use of the subject and potential sales are determined, they may be classified into one of the investment classes (A, B, C, or D as described earlier) and/or segmented by type, such as home improvement, discount department store, and so forth. Segmenting sales properties into investment classes ensures that similar properties are being used as comparisons to the subject property, ideally with first generation compared to first generation and so on. With regard to vacant properties being used as comparisons with occupied properties, until vacant properties have tenants in-place, it is somewhat uncertain what investment class is appropriate or what adjustment would be required for the speculative lease-up period. Unless the property leases up quickly and this information is available, similar properties should be used in trying to measure market prices and investment classes.

5. Deed-Restricted Comparable Sales

Deed restriction is defined by The Dictionary of Real Estate Appraisal as follows:

*A provision written into a deed that limits the use of land. Deed restrictions usually remain in effect when title passes to subsequent owners.* (Appraisal Institute 2015, 6)

If the subject property does not have a deed restriction, comparable sales with such deed restrictions should not be used as comparisons to the subject. It is difficult, if not impossible, to quantify an adjustment that accurately captures the number of prospective buyers who turned
away from a property that sold with a deed restriction. By design, deed restrictions are imposed to limit competition by forcing a change in that property’s originally intended highest and best use, rendering the sale unsuitable as a comparable substitute for the subject property.

The following excerpt was taken from a deed restriction on a big-box property and serves as an example of the types of limitations that may be imposed:

This conveyance is expressly subject to the following conditions and restrictions:

(a) The Property will not be used for or in support of the following: (i) a grocery store or supermarket, as hereinafter defined below; (ii) a wholesale club operation similar to that of a (retailers intentionally omitted); (iii) a discount department store or other discount store, as hereinafter defined; (iv) a pharmacy (the “Property Restrictions”).

“Grocery store” and “supermarket,” as those terms are used herein, shall mean a food store or a food department containing more than thirty-five thousand (35,000) square feet of gross leasable area, for the purpose of selling food for consumption off the premises, which shall include but not be limited to the sale of dry, refrigerated or frozen groceries, meat, seafood, poultry, produce, delicatessen or bakery products, refrigerated or frozen dairy products, or any grocery products normally sold in such stores or departments. “Discount department store” and/or “discount store,” as those terms are used herein, shall mean a discount department store or discount store containing more than fifty thousand (50,000) square feet of gross leasable area, for the purpose of selling a full line of hard goods and soft goods (e.g., clothing cards, gifts, electronics, garden supplies, furniture, lawn mowers, toys, health and beauty aids, hardware items, bath accessories and auto accessories) at a discount in a retail operation similar to that of (retailer intentionally omitted) or any parent company, affiliate subsidiary, or related company.

(b) The property Restrictions shall remain in effect for a period of twenty (20) years from the recording of this deed. The aforesaid Property Restrictions shall run with and bind the Property, and shall inure to the benefit of and be enforceable by Grantor, or its successors and assigns, by any appropriate proceedings at law or in equity to prevent violations of such aforesaid Property restrictions or to recover damages for such violations.

C. Income Capitalization Approach

In the Income Capitalization Approach, market value is defined as the present worth of future benefits arising from the ownership of the property. This definition reflects the Principle of Anticipation. Income-producing real property typically is purchased for the right to receive the future income stream of the property. The assessor analyzes this income stream in terms of
quantity, quality, and duration and then converts it by means of an appropriate capitalization rate into an indication of market value (Thimgan 2010).

Big-box properties are mostly owner-occupied by retailers, but often these properties are owned by investors and occupied by the retailers under a long-term lease. Thus, the use of the income capitalization approach to value can be utilized with empirical evidence supporting market rent estimates and overall capitalization rates. The income capitalization approach emulates market behavior from the perspective of investors, particularly of big-box, net-leased sale transactions. Investors buy a property for the income stream, and they understand that there is a direct relationship between income characteristics and property value.

1. Strengths of the Income Capitalization Approach

Big-box properties are often leased. Thus, it is likely that the fee simple owner of the real estate is interested in the income stream of the property and consequently looks to an income approach to determine the value of the property. There are a few parameters to consider for a single-tenant, triple-net-leased, big-box property. Typically an appraiser ascribes market rent, nominal vacancy, a small amount for management and miscellaneous expenses, and a market-supported capitalization rate in order to derive an estimate of market value.

2. Weaknesses of the Income Capitalization Approach

A major concern with the income capitalization approach is the selection of an appropriate capitalization rate. While estimating the income and the projected operating expenses may be challenging, any slight error in either estimate is magnified on capitalization.

3. Yield Capitalization versus Direct Capitalization

A criticism of this approach, in jurisdictions in which market rent is the underlying valuation requirement, is that it incorporates speculative modeling criteria and is rarely used by market participants in the sale and purchase of big-box properties. Also, courts are often skeptical about the reliability of yield capitalization. Direct capitalization, on the other hand, uses the relationship of one year’s net income, usually the first year of ownership, to determine a value. This method is preferred by buyers and sellers of big-box properties and is often quoted on broker marketing flyers and emails. This is the method generally accepted by appraisers and generally receives greater acceptance in courts. For mass appraisal, direct capitalization is used because it is simpler and less speculative and has more market evidence.

4. Direct Capitalization Methodology

a. Identification of Lease Comparable Properties

The first step in the direct capitalization approach is to determine market rent:

\[ T \text{he most probable rent that a property should bring in a competitive and open market reflecting the conditions and restrictions of a specified lease} \]
agreement, including rental adjustments and revaluation, permitted uses, use restrictions, expense obligations, term, concessions, renewal and purchase options, and tenant improvements (TIs) (Appraisal Institute 2015, 140).

Market rent is the essential basis of fee simple valuations:

*Market rent is the rental income a property would command in the open market. It is indicated by the current rents that are either paid or asked for comparable space with the same division of expenses as of the date of the appraisal ... .*

*Rent for vacant or owner occupied space is usually estimated at market rent levels and distinguished from contract rent in the income analysis. In fee simple valuations, all rentable space is estimated at market rent levels.* (Appraisal Institute 2015, 447)

For a fully occupied, well-maintained, functional big-box property, recent comparable rents for first-generation space (investment classes A and B) should be used:

*First-generation space—a building or space designed to be functionally and economically efficient for the original tenant or a similar class of tenants over a period of time during which the space retains its original utility and desirability* (Appraisal Institute 2015, 210).

Investment classes C and D improvements are losing or have lost their appeal to first-generation users and may be suitable only to second-generation users. Recent comparable rentals of these types of properties are appropriate for consideration of market rent estimates for properties that are no longer prime investments or are nearing the end of their useful lives for their intended use and utility when built.

*The Dictionary of Real Estate Appraisal* defines second-generation space as follows:

*Second-generation space—a building or space used by a tenant other than the original tenant; often functionally obsolete before refurbishment but sometimes containing tenant improvements that can be reused by a new tenant* (Appraisal Institute 2015, 210).

We propose the following alternative definition, which is consistent with the concepts underlying the definition of first-generation space shown above and is a more accurate depiction of second-generation space:

*Second-generation space—a building or space whose design is no longer functionally and/or economically desirable for the original tenant or a similar class of tenants. The space may no longer retain its original utility and/or desirability for the original tenant but may be used by a tenant other than the original or similar class of tenant.*
b. Vacancy and Collection Loss

Vacancy is typically determined by examination of the market. However, in the case of national credit, single-tenant, big-box retailers, the likelihood of incurring any vacancy or collection loss during the term of the lease is highly improbable. Nonetheless, a vacancy and collection loss, even if negligible, may be justified for future uncertainty.

c. Operating Expenses

In big-box retail, the lease structure generally is triple net or absolute net, so expenses to the owner are nominal. In the triple-net lease, the owner may be responsible only for structural repairs and a management fee. Because a big-box property is occupied by a single tenant, management involvement is minimal.

d. Capitalization Rates

Data extracted directly from market transactions may be the most reliable source for capitalization rates. However, when sales transactions and such data are scarce, additional examination should be given to investor surveys. Some surveys reflect investor expectations, not actual market transactions, and it is essential to understand the range indicated in investor surveys rather than simply relying on the average. Investor surveys cast a wide net and may not be market-specific, so care should be taken in considering what the surveys actually measure. The average will likely be higher than the capitalization rate for investment classes A and B big-box properties and lower than the capitalization rate for investment classes C and D big-box properties. The band-of-investment technique may also be used to determine overall capitalization rates using criteria that factor in current debt and equity parameters.

X. RECONCILIATION

In estimating a value for the subject property, the appraiser must consider and resolve multiple value indications produced by the three approaches to value. The reconciliation can also serve as a test of reasonableness in support of one approach over another or as additional support for an indication of value arrived through any of the approaches used.

The cost approach is useful when there is a scarcity of comparable sales in the market and another approach is needed to develop a well-founded valuation. The cost to acquire land and construct improvements is a fundamental financial feasibility analysis that big-box investors perform to assess the economic viability of new big-box construction, so this approach directly replicates investor behavior.

The cost approach also serves as a reliable indication of value, particularly for investment classes A and B properties that are new or well-maintained and for which depreciation is minimal. A supportable land valuation may also provide valuation support to investment classes C and D properties that are approaching the end of their economic lives. A well-founded estimate of land
value assists the appraiser in determining when a property is approaching or has reached the end of its economic life, as class D properties are often interim uses or potential redevelopment sites.

The sales comparison approach provides strong support when there are ample data with suitable substitute properties, but it is less reliable when true comparables are not available. Again, investment class identification for the subject property and stratification of potential sales will reveal which comparable properties are most appropriate comparisons for the subject property and whether the search may be broadened to identify other similar class properties for use in this analysis.

The income capitalization approach is a method used by investors to convert income into value, but this approach is dependable only when the data obtainable are comparable to the property being appraised. Investment classes A and B properties generally have the highest rents and lowest capitalization rates. By grouping the properties into investment classifications, the appraiser will be able to identify the appropriate estimate of market rent and market-supported capitalization rates to use for the subject property.

It is difficult to address all these big-box retail valuation issues in one approach to value; developing all three approaches reinforces one another. Each approach to value has its strengths and its weaknesses. Strengths are magnified when more approaches are applied, and weaknesses are amplified when approaches are eliminated.

When all three methodologies are used, they enhance the credibility of an equitable big-box retail property assessment. When using more than one approach to value, the appraiser should reexamine the entire appraisal, especially for accuracy, relevance, and market support of all of the data in each approach, and reconcile the differences in the value conclusion between the approaches. The final step is to exercise judgment in determining the approach or approaches to rely on for a final conclusion of value.

XI. CONCLUSION

Recent controversy and litigation surrounding big-box valuation claims that assessments are not equitable have prompted a need for this position paper. This paper provides guidance with using appraisal methodologies to derive the appropriate value required by the jurisdiction for big-box retail stores’ assessments. A myriad of issues are involved in the valuation and defense of big-box retail, and it is recommended that an appraiser develop all three approaches to value when determining a property’s market value.

The appraiser may ultimately discard or give no or little weight to a particular approach if a jurisdiction has specific requirements for methodologies to consider, disqualify, or rely on. Otherwise, it is important to employ all appraisal valuation approaches that will lead to credible conclusions.

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XIII. REFERENCES


Restatement of Property §14 (Am. Law Inst. 1936)
Hardly a week goes by without news about a big-box store fighting its property tax assessment. Although big-box stores have existed for decades, challenges to the way they are assessed for property tax purposes have accelerated in the last few years. Recent court cases in the Midwest have some assessors reviewing their techniques for valuing these properties. This article examines the most common appeal arguments by big-box stores and relevant court cases and it recommends a method for estimating their market value.

Big-box stores were born in 1962 when several national retail chains experimented with a new prototype—a large store with a large variety of merchandise. Shopping became a family affair, where dad, mom, and the kids could wander through aisles and aisles of merchandise. One of the first retailers to try this new format was (the now defunct) Woolworths, which opened its first big-box store as Woolco. Other retailers such as Meijer, Walmart, Target, and K-Mart soon followed, and by the mid-1960s this type of store began to appear throughout the country. The term big-box stems from the store’s most defining characteristic: its large size and windowless, box-like appearance. In those early days, large was 50,000 square feet, but today’s big-box stores can exceed 200,000 square feet. They exist in almost every jurisdiction in the United States. A few examples are Walmart, Target, Meijer, Costco, Ikea, Home Depot, and Lowe’s.

There is no accepted definition of big-box stores. They are often lumped into categories such as discount department stores (Walmart, Target, Meijer), specialty stores (Best Buy, Dick’s Sporting Goods), and warehouse stores (Home Depot, Lowe’s, Costco). Typically, these stores exceed 100,000 square feet and are located on 15- to 20-acre sites. While most big-box stores are single-story, they typically have a two- to three-story height. Although smaller stores such as Office Depot and Sports Authority could be considered big-box, this article focuses on stores larger than 100,000 square feet.

What makes a big-box store so challenging to assess? After all, it’s just a big-box, right? No curves, angles, or unusual architecture to contend with. Arguably, the only unusual feature of big-box stores is their large size. For a property type that seems relatively simple, it is surprising how it generates an abundance of appeal arguments.

There are thousands of these stores throughout the United States, and more are being built every day. Big-box owners and their representatives rarely argue that the assessment of these stores exceeds replacement cost. Instead, the dispute typically centers on which comparables are most applicable. Because of the way these stores are bought and sold, the sales are either very high, sometimes exceeding development costs, or very low, considered bargain-basement prices by some.
Appeals

Big-box chains are organized and aggressive in their property tax appeals. About Walmart, a 2011 report by the nonprofit research organization Good Jobs First stated,

Using an army of lawyers and consultants, it systematically challenges property tax assessments to chip away at its property tax bills, costing local governments several million dollars a year in lost revenues and legal expenses (Mattera 2011).

That comes as no surprise to those who must defend the assessments of Walmart and other big-box stores. Although all taxpayers are entitled to appeal assessments they deem unfair, the sheer number of big-box appeals suggests a larger strategy to lower property taxes across the board. Successful appeals in the Midwest have motivated big-box owners to expand their appeals far and wide.

Typical Big-Box Property Tax Appeal Arguments

The following are the most common arguments related to assessment of big-box stores:

- Big-box stores are becoming obsolete because consumers are shifting to online shopping and the large chains are shifting to a smaller store design.
- Sales of occupied big-box stores usually involve sale-leaseback transactions in which investors care more about the tenant than the real estate. These sales represent leased-fee value, not fee-simple value.
- Fee-simple value is best reflected by sales of vacant big-box stores because those properties are not encumbered by leases (aka the Dark Store Theory).
- The highest and best use of a successful operating store is no different than the highest and best use of a vacant abandoned store.
- Considering the business success of an operating store results in value in use, not value in exchange.

Big-Box Demise Due to Online Shopping

A frequent argument concerning big-box stores is that they suffer from obsolescence because of the threat from online retailers such as Amazon. The benefits of e-commerce are obvious: not only are prices sometimes lower, but also products can be ordered from home. The obsolescence argument suggests that consumers can easily purchase retail goods online, so there is no need to shop at the big-box stores. That argument is not new.

A 1989 New York Times article, “Rewriting the Rules of Retailing,” stated,

Technology, in fact, is making it easier to stay out of stores entirely. Home television shopping, for instance, which peddles primarily low-priced items, is expected to move into higher-ticket goods. And shoppers can even buy products over their personal computers through such services as Prodigy, which is marketed by Sears and the International Business Machines Corporation. (Wayne 1989)

This early prediction that online purchases would nudge out brick-and-mortar retailers was made a full five years before Amazon even existed. In the 25+ years since that article appeared, brick-and-mortar stores are still around, even flourishing. Pundits have been forecasting the demise of physical stores for decades. But retail giants such as Walmart, Lowe’s, and Costco apparently didn’t get the memo, because new big-box stores are being built every year.

What the experts overlook is that brick-and-mortar stores can also play in the online sandbox. All the big players have an online presence and, in fact, are incorporating online purchases into their overall strategy. As stated in Costco’s 2014 annual report,

The lines between online and brick-and-mortar stores are blurring as multichannel retail is evolving as part of the everyday retail environment. Many of our members are well-traveled digital shoppers who research product features, check official reviews and conduct price comparisons online with the use of computers, tablets, and mobile devices. We see this as both a challenge and an opportunity, and continue to seek ways to enhance our website and mobile applications to better meet the needs of our members. (Costco Wholesale Corporation 2014)
This new strategy, called *omni-channel retailing*, is being pursued by all the large retailers. There is no doubt that online shopping will continue to grow and affect sales from brick-and-mortar stores. But it’s not an either/or scenario. Most consumers these days shop online and in-person at their local stores. In fact, the term *showrooming* was coined to describe the practice of consumers viewing merchandise in a traditional brick-and-mortar store, but then purchasing the same product online. Retailers have countered this practice by steering consumers to their own websites, price-matching, free-shipping, and allowing consumers to order online and then pick up merchandise in local stores. Some even have in-store kiosks from manufacturers such as Samsung, Apple, and Microsoft. Despite the threat from online shopping, brick-and-mortar stores continue to dominate retail sales. A study of consumer practices by the International Council of Shopping Centers found that consumers spend significantly more per month in physical stores than online. It also found that 73 percent of consumers want to try on or touch merchandise before they purchase it (ICSC 2014).

A comparison of brick-and-mortar sales with online sales reveals a surprising statistic. According to the Census Bureau, online sales represent only 7 percent of total retail sales nationwide; see figure 1 (U.S. Census Bureau 2015). Although that figure varies when the focus shifts to specific types of products, such as electronics, it still represents only a fragment of the sales generated in physical stores. In short, people still want to shop in stores.

**Smaller Stores**

Another common argument in big-box appeals is that large stores are obsolete, as evidenced by the national chains shifting to smaller stores. It is undeniable that the large chains are exploring different store concepts. Walmart actually has six different store types, ranging from its Supercenter, with approximately 180,000 square feet, to its Walmart Express, a 15,000-square-foot competitor to local drugstores. Despite the claim that the larger stores are being replaced by smaller ones, Walmart actually opened 130 Supercenters but only 121 small-format stores in 2014 (Walmart 2014). Interestingly, Walmart has converted or replaced many of its traditional 100,000-square-foot discount stores with the larger Supercenters.

According an article in *Market Realist*, in the past five years, Walmart converted or replaced 409 discount stores with Supercenters (Soni 2015). Walmart plans to open 120 new Supercenters in 2015 and another 60–70 in 2016. So although Walmart is forging ahead with the small-store format, it also continues to build large stores, in fact, very large stores. The Supercenter format provides several advantages. It allows Walmart to provide a wide variety of merchandise, and it also allows the large stores to serve as distribution points for the small-format stores.

*Costco’s 2014 annual report stated that it continues to seek ways to enhance its website and mobile applications to meet its members’ needs.*

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*Figure 1. Brick-and-mortar sales versus online sales ($ trillion) in the United States, 2005–2014 (U.S. Census Bureau 2015)*

![Figure 1. Brick-and-mortar sales versus online sales ($ trillion) in the United States, 2005–2014 (U.S. Census Bureau 2015)](image-url)
Walmart is not the only big-box retailer adding new stores. As table 1 illustrates, Target, Costco, Home Depot, and Lowe’s are all opening new stores in 2015. Although some of these new stores will be small-format designs, most will be the traditional large-format design with more than 100,000 square feet.

Table 1. Largest big-box stores in the United States (The Home Depot Inc. 2014; Lowe’s Companies, Inc. 2014; Target Corporation 2014b; Walmart 2014; Costco Wholesale Corporation 2014)

<table>
<thead>
<tr>
<th>Company</th>
<th>Number of Stores</th>
<th>Stores Owned</th>
<th>Typical Size</th>
<th>New Stores for 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Walmart</td>
<td>11,453</td>
<td>9,078</td>
<td>105,000</td>
<td>24</td>
</tr>
<tr>
<td>Home Dept</td>
<td>2,270</td>
<td>2,042</td>
<td>128,000</td>
<td>6</td>
</tr>
<tr>
<td>Lowes</td>
<td>1,840</td>
<td>1,541</td>
<td>109,000</td>
<td>15</td>
</tr>
<tr>
<td>Target</td>
<td>1,790</td>
<td>1,536</td>
<td>135,000</td>
<td>15</td>
</tr>
<tr>
<td>Costco</td>
<td>663</td>
<td>522</td>
<td>143,700</td>
<td>24</td>
</tr>
</tbody>
</table>

*includes 647 Sam’s Club stores

There is no doubt that consumer demand changes from year to year and decade to decade, and large retailers are constantly tweaking their store designs to cater to these demands. Retail will evolve in the coming years, just as it always has, but until retailers abandon the big-box design, it would be improper to adjust for obsolescence. Mark Twain once observed that, “reports of my death have been greatly exaggerated.” If he were alive today, we suspect he might say something similar about big-box stores.

Sale-Leasebacks

Although the vast majority of big-box stores are owner-occupied, on rare occasions they do sell with a big-box retailer in place. This often happens when big-box owners sell their own property in a sale-leaseback transaction and remain as tenants. Sale-leaseback transactions usually involve first-generation space, a building often designed and occupied by the original tenant. These properties are attractive to investors because they are high-quality buildings, usually with desirable tenants. Sale-leaseback prices are based on the rent being paid, and the rent is typically based on the underlying development costs.

The argument against using these sales is that the sale prices represent the leased-fee interest (rather than fee-simple interest), and that investors care more about the creditworthy tenant than they do about the real estate. Some suggest sale-leasebacks are nothing more than financing arrangements, not market transactions that have been exposed to the open market. The big-box chains argue that because of these factors, sale-leaseback transactions should not be used at all.

The price paid by investors in sale-leaseback transactions is a leased-fee interest. Since fee-simple value is typically sought, an adjustment for property rights would be necessary if it is determined that a premium over and above the value of the real estate was paid. Although the rent being paid is typically based on the development costs, it is possible that investors will pay even more than cost to obtain the benefits of a credit-worthy tenant. This leased-fee premium would require a property rights adjustment to bring it in line with fee-simple value. In discussion of property rights adjustments in the sales comparison approach, the Appraisal of Real Estate states,

*The appraiser must also consider any differences in the property rights appraised between the comparable properties and the subject property because the comparable sales may include the transfer of a leased fee interest (Appraisal Institute 2013, 395).*

So how do assessors measure the premium that investors might be paying so that a property rights adjustment can be made? One approach is to compare the value derived from the cost approach to the leased-fee sale price. The cost approach inherently excludes encumbrances such as leases and also intangible value that may result from above-market sale prices. If a sale price for a leased big-box store exceeds replacement cost, the difference could be attributed to the premium paid by investors and that could be the basis for a property rights adjustment.

So how do assessors measure the premium that investors might be paying so that a property rights adjustment can be made? One approach is to compare the value derived from the cost approach to the leased-fee sale price.

Unlike many other property types, big-box stores are not built to be sold. Instead, they are typically built and occupied by the owner. For this reason, the only first-generation big-box stores available for purchase are those that are being offered in sale-leaseback transactions or investor-to-investor purchases in which the big-box chains are tenants. These sales require research because of the issues previously mentioned, but like any other sale, verification will often reveal whether it is valid and whether adjustments for property rights are necessary. Sale-leaseback transactions represent an important piece of the puzzle in big-box valuation and should not be ignored.

Dark Store Theory

Owners and tax representatives of big-box stores suggest there is an easy alternative to sale-leaseback transactions—vacant big-box stores. The argument is that, since fee-simple represents unencumbered value, the best sales are vacant big-box stores because there is no lease involved. This approach has been coined the Dark Store Theory.
Big-box chains close underperforming stores every year. A 2014 Target press release spoke to store closings, saying, "The decision to close a Target store is only made after careful consideration of the long-term financial performance of a particular location" (Target Corporation 2014a).

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. Abandoned big-box stores are often occupied by furniture stores, churches, indoor flea markets, or similar second-tier uses. Dark store sales usually involve what is commonly called second-generation space. This describes a building whose original tenant has departed and has been replaced with a new user, and often there is a new use for the property. This situation is not exclusive to big-box stores. When unsuccessful grocery stores, drugstores, even corporate headquarters go dark, they are often sold at a fraction of their original cost and converted to a different use. Usually the use of the property changes because the property is no longer suitable for its original purpose.

Another factor that often affects dark stores is the restrictions placed on them when they are sold. Why doesn't Target purchase a closed Walmart store instead of building a new one in the same town? Because they can't. Walmart, Target, Home Depot, Lowe's, and other big-box chains use deed restrictions (sometimes called restrictive covenants) to prohibit rivals from operating in one of their former stores. Even if a chain made a poor decision by closing a store, it will never be known, because its competitors are blocked from purchasing or leasing the property through these deed restrictions and restrictive covenants. This is unfortunate for assessors, because those transactions would clearly demonstrate fee-simple market value.

Deed restrictions are akin to the removal of a stick from the comparable properties' bundle of rights; thus a transfer of such restricted properties would entail something less than fee-simple value. An example of these restrictive covenants is a deed restriction utilized by Target. In the deed transferring one of its properties, a clause states, "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)

These restrictions typically last decades and can inhibit efforts to find buyers. Partially because of the deed restrictions, these stores can remain vacant for many months, even years. Dark stores often create blight in neighborhoods and can negatively affect a community because they attract vandalism and crime, discourage retail growth, and potentially affect adjoining property values.

Understandably, Target, Walmart, Lowe's, Home Depot, and other big-box chains have no interest in selling or leasing their closed stores to the competition. But for valuation purposes, these restrictions artificially alter the forces of supply and demand, preventing the most likely market participants from illustrating through their actions the true fee-simple market value of these properties.

If there is any doubt that big-box chains take these restrictions very seriously, consider the case of Thirty 141 v. Lowe's.
Home Centers, Inc. (2010). In that case, a landlord leased a site to Lowe’s and agreed to place deed restrictions on adjoining parcels to block rival home improvement stores. When the landlord failed to place restrictions on all adjoining lots, Lowe’s successfully sued to force the landlord to do so.

The Appraisal Institute addresses the issue of deed restrictions as follows:

Some sale contracts call for the sale of real property rights but add deed restrictions or other forms of limitations on the purchaser or future users of the property. That sort of title or use limitation may limit the transaction’s use to a general market indicator or render the transaction unusable for direct market comparison because the real property rights conveyed are less than fee simple. (Appraisal Institute 2013, 406)

Highest and Best Use and the Selection of Comparables

Determining a big-box store’s highest and best use as improved may seem obvious and even unnecessary, but highest and best use serves an important and critical purpose. The determination of highest and best use guides the assessor to the most appropriate comparables. According to the Appraisal of Real Estate,

Each improved property should have the same or a similar highest and best use as the improved subject property, both as though vacant and as improved. (Appraisal Institute, 2013, 43)

Both sides in big-box appeals usually agree that the highest and best use of an operating store is continued use. Where they usually part ways is the selection of comparables. The assessor often chooses sale-leaseback transactions, while the taxpayer selects dark store sales. Sale-leaseback transactions usually occur at the beginning of a big-box store’s life when the property is successful and thriving. Dark store sales occur at the end of a store’s economic life, when a particular location is no longer popular and the property may be burdened with deed restrictions. Neither of these sales is inherently bad—it just depends on the property they are being compared with.

In appraising or assessing a dark store, the most appropriate comparables are sales of other second-generation stores, because they are similar in location, demographics, trade area, demand, and rent potential. In other words, they have similar highest and best uses. Instead, in assessing or appraising an operating first-generation store, the most comparable sales are other successful operating big-box stores, which are typically represented by sale-leaseback transactions. Using dark store sales (apples) to value first-generation, successful operating stores (oranges) or vice versa is a mismatch. These properties represent different highest and best uses. Because of the conditions surrounding dark store sales, they represent a different and inferior market or, in other words, their second-best highest and best use.

The valuation date for most assessment jurisdictions is January 1. Because most operating big-box stores do not actually sell on January 1, the assessor must assume a hypothetical sale between seller and the most probable buyer. The Appraisal of Real Estate notes the importance of identifying the most probable buyer, stating,

The most probable buyer is a critical conclusion used in choosing comparable sales in the sales comparison approach. (Appraisal Institute 2013, 357)

So who is the most probable buyer for a big-box store in a hypothetical sale? Is it the big-box chains themselves since they build, own, and occupy most of the stores? There is ample evidence of what big-box stores pay to purchase land and construct buildings. Is it the investor that occasionally purchases stores in sale-leaseback transactions? A simple search in CoStar will find dozens of sales like that. Or is the typical buyer the second-generation user who purchases the store after the first-generation user (usually a national chain) abandons it? Dozens of vacant big-box stores are for sale around the country. In fact, Walmart has its own website, Walmartrealty.com, to dispose of these properties (with restrictions on future use).

The most overlooked market participant in big-box property tax appeals is actually the most obvious: the big-box chains themselves.

All three market participants—big-box chains, sale-leaseback investors, and second-generation users—have different motivations and thus different prices they are willing to pay. The perceived benefits from a creditworthy tenant may cause sale-leaseback investors to pay the most, even more than replacement cost. Second-generation store users would probably pay the least. They are typically buying a property that has failed for the first-generation user, and they must conform to deed restrictions that limit the use of the property. These purchasers often repurpose the property to something that is not blocked by deed restrictions, but that may not be the highest and best use.

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. They have intimate knowledge of the best designs, locations, and nuances that make one store more successful than another. They publish their store plans, projections, costs, achievements, and even
their store failures in annual investor reports that are easily accessible by appraisers, assessors, and the general public. Why is the most active and obvious market participant often ignored in the hypothetical sale of a big-box store?

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. For example, a common argument in drugstore property tax appeals is, Who would purchase a CVS store when a Walgreens is already on the opposite corner? The question fails to consider that CVS (or someone like them) would probably be first in line if the property were hypothetically offered for sale. The store’s success as an operating drugstore would attract a drugstore user. They would probably not pay as much as the investor that seeks benefits beyond the sticks and bricks. But they would pay more than the second-generation user that cannot maximize the property. In fact, as demonstrated by the price they pay to purchase land and construct buildings, a typical drug store user would likely pay replacement cost.

In CVS v. Turner (2013), the court acknowledged this likelihood, saying,

*It is logical that, should a drug store chain decide what to pay for one of these properties, the drug store would look to the costs involved in building a new store on a competing corner. As noted by Lee Lapierre, CVS itself weighs the costs and benefits of building their own stores when it comes to the decision to acquire an existing store or chain of stores.*

The same logic is true for the big-box stores. 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.

**Value in Exchange versus Value in Use**

The trap that assessors sometimes fall into when they point to the national chain occupant as a potential buyer is the issue of value in use. Despite the fact that most states require an estimate of *value in exchange*, in big-box appeals, assessors are sometimes accused of inappropriately applying *value in use*. The *Dictionary of Real Estate Appraisal* defines value in use as,

*The value a specific property has to a specific person or specific firm as opposed to the value to persons or the market in general* (Appraisal Institute 2002, 306).

Critics argue that focusing on the occupant’s business is improper and crosses the line into value in use. This criticism is not new. A court case early in the last century addressed this issue when the local assessor pointed to the success of a street railway company as support for his assessment. In *City Council of Marion v. Cedar Rapids* (1903), the court said,

*The franchise of a street railway company is not assessable, but the fact that the railroad is in successful operation may be taken into consideration in fixing its value.*

It would seem reasonable, in fact necessary, to consider the success or failure of a business at a specific location in determining the value in exchange. We have all seen that certain stores or restaurants seem to fail over and over again, regardless of what business occupies it. That continued failure casts doubt on the viability of that use at that location. Alternatively, the continued success of a business tends to indicate that the property is operating at its highest and best use.

*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.*

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. True, these companies are the most common occupants, but it would be improper to conclude, for example, that the highest and best use is a *Home Depot*, rather than a *home improvement store*. This small nuance can result in a conclusion of value in exchange versus straying into the value in use territory.

It is true that value in use is based solely on a property’s actual use, but that value is not always different from value in exchange. 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.

Similarly, assessors should be careful not to assess features that are so peculiar to a specific owner that others would not want them. Although Walmart, Target, Home Depot, and other big-box stores spend significant amounts of money for signage, no one other than Walmart could use a sign that says Walmart, so the fee-simple market value of that item is essentially zero, while its value in use is the depreciated replacement cost. Although the sign stanchion and electrical equipment could be used by anyone, the name itself has value only to Walmart.
Some argue that the design, colors, façade, and even layout of big-box stores are so unique to their specific users that they represent functional obsolescence to anyone else. To support that claim, they point to the costs incurred by subsequent owners to tailor a property to the new occupant’s brand. But these tenant improvement costs are not unique to big-box stores. When almost any property sells, there will be changes and improvements that personalize a property for the new occupant. These changes are often cosmetic, such as painting, signage, and layout, but they do not rise to the level of functional obsolescence. In essence, the design of big-box stores makes them easy for other occupants to utilize. After all, it’s a big box.

The Courts

The courts have sent mixed messages about the proper way to value big-box stores. Some recent cases from Michigan, Indiana, and Ohio indicate that assessors should embrace dark stores as comparables, 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.

One case that has received a great deal of attention is the consolidated case of Lowe’s Home Centers, Inc., v. Township of Marquette (2014) and Home Depot USA, Inc. v. Township of Breitung (2014). In that case, the Michigan Court of Appeals took issue with the assessor’s appraiser concluding that the highest and best use was “continued use as a Lowe’s home improvement center.” In deciding in favor of the taxpayer, the court said,

Moreover, by taking the position that the HBU of the properties is use as a Lowe’s and Home Depot store, respondents confuse the distinct concepts of fair market value (i.e., value-in-exchange) and value to the owner (i.e., value-in-use) by treating them as one in the same.

The appraiser made the fateful decision to include the name of the business in highest and best use. Although many other issues were involved in the case, the misapplication of highest and best use was likely the lynchpin that persuaded the court to side with the taxpayer.

In Hy-Vee, Inc. v. Dallas County Board of Review (2014), the Iowa Court of Appeals sided with the assessor, whose appraiser indicated that the highest and best use was “continued use as a grocery store.” In that case, the appraiser avoided concluding that a specific user would represent highest and best use, instead focusing on the most likely use. As these cases show, the distinction between use and user can make the difference between winning and losing.

What seems to garner most of the attention in big-box property tax appeals is the so-called Dark Store Theory. In almost every case we reviewed, dark store comparables were one of the primary issues. Again, the courts have been divided on whether these sales are appropriate to use in setting assessments. In Home Depot v. Assessor of Town of Queensbury (2015), the New York Supreme Court embraced the taxpayer’s dark store sales and rejected the assessor’s sales that were subject to long-term leases.

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Yet in Daniel G. Kamin Cleveland Ents. v. Cuyahoga Cty. Bd. of Revision (2015), the Ohio appellate court rejected dark store sales for a K-Mart, even though the store was in the process of closing and was actually vacant by the time the case made it to trial. The court upheld the assessment, saying, [A]s of the relevant tax lien date, January 1, 2009, the property in question was leased and a fully-functioning retail store. It was not until late in 2009, well after the valuation date at issue, that the property owner learned that Kmart was going to close this store.

In most of the big-box cases we reviewed, the issue of deed restrictions was seldom raised, despite the fact that dark store sales typically include restrictions that prevent them from being put to their highest and best use. In cases in which deed restrictions were highlighted, the court recognized their negative impact on the sale price and rejected their use in the sales comparison approach.

In Target v. Kansas Court of Appeals (2015), the court noted that many of the comparable sales used by the taxpayer were properties with deed restrictions preventing retail use, which were not comparable to an owner-occupied building (In the Matter of Equalization Appeal of Target Corp. 2015).
Similarly, in *Wal-Mart Real Estate Business Trust v. Town of Plymouth* (2010), the New Hampshire Board of Tax and Land Appeals recognized the negative impact of deed restrictions on highest and best use, saying,

*All three Wal-Mart sales were for smaller, older stores where the Taxpayer had the atypical motivation of a seller having surplus property on its hands, once it decided to build a new store in the same market area and once it decided to encumber the sale of each old store with deed restrictions that limited the pool of potential buyers to exclude what it perceived to be its competitors. These factors tended to change the highest and best use of each property once the Taxpayer decided to sell it.*

The inclusion of dark stores as comparables usually results in the taxpayer’s conclusion that the subject property suffers from functional and economic obsolescence. The price users are willing to pay for abandoned big-box stores pales in comparison to their replacement cost. That difference is typically attributed to obsolescence.

Such was the situation in the Ohio Supreme Court case of *Target Corporation v. Greene County Board of Revision* (2009). In that case, the taxpayer’s appraiser successfully argued that,

*The fee simple market value of these properties is substantially lower than replacement costs, not only due to physical depreciation but also obsolescence. This obsolescence occurs the day they are completed; thus even brand new big box stores are worth less than their cost to rebuild.*

Giving consideration to the business operating inside a big-box store resulted in conflicting opinions in two cases we reviewed. In *Lowe’s Home Centers v. City of Grandville* (2014), the Michigan Court of Appeals said,

*Even if the subject property is in fact continuously occupied and successful, these characteristics of the property are not relevant for determining the property’s true cash value. They are accidents of ownership, not measures of value inherent in the property itself.*

The court thought that the assessor’s consideration of Lowe’s success was an attempt to incorporate value in use, contrary to Michigan law. But in *Soifer v. Floyd Cnty Bd. of Review* (2009), an Ohio court said,

*To obscure the fact that this real estate is being operated as a viable McDonald’s restaurant, a quite popular American establishment, would be to ignore reality.*
Interestingly, that case also involved deed restrictions, and the court opined on their effect on value, saying,

*It would be contrary to legislative intent to allow a taxpayer to circumvent the statutory scheme by voluntarily eliminating buyers who would use the property in the same manner, thereby artificially reducing the potential sales price of the property.*

Although the Soifer case did not involve a big-box store, the issues are similar.

**Legislation**

Successful property tax appeals in many jurisdictions have had newsworthy reductions. In Marquette Township, Michigan, Lowe’s successful property tax appeal resulted in a tax refund that ultimately caused the township to close the public library on Sundays (LaVecchia 2015). Major road repairs in Escanaba, Michigan, had to be shelved because of a property tax refund garnered by the appeal of a Menard’s home improvement store (Dawsey 2015). A study commissioned by the Indiana County Assessors Association found that assessed values statewide could fall as much as $3.5 billion, or approximately $43 million in tax revenue, if the dark story theory was applied statewide (Dawsey 2015).

In Marquette Township, Michigan, Lowe’s successful property tax appeal resulted in a tax refund that ultimately caused the township to close the public library on Sundays.

The impact of assessment appeals on big-box stores has caused some jurisdictions to turn to their state legislature to craft laws that would prevent reductions based on dark store sales.

In 2015, the Indiana General Assembly unanimously approved Senate Bill 436, which expands the definition of special-purpose properties to include retail buildings of 50,000 square feet or more. The bill directly targets the big-box appeals by requiring assessors to value them by the cost approach and prevents the use of dark store comparables. Language in the statute states,

*If the effective age of the improvement is ten years or less, the sale of a comparable property may not be used in determining the assessment if the comparable property (1) has been vacant for more than one year [or five years, if the comparable property is an industrial property], (2) has significant restrictions on its use, (3) was sold and is no longer used for its original purpose, or (4) was not sold in an arm’s length transaction.* (Indiana 119th General Assembly 2015)

In Michigan, a bipartisan group of state lawmakers comprising Senator Tom Casperson, Representative Ed McBroom, and Representative John Kivela, plans to introduce legislation in the fall of 2015 that would prevent the use of dark stores as comparables or those with deed restrictions that prevent retail use (Dawsey 2015). In a more unusual proposal, Michigan State Representative Scott Dianda introduced House Bill 4681 in June 2015, which would require big-box stores to pay a user fee if they successfully appeal their property taxes (Michigan Legislature 2015).

**Recommended Approach to Assessment of Big-Box Stores**

To correctly assess a big-box store (or any other property for that matter), an accurate determination of highest and best use must be made, appropriate approaches to value selected, and proper adjustments applied. These recommended steps are tailored for an estimate of fee-simple market value in exchange, the standard in most states.

**Highest and Best Use**

Identification of the correct highest and best use is critical, because it also serves as the basis for selecting the appropriate comparables. The assessor should review the current use of a big-box store and determine the most likely buyer in a hypothetical sale. If a store is occupied by a first-generation user and from all appearances the store is successful, the highest and best use is likely continued use as a first-generation big-box retail store (the assessor should be careful not to conclude a highest and best user, but instead, a highest and best use). Once it has been determined that the highest and best use is continued use as a big-box retail store, the selection of comparables begins.

**Sales Comparison Approach**

There are typically two types of sales of big-box stores, and both pose challenges for assessors. They sell either as occupied in a sale-leaseback (or subsequent investor-to-investor purchase) or as vacant after a big-box chain has abandoned a particular location.
The prices paid by investors in sale-leaseback transactions typically meet or exceed replacement cost, because the rent being charged is based on the original development costs—and the price paid is based on the rent. Critics of sale-leaseback transactions argue that the buyers in these transactions are more interested in the tenant, and they may pay a premium for the security that a creditworthy tenant provides. That argument is valid, and for that reason a property rights adjustment should be considered to ensure the adjusted price reflects fee-simple value. Adjustments for a property rights premium can be made in a number of ways. The easiest and most efficient way is to compare the sale price of a comparable to its replacement cost. Because the cost approach inherently reflects fee-simple value, a higher leased-fee sale price would suggest a property rights adjustment is warranted. Sale verification will confirm whether a sale-leaseback is a valid market transaction.

Sales of vacant big-box stores should also be considered. However, the assessor should ensure that the sale and the comparable have the same highest and best use. When big-box chains abandon a location, it is usually because the property failed. In addition, dark store sales are often burdened with restrictions that prevent them from being utilized for their intended purpose. A failed store usually results in a change of highest and best use, and the placement of deed restrictions almost guarantees it. Adjusting sales for these conditions is difficult if not impossible, and the use of sales with highest and best uses different from that of the subject property is improper.

Another option is to use fee-simple purchases of operating big-box stores by their users. National big-box chains occasionally purchase their own buildings through build-to-suit arrangements, and those sales are ideal because no lease is involved. But those sales are rare.

The two most common options in a sales comparison approach for big-box stores are sale-leasebacks and dark store sales, but both have challenges and limitations. Although it might seem tempting to discard the approach entirely, appeal boards and courts really like sales. However, they don’t always like sale-leaseback transactions or dark store sales. Despite their limitations, the assessor would be well-served by analyzing and presenting both types of sales and, if enough data are available, performing appropriate adjustments.

**Income Approach**

The same limitations that affect the sales comparison approach affect the income approach. Big-box stores that are leased are either first-generation users in a sale-leaseback or former dark stores leased to secondary users.

For first-generation big-box stores that are leased, the annual rent is typically a function of the original development costs. Because market rent is required to estimate fee-simple value, it is important to determine whether the contract rent is above or below market, possibly influenced by the amount of time that has passed since the lease originated. Because contract rent is established in the year of construction and is typically fixed for the lease term, the rent may be outdated. Older stores typically have rental rates different from newer ones because construction costs change. For this reason, the assessor should carefully analyze contract rents to determine whether dated rental rates need to be adjusted for time.

An alternative to adjusting big-box contract rent is using rental rates from second-generation stores. Although second-generation big-box stores (former dark stores) are physically identical to first-generation stores, they have been rejected for retail use by the market. Whether the location did not meet expectations or the submarket was saturated with stores, these properties are no longer used for their intended purpose. In fact, rejection by market participants signals a change in highest and best use.

When big-box stores are closed, they are typically not offered for lease to competing users.

In addition, when big-box stores are closed, they are typically not offered for lease to competing users. Deed restrictions and lease clauses often prevent one national chain from leasing the vacated property of another. This constraint limits the ideal user from negotiating and establishing market rent. Although a competing chain might be willing to pay higher rent than a secondary user, the desire to block the competition from a closed store outweighs the need to maximize rent. Given these limitations, adjusting first-generation contract rent is the most accurate and effective way to determine a current market rent for an operating store.

When big-box stores are leased on a net-net-net basis, the property expenses are mostly borne by the tenant. Although landlords incur few costs, time may be required for oversight of the investment, and sometimes the landlord is responsible for major capital repairs, such as the roof and structural walls.
An assessor may want to account for these two factors by including a nominal expense estimate in the income approach. Since lease terms for big-box stores typically exceed 20 years, vacancy is an insignificant factor, with the only risk the unlikely default of a tenant. However, in an estimate of fee-simple value, the assessor should utilize a vacancy rate typical for net-leased properties overall.

Capitalization rates from big-box sales reflect investor motivation to obtain both quality real estate and a dependable income stream from a highly rated national tenant. Although sales of other property types reflect similar motives, the security of national big-box chains is highly appealing. Investors are willing to pay more for these assets in exchange for the low risk and freedom from day-to-day management. But buyers do not want to pay more than they have to. Again, sale verification will indicate whether the price paid, and ultimately the capitalization rate, reflects market.

Functional obsolescence normally originates from defects in design. The Dictionary of Real Estate Appraisal defines functional obsolescence as,

An element of depreciation resulting from deficiencies or super adequacies in the structure (Appraisal Institute, 2002, 122).

Big-box stores got their name because of their simplistic design and large amount of open floor space. Although big-box stores vary slightly because of user branding, they are largely similar, and it would seem that any design flaws have been corrected and not repeated. Because the national chains continue to build new stores of similar design, it would seem they have been almost perfected.

External obsolescence is defined as,

An element of depreciation; a defect, usually incurable, caused by negative influences outside a site and generally incurable on the part of the owner, landlord, or tenant … (Appraisal Institute, 2002, 106).

Big-box chains are very selective in choosing a location for their stores. It is not typical for a big-box store to be close to a negative influence, such as a landfill or an industrial use. Big-box stores are susceptible to the same negative economic forces as any property type, such as recessions and changes in consumer demand. Some big-box appeals argue obsolescence due to the growth of online shopping, but this argument fails to hold water. True, online shopping is growing, but brick-and-mortar stores are still in great demand, as demonstrated by consumer sales and by the continued construction of new stores.

The most typical argument for functional and external obsolescence by big-box owners and their representatives originates from the difference between the values derived from the cost approach and those from the sales comparison and income approaches. This obsolescence adjustment usually occurs when dark stores have been used as comparables for first-generation operating stores and the values they produce fall well short of replacement cost. Although this approach is valid, the selection of the wrong comparables will result in an incorrect estimate of obsolescence. In addition, this method should be used to calculate the impact of obsolescence that has already been identified. If the specific source of obsolescence cannot be identified, a conclusion of phantom obsolescence by comparing the approaches to value is questionable. Instead, the assessor should carefully review the property, the industry, the economy, and other factors to independently determine whether functional and/or external obsolescence exists.

Once the depreciated value of improvements is calculated and added to the land value estimate, the value by the cost approach can represent a reliable estimate of the market value of a big-box store.
After all three value approaches have been estimated, assessors weigh the applicability of each approach. For big-box stores, all three approaches to value have merit. Depending on the availability and quality of data and the amount of judgment required in making adjustments, one approach may be more beneficial than others.

Conclusion

For a property type that is fairly simple in design, big-box stores generate an abundance of appeal arguments and challenges for assessors. This article has discussed the typical appeal arguments, related court cases, and recommended approaches for assessing big-box stores. We hope that it has shed some light on these issues and provided assessors with a framework for assessing these properties. The key elements related to the assessment of these properties are as follows:

- The demise of brick-and-mortar stores as a result of online shopping is exaggerated. Online shopping only represents 7 percent of total retail sales. Although Amazon and other online retailers are having an impact on the retail industry, big-box stores continue to thrive.
- While national big-box chains are experimenting with smaller stores, they continue to build large, 100,000+ square foot stores. Until retailers abandon the big-box design, it would be improper to adjust for obsolescence based on speculation about future retail trends.
- Sale-leasebacks are leased-fee transactions that require verification and consideration of adjustments for property rights. They often represent the only sale of first-generation big-box stores.
- Sales of vacant big-box properties (dark stores) usually involve a failed store that has been abandoned by the first-generation user. A failed store usually results in a change of highest and best use. The use of a sale with a different highest and best use as a subject property is improper.
- Dark store sales are usually encumbered with deed restrictions that prevent occupancy by the most likely buyers. That use limitation may render the transaction unusable because the real property rights conveyed are less than fee simple.
- When evaluating highest and best use, the assessor should not exclude the present occupant (or someone similar) as a potential purchaser in a hypothetical big-box sale. Although the current occupant (or someone similar) can be considered a market participant, it would be improper to conclude that the highest and best use is a Walmart rather than a big-box retail store.
- The design of big-box stores is not so unique that it automatically results in functional obsolescence. Although big-box stores vary slightly because of user branding, they are mostly similar and can easily be altered for other users. Changes in design and branding after a sale are common and do not represent functional obsolescence.
- All three approaches to value are possible for big-box stores. The sales comparison and income approaches are the most challenging because of the way big-box stores sell and lease. The cost approach is often the most straightforward and supportable estimate of value.

Often the most reliable approach—and one that best reflects the behavior of the market—is the cost approach. As always, the assessor makes the final estimate of market value based on the best available data.

Big-box stores are not built to be sold. They are built for utility. When they sell occupied, it is usually a sale-leaseback, which represents a leased-fee interest. When they sell vacant, it is usually because a location failed and is deed-restricted and cannot be sold or leased to a competitor. These conditions present challenges in applying the sales comparison and income approaches to value. Often the most reliable approach—and one that best reflects the behavior of the market—is the cost approach. As always, the assessor makes the final estimate of market value based on the best available data.

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Glossary (IAAO 2013)

**Fee Simple**—In land ownership, complete interest in a property, subject only to governmental powers such as eminent domain.

**Functional Obsolescence**—Loss in value of a property resulting from changes in tastes, preferences, technical innovations, or market standards.

**Highest and Best Use**—A principle of appraisal and assessment requiring that each property be appraised as though it were being put to its most profitable use (highest possible present net worth), given probable legal, physical, and financial constraints. The principle entails first identifying the most appropriate market and, second, the most profitable use within that market. The concept is most commonly discussed in connection with underutilized land.

**Leased Fee Estate**—An ownership interest held by a lessor with the rights of use and occupancy conveyed by lease to another.

**Net Lease**—A lease in which the landlord (lessor) receives a stipulated rent amount and the tenant (lessee) pays all operating expenses and taxes attributable to the property. A net lease produces net income to the lessor.

**Replacement Cost; Replacement Cost New (RCN)**—The cost, including material, labor, and overhead, that would be incurred in constructing an improvement having the same utility to its owner as a subject improvement, without necessarily reproducing exactly any particular characteristics of the subject. The replacement cost concept implicitly eliminates all functional obsolescence from the value given; thus only physical depreciation and economic obsolescence need to be subtracted to obtain replacement cost new less depreciation (RCNLD).

**Sale-Leaseback**—A sale and subsequent lease given by the buyer back to the seller as part of the same transaction.

**Value in Exchange**—(1) The amount an informed purchaser would offer for property under given market conditions. (2) The concept that states value is based on the ability of property to command another asset, such as money, in trade.

**Value in Use**—The value of property for a specific use. The concept that holds value to be inherent in property itself, that is, the value is based on the ability of the asset to produce revenue through ownership.

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Exposure Draft

Setting the Record Straight on Fee Simple

by the IAAO Fee Simple Task Force

May 2019
Setting the Record Straight on Fee Simple

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I. Introduction

The purpose of this paper is to address issues surrounding the definition of the term *fee simple*. The fee simple estate definition is the foundation of what assessors are often asked to examine. It is evident, particularly in property tax appeals, that it is necessary to clarify this concept for assessors, appraisers, the courts, and others in the appraisal community.

Misunderstandings about the term *fee simple*, more appropriately, *fee simple absolute*, have led to uncertainty in the appraisal of a fee simple absolute estate.

Issues arising from the term *fee simple absolute* include whether the property should be valued as if vacant, whether the term assumes any encumbrances on the property, and whether the term assumes market rent. An investigation of the evolution of the term reveals that the appraisal industry definition has diverged from the legal definition, leading to confusion in the appraisal community, particularly in the field of property taxation. Therefore, it is essential to clarify fee simple in order to maintain accuracy, consistency, and uniformity in assessment practices and to retain credibility in the assessment profession.

This paper explains these issues and sets the record straight about what fee simple is and what fee simple is not.
II. Definition of Fee Simple

A. Legal Definition

1. History of the Term

The term \textit{fee simple absolute} dates back to the early 1300s in England (Garner 2014, 733–734; Wolf 2009, 13–1). The legal definition remained constant over the years and is generally defined as an estate that has a potentially infinite duration and, if limited in favor of a person, would be inheritable by his heirs (Wolf 2009, \textit{First Restatement of Property}, section 14; section 13.02) The history of fee simple absolute, and the other estates traditionally recognized in the United States, is long. Estates arose from feudal law in England centuries ago and were carried over to the United States.\textsuperscript{2} The definition in the legal arena has not changed in meaning over time; however, the concept of fee simple within the appraisal community has changed significantly.

2. Definition

The definition of \textit{fee simple} in the \textit{First Restatement of Property} is as follows:

\begin{quote}
\textit{An estate in fee simple absolute is an estate which has a duration potentially infinite, or if limited in favor of a natural person, would be inheritable by his collateral as well as by his lineal heirs} (Wolf 2009, section 13).
\end{quote}

Similarly, \textit{Black's Law Dictionary} defines fee simple as follows:

\begin{quote}
\textit{An interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs; esp., a fee simple absolute} (Garner 2014, 733).
\end{quote}

\begin{quote}
\textit{Introduction to The Law of Real Property} describes fee simple as,
\end{quote}

\begin{quote}
\textit{... the largest estate known to law. It denotes the maximum of legal ownership, the greatest possible aggregate of rights, powers, privileges, and immunities}
\end{quote}

\textsuperscript{2} The likely first reference to \textit{fee simple} in the courts in the United States was in a Maryland court in the case of \textit{Smith's Lessee v. Broughton} in the year 1714.
which a person may have in land. It is an estate of potentially infinite duration
in the holder’s successors who acquire the holder’s interest in the property
either by conveyance, devise, or inheritance. The three hallmarks of the estate
are that it is alienable, devisable, and descendible. (Moynihan and Kurtz
2002, 34)

Although these legal texts do not use identical terminology, the definitions have similar
meanings that emphasize absolute control, duration, and inheritability.

3. Distinguishing Fee Simple from Other Estates in Real Estate

As noted above, the fee simple absolute estate implies nothing more than an ownership
interest in property in which the owner has complete control of the disposition of the property.

Fee simple is one of six freehold estates in real property:

(1) Fee simple absolute
(2) Life estate
(3) Fee simple determinable
(4) Fee simple on condition subsequent
(5) Estate for years
(6) Estate at will.

These estates essentially determine the disposition of the property. For example, a life
estate terminates upon the death of the holder of that estate, with the property predetermined to
go to another person, the remainderman. With a fee simple determinable or fee simple on
condition subsequent estate, the owner of these estates loses title upon the occurrence of some
event specified in the deed, say, marriage, or the use of the property for other than a public use.

With an estate for years, the owner of the estate is simply divested of title after the expiration of
a certain time frame, say, 10 years. Finally, the owner of an estate at will can lose title at the will
of the grantor.
However, with a fee simple absolute estate, there is no event that triggers a loss of ownership of the property. The holder of the fee simple absolute estate can sell the full unrestricted estate in the property or put it in a will so that the owner can determine the disposition of the property upon death.

B. Appraisal Definition of Fee Simple

1. History

The appraisal definition of the term fee simple differs from the legal definition, and the distinction becomes evident upon tracing the definition’s evolution in appraisal industry.

Initially, the appraisal definition aligned perfectly with the legal definition of fee simple absolute; however, in the 1980s the term *unencumbered* was appended to the definition. It is that divergence from the legal term that has caused the issues addressed by this paper. The following chronology describes the transformation of the definition in the appraisal industry.

- *Appraisal Terminology*, 1938, **absolute fee simple**. The largest possible interest or estate in property, subject, however, to the limitations of Eminent Domain, Escheat, Police Power, and Taxation; an inheritable estate. (American Institute of Real Estate Appraisers 1938)
- *The Appraisal of Real Estate*, 1983. A person owning all of the rights is said to have fee simple title. Fee simple title is regarded as an estate without limitations or restrictions. (Appraisal Institute 1983)
- *The Dictionary of Real Estate Appraisal*, 1984. fee simple estate. Absolute ownership *unencumbered by any other interest or estate*; subject only to the limitations of eminent domain, escheat, police power, and taxation. (Appraisal Institute 1984)
A person who owns all the property rights is said to have fee simple title. A fee simple estate implies absolute ownership unencumbered by any other interest or estate. (Appraisal Institute 1987, 1992, 1996)

The Dictionary of Real Estate Appraisal, 1989, fee simple estate. Absolute ownership unencumbered by any other interest or estate subject only to the four powers of government. (Appraisal Institute 1989)


The Appraisal of Real Estate, 2001. The most complete form of ownership is title in fee. Such ownership establishes an interest in real property known as fee simple interest, that is, 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. (Appraisal Institute 2001)

The Appraisal of Real Estate, 2008, 2013. The most complete form of ownership is the fee simple interest, that is, 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. (Appraisal Institute 2008, 2013)

Note that the 1984 version of The Dictionary of Real Estate and the 1987 version of The Appraisal of Real Estate were the first publications to diverge from the established definition of fee simple.

2. Appraisal Industry Definition

The current definition in The Dictionary of Real Estate Appraisal defines fee simple estate as,

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 (Appraisal Institute 2015).

The concept that fee simple means the property is “unencumbered by any other interest or estate” is the point at which the appraisal definition digresses from the legal definition. The Dictionary of Real Estate definition emphasizes absolute ownership, but the “unencumbered by any other interest or estate” phrase implies that the existence of an encumbrance results in
something other than fee simple absolute ownership. That premise is inaccurate. In particular, the word *unencumbered* has led some to mistakenly interpret fee simple to mean that any property with a lease is no longer a fee simple estate.³

The courts have also noted the discrepancy between the legal and appraisal definitions of fee simple:

> The distinction between ‘fee simple’ and ‘leased fee’ is one drawn in the context of appraisal practice. The appraisal industry uses the term ‘fee simple’ to refer to unencumbered property – or to property appraised as if it were unencumbered. This distinction is not one recognized by the law, however. A ‘fee simple’ may be absolute, conditional, or subject to defeasance, but the mere existence of encumbrances does not affect its status as fee simple. (Meijer Stores Ltd. Partnership v. Franklin Cty. Bd. of Revision 2009; HIN, L.L.C. v. Cuyahoga Cnty. Bd. of Revision 2014)

In addition, the United States 9th Circuit Court of Appeals notes that a leaseholder is not “seised of land” and that a “lease-hold is not an ownership interest” (*City of L.A. v. San Pedro Boat Works* 2011). If the tenant has no ownership interest in real estate, then the fee owner has not given up any ownership rights.

The final clause in the definition, which references the four powers of government (powers of taxation, eminent domain, police power, and escheat), is simply an acknowledgment that all privately owned real estate, regardless of the estate in which it is held, is subject to those governmental limitations.

### 3. Implications of the Word ‘Unencumbered’

The appraisal industry definition of fee simple does not identify any specific encumbrances that would allegedly destroy the fee simple estate, but instead uses the all-

³ The phrase “unencumbered by any other interest or estate” also raises another issue. As already established, fee simple absolute is an estate. An estate is not an encumbrance. A fee simple estate cannot be encumbered with another “estate”—the existence of another estate simply means the estate is not fee simple.
encompassing word *unencumbered*. The definition states that the existence of an encumbrance results in something other than fee simple absolute. This is incorrect; moreover, it is rare, if ever, that an appraisal assignment, for property tax purposes or otherwise, would request a value of an unencumbered estate. Valuing an unencumbered estate would mean ignoring utility easements (i.e., gas, electric, water, and the like), access easements, and restrictive covenants (i.e., deed restrictions). Whereas many appraisal assignments request a value of the fee simple estate, it is unlikely that the purpose of the appraisal is to value the property ignoring easements and restrictive covenants, among other encumbrances. Thus, the appraiser is caught between conforming to the appraisal industry definition of fee simple (ignoring all encumbrances) and to the actual goal of the appraisal, which likely seeks a value considering utility and access easements and any restrictive covenants.

This illogical result arising from the erroneous definition is pointed out in *The Appraisal of Real Estate*:

> The complexity of real property ownership in the United States today suggests that a true fee simple interest seldom exists because nearly all properties are encumbered to some degree by easements, reservations, or private restrictions. ... Even so, many assignments call for the valuation of the fee simple interest. ... (Appraisal Institute 2013, 111).

In sum, the important aspect to note is that *fee simple* has absolutely nothing to do with leases/mortgages/liens/deed restrictions/easements or any other encumbrance or distribution of property rights to others. The typical homeowner likely owns the home in fee simple absolute, and the deed reflects that estate. The existence of a mortgage does not mean the owner has less than a fee simple absolute estate. The home also has utility easements for water, power, and cable; however, the owner still holds the property in fee simple absolute. More specifically, the property is owned in fee simple absolute *subject to* the mortgage and the utility easements. And
if the home is leased, then the property is owned in fee simple absolute subject to the lease.\textsuperscript{4} A fee simple estate or any other estate is not defeated by the existence of encumbrances.

C. Interests, Estates, Encumbrances, and Real Estate

Much of the confusion in this area is the result of the intermingling of terms that do not carry the same meaning. The general term real estate (i.e., land and all things permanently attached thereto) represents the physical asset to which the interests held by an owner of real property (i.e., the bundle of rights or sticks) pertain. The term interest as used in both the legal and real estate industries is a broad generic term representing any of the rights in real estate and can refer to estates, encumbrances, leases, possessory interests, mortgages, and so forth. The term estate, as discussed above, specifically identifies the category of ownership interests that define the length of the ownership along with any events affecting the duration of that ownership term.

The universal term interests encompasses any of the various rights in real estate; however, the various subcategories of interests do not overlap. Thus, while estates, possessory interests, leasehold and leased fee interests, encumbrances, and so on can all be considered interests, they are still separate from each other.

III. Problems Arising from the Appraisal Industry Definition

A. Fee Simple and Vacancy

One of the main controversies that has emerged as a result of the word unencumbered is the interpretation that a property encumbered by a lease is not fee simple, and that appraising a property in fee simple means one must assume the property is unencumbered by a lease, that is,

\textsuperscript{4} A lease fulfills the basic wish of an owner to receive rent. It is a contract for the use of the property to provide rental income to the owner.
vacant. Fee simple does not mean the property is vacant. Fee simple defines an estate. It is not synonymous with dark value or liquidation value. Under this misguided theory of the fee simple estate, multitenant office buildings and apartment buildings would be appraised as vacant properties even if fully occupied—something contrary to what exists, otherwise known as a hypothetical condition. If the appraisal industry definition of fee simple were accurate, then according to USPAP, every appraisal of the fee simple interest of a leased property would require the application of a hypothetical condition valuing the property as vacant, which is not likely to be the intended result of the appraisal of a fee simple estate.

The Uniform Standards of Appraisal Practice (USPAP) (TAF 2018) defines hypothetical condition as,

\[ A \text{ condition directly related to a specific assignment, which is contrary to what is known by the appraiser to exist on the effective date of the assignment results, but is used for the purpose of analysis.} \]

Comment: Hypothetical conditions are contrary to known facts about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends, or about the integrity of data used in an analysis. (TAF 2018, 4)

Of course, an appraisal assignment may specify that the property be appraised as vacant; however, unless this is part of the defined scope of work, the phrase *fee simple absolute* should not imply vacant when the subject property is occupied.

What also emanates from this faulty presumption is the theory that a fee simple valuation assumes the property is vacant and available for lease or for sale to some other prospective user, a hypothetical user. Some then go further and eliminate the current use and user from the pool of prospective uses and users. This perspective ignores the current use of the property even if that is the highest and best use. In other words, it ignores the fact that the continuation of the current use of the property could be the highest and best use and biases the appraisal development process.
B. Fee Simple Absolute and Leased Fee Interest

Another issue arising from the erroneous fee simple definition is whether a fee simple estate and leased fee interest are mutually exclusive of one another. *Leased fee* is a term defined by *The Dictionary of Real Estate Appraisal* as

> The ownership interest held by the lessor, which includes the right to receive the contract rent specified in a lease plus the reversionary right when the lease expires. The term is used by appraisers as a basis to estimate the lessor’s value subject to a lease. It is based usually on the capitalization of net operating income (NOI) or the sum of the present value of the forecast NOI over a holding period and the present value of the reversion. In reality, leased fee is synonymous with fee simple, subject to a lease when possession but not the ownership is temporarily transferred to another. (Appraisal Institute 2015, 128)

As noted, leased fee is merely an interest, not an estate. As the definition also notes, leased fee is actually a fee simple interest subject to a lease. (Obviously any estate may be subject to a lease—life estate, fee simple on condition subsequent, and so on). Therefore, an appraiser may use leased fee properties as comparable sales when estimating the market value of a fee simple estate, provided that necessary adjustments are applied to account for above- or below-market characteristics.

C. Bundle of Sticks

Another common but inaccurate description of the fee simple estate is that it represents the whole *bundle or rights* or *bundle of sticks*. The bundle of rights or bundle of sticks metaphor originated as a description of real estate, not a fee simple absolute estate. Fee simple absolute is not synonymous with the term *real estate*.

The problem with this description of fee simple is that the metaphor implies that fee simple represents the entire set of rights and that each stick represents one piece of the whole. When any stick is removed, what remains is something less than fee simple. Any of the estates in real property contains that same bundle of rights. When the fee simple estate owner exercises the
right to lease the real estate, he/she receives a benefit of ownership for a finite period of time after which the real estate can be owner-occupied, leased, or left vacant. Thus, the transfer of one or more sticks from the bundle of rights does not diminish the estate. The owner of a property that has a fee simple absolute estate can still lease the property, encumber it with a mortgage or other lien, and transfer easement rights to another, without diminishing or changing the fee simple absolute estate.

D. Fee Simple Is Not a Value Concept

Another point of confusion is equating fee simple with market value. Fee simple is an ownership concept, not a value concept, although some appraisers have mistakenly used fee simple to imply at market. Market rent or market value is precisely that, and fee simple should not be used interchangeably with those terms.

IV. The Definition of Fee Simple Should Not Differ among the Appraisal, Legal, or Real Estate Industries

The appraisal industry is too closely associated with the legal industry and the general real estate industry for different definitions to exist among the three. Review of the real estate industry shows that brokers and real estate salespersons, real estate financing persons, real estate attorneys, and the courts all understand fee simple to have the meaning set forth by the legal definition, which has remained constant throughout the years. Statutes governing property tax can be also assumed to follow the legal definition. There is no rationale for the appraisal industry to apply its own definition to a term universally understood by the other participants in the real estate industry.
V. Conclusions

Once the definition of *fee simple absolute* is clarified, it is evident that *fee simple* is a property rights concept that does not mean vacant or unencumbered by a lease and is not a value concept to be used interchangeably with market value. It is important to understand these distinctions so that the appraiser or assessor can properly define the appraisal problem. An appraiser can value the fee simple ownership of an occupied apartment building assuming leases in-place, market rents, or a lease-up period. The mere fact that there are renters in a commercial property does not detract from fee simple ownership. In other words, if that apartment building, whether occupied or vacant, were to convey in a sale, the deed would state that the property transferred in fee simple. What is being valued is based on the scope of work of the assignment. Whether the appraiser or assessor considers an easement or above- or below-market leases is defined by the appraisal assignment and, in the case of property taxation, by the jurisdictional requirements mandated by statutes and the courts.

VI. References


*City of L.A. v. San Pedro Boat Works*, 635 F. 3d 440 (9th Cir. 2011) (quoting *Auerbach v. Assessment Appeals Bd. No. 1*, 137 P.3d 951, 956 (Cal. 2006)).


*Smith’s Lessee v. Broughton*, 1 H & McH. 33, 1714.


Revised APB Valuation Advisory #4

Identifying Comparable Properties

This communication is for the purpose of issuing guidance on recognized valuation methods and techniques. Compliance with such guidance is voluntary, unless mandated through applicable law, regulation, or policy.

Important Note: This revised APB Advisory #4 is being issued to make edits to a Supreme Court Case citation on page 9 for the *Mississippi & Rum River Boom Co. v. Patterson, 98 U. S. 403 (1878)*. Additional edits were made to add complete text titles and correct page references in the Glossary of Terms and Definitions beginning on page 13.

Date Issued: September 26, 2013

Application: Residential and Non-residential Real Property

Issue: As part of its ongoing responsibilities, the APB is tasked with identifying where appraisers and appraisal users believe additional guidance is required. One such issue identified by the APB is identifying comparable properties. Comparability analysis is a fundamental study in determining property value. This analysis involves a side-by-side examination of physical and transaction characteristics of the identified comparable properties relative to the subject. The reliability of this valuation technique relies heavily on the proper selection of suitable comparable properties.

This guidance discusses the terms and definitions associated with a comparable property, the characteristics generally considered for determining comparability; and the degree of suitability of a property as a comparable.

The guidance addresses whether there is a threshold of differences, which based on their magnitude, automatically disqualifies a property as comparable.

The guidance examines a closely related topic; the differences between the terms, “market area” and “neighborhood” and a broad summary of the characteristics to consider for delineating a market area.
With regard to the use of “distress sales” (e.g., short sales, foreclosures) please see APB Valuation Advisory #3, *Residential Appraising in a Declining Market*. The Board is also considering developing guidance on the valuation of new residential construction.

**Subject Matter Experts:** The Appraisal Practices Board and The Appraisal Foundation wish to express our sincere gratitude to each of the following Subject Matter Experts for volunteering their time and expertise in contributing to this document:

- Grant Austin, Orlando, Florida
- Anthony Graziano, Miami, Florida
- Michael Ireland, Bloomington, Illinois
- Karen Oberman, Clive, Iowa
- Jo Anne Traut, Brookfield, Wisconsin

APB Liaisons: Guy Griscom and John S. Marrazzo

The APB would like to express its thanks to Gary Taylor, former APB Chair, for his participation and direction on this project.

**Identifying Comparable Properties**

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Identifying Comparable Properties

I. Introduction

Real property valuation considers three approaches to value which are distinctly different given their underlying foundational premises. However, all three approaches rely on a comparability analysis in developing credible results under each approach. The Sales Comparison Approach provides an indication of value based on units of comparison derived from sales of similar or comparable properties. The Cost Approach requires land value comparability analysis, cost comparability analysis, and market extracted depreciation comparability. The Income Approach requires income/lease comparability, expense comparability, income potential comparability, capitalization rate, and minimum acceptable rate of return on investment comparability. All of the above approaches rely on the same fundamental underpinnings of determining “comparability.”

Therefore the identification of what constitutes a similar, or “comparable property” is critical to the proper application of the three approaches to value. In this Advisory we will provide guidance to assist in the identification of comparable properties.

II. Property Characteristics

The principle of substitution is the foundation of comparability. It states that a rational buyer will not pay more for an item than the cost of an acceptable substitute. The appraiser must analyze transactions of closed sales, pending sales, and listings of properties and determine which are acceptable substitutes by weighing the elements of comparison. In developing an opinion of value for the subject property, the appraiser attempts to answer the question “What would a buyer of the comparable property have paid for the subject property given the observed sale price (or asking price, in the case of a listing) for the comparable property?”

Generally speaking, the more similar a competing property is to the subject property, the better. A high degree of similarity in property characteristics between the subject property and the available properties improves comparability. Many courts recognize “…that ‘similar’ does not mean ‘identical,’ but means having a resemblance, and that property may be similar in the sense in which the word is here used though each possesses various points of difference.”

The appraiser weighs the relevance of the property characteristics (including, but not limited to: location, economic, legal and physical factors) based on the importance assigned by market participants. The most relevant property characteristic(s) are then examined on each available property. By examining and weighing the relevant property characteristics, the appraiser is better prepared to select the most appropriate comparable properties available. Another court has defined a comparable property as one that “Has similar use, function, and utility; is influenced by the same set of economic trends and physical, governmental, and social factors; and has the potential of a similar highest and best use.”

1 Adapted from The Appraisal of Real Estate, 13th Ed., pp. 38-39.
Because real property is truly unique, there are always differences between the property under analysis and the selected competing properties used for comparative purposes. When considering a property as a comparable, the appraiser should first ask “Is the property sufficiently similar, in all fundamental aspects to the subject property?” This leads to the critical analysis of evaluating the property characteristics that make a property sufficiently similar. The following chart below summarizes the primary elements of comparison:

<table>
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<tr>
<th>Elements of Comparison</th>
<th>Description</th>
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<tr>
<td>Location (Market Area) Aspects</td>
<td>Other than market conditions at the time of sale, location is the most distinctive element of property analysis. Would a potential buyer of the subject consider the comparable property as a potential substitute given its location within the market area?</td>
</tr>
</tbody>
</table>
| Economic Aspects                | Economic aspects include seller concessions, buyer’s expected expenditures after sale, financing considerations to reflect “cash-equivalent” pricing. In lease comparability, economic aspects might include reimbursement terms, landlord amortization of tenant improvements, etc.  
Also, includes market conditions: especially time, which is an element of all property analysis. Did the comparable transaction occur under similar market conditions as the subject property’s date of analysis? What are the driving elements which differ and contribute to the adjustments necessary to infer pricing within the current market? |
| Legal Aspects                   | Comparability of property title and occupancy tenure, generally expressed as “interest appraised”  
Highest and Best Use: significant effort should be given to compare similar transactions based on the subject property’s highest and best use. |
| Physical Aspects                | Each type of real estate (residential and non-residential) has physical characteristics which are desired or required by buyers. Different market areas demonstrate different buyer preferences with respect to cost/value of physical property characteristics. An exhaustive list could be compiled considering all of the various physical elements by asset class which might be measured and compared. What is significant to the analysis are those elements that contribute to measurable price differences in the market. A summary listing of typical major physical elements of comparison by asset class is provided as a supplement to this table. |
III. Comparable Suitability

Sales information⁴: Before a property can be considered a comparable, the appraiser must confirm the type of sale transaction. In other words, did the sale occur under conditions commensurate with the type and definition of value under consideration? “In the case of market value, the following factors must be considered:

1. Did the sale convey property rights similar to the property rights being appraised? Were the property rights similarly encumbered or unencumbered at the time of sale?
2. Were both the buyer and seller typically-motivated?
3. Were both parties well informed or advised and each acting in what they considered their own best interests?
4. Was the property allowed exposure in the open market for a reasonable length of time?
5. Was payment made in cash or its equivalent?
6. Was financing, if any, on terms generally available in the community at the time of sale and typical for the property type in its locale?
7. Did the price represent normal consideration for the property sold unaffected by special financing amounts and/or terms, services, fees, costs, or other credits incurred in the transaction?”⁵

The appraiser’s experience and skill in consistently observing the market coupled with ongoing interviews with buyers, sellers, and brokers as to what factors drive local values assist in providing credible value indications by comparison.

In addition to closed sales, knowledge of listings and pending (under contract) properties may be used to demonstrate the most current market activity and current competition considered by potential buyers. Because the final conveyance amount is unknown, listing comparables and pending sales should be used cautiously, but are often helpful: (a) in establishing the upper limit of probable value in the final reconciliation, or (b) as guidance in times of rapidly changing market conditions.

The appraiser cannot control the quality or suitability of the activity available in the market during the timeframe of analysis. Information could be limited in many markets, and many properties do not lend themselves to simplified comparison. In such cases, analysis of older transactions may also be required due to limited current activity in the market; however, such data should be cautiously considered. It is necessary for the appraiser to clearly express these limitations and to reconcile the reliability of the approach where a substantial number of the elements are sufficiently different.

Magnitude of adjustments: In markets where competing properties are highly similar to the subject property, it is unlikely that large and/or numerous adjustments would be required.

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⁴ Sources of sales information are discussed in APB Valuation Advisory #2: Adjusting Comparable Sales For Seller Concessions.
⁵ Real Estate Valuation in Litigation, 2nd Edition, pp. 204-205.
However, in markets that are less homogeneous or have limited market activity, it is possible that large and/or numerous adjustments may be necessary.

When a comparative analysis requires large and/or numerous adjustments, questions may arise regarding the true comparability of the property.

At what point is a competing property not considered comparable? While there is no single source to determine comparability, it is up to the appraiser within the context of the scope of work to determine whether the property is comparable and will lead to credible assignment results. Consideration of the quantity and magnitude of adjustments may assist in identifying when a property becomes suspect as a comparable; however, this does not conclusively result in such a determination. “The degree of similarity varies from case-to-case, so neither appraisers nor the courts can arrive at a formula to test comparability or similarity. In one instance adjustments totaling 15% of the sale price may indicate that the property is, in fact, not a comparable sale, but in another instance a sale with total adjustments equaling 15% of the sale price might turn out to be the most comparable sale available.”

In summary, the appraiser identifies the comparability of the property by determining whether it is a competitive substitute for the subject property. The quantity and/or magnitude of the adjustments may not dictate comparability.

Some of the most common written guidelines on this issue are the appraisal underwriting guidelines issued by Government Sponsored Enterprises (GSE) (e.g., Fannie Mae). It is important to recognize that these appraisal guidelines are written primarily to determine whether or not a property is eligible for purchase on the secondary mortgage market, and not as a definitive tool to determine comparability.

GSE guidelines also apply exclusively to residential properties, generally speaking the most homogeneous property class nationally with sufficiently similar properties transacting within the shortest period of time. It is typical to find that appraisals of non-residential properties, complex residential properties, and properties in unstable markets require the use of comparable properties that may possess greater differences.

According to Fannie Mae, a property is comparable if the market considers it a competitive substitute. Once a property is determined to be comparable by the appraiser, then appropriate analysis and market adjustments are applied. “Analysis and adjustments to comparable sales must be based on market data for the particular neighborhood and for competing locations – not on predetermined or assumed dollar adjustments. Adjustments must be made without regard for the percentage or amount of the dollar adjustments.” (Bold added for emphasis.)

The key is for the appraiser to adequately explain and support the rationale for using the comparable properties selected in the appraisal report. Such narrative assists in demonstrating the reliability and credibility of the opinion of value. Where the comparable properties possess significant differences from the subject property, additional comparable properties may be included for additional support of the opinion of value.

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Appropriate analysis, consideration, and explanations are necessary regardless of the amount of an adjustment. If numerous adjustments or a singular atypical adjustment is required, then an explanation and support (i.e., stating search criteria and results) regarding the lack of more “similar” properties that require fewer adjustments should be explained.

If the subject property has a significant element of comparison that competing properties lack or conversely, if the subject property lacks a significant element of comparison that competing properties possess, explanation is necessary. In such situations, generally recognized appraisal methodology would dictate an effort to use comparable properties that are both superior and inferior to the subject for that specific element of comparison (this process is often referred to as “bracketing”). Comparing properties with superior, similar, and inferior elements of comparison to the subject property may assist in validating the adjustments applied.

Following is an illustration of bracketing on two physical features of a residential subject property. The features bracketed in this illustration are the subject property’s gross living area above grade and the garage count. This is a generalized illustration of the sales comparison analysis focusing on these two units of comparison only (highlighted in yellow).

In the following example, the subject property’s gross living area (GLA) was measured at 2,200 sq. ft. The GLA feature is bracketed by comparable property # 1 that has an inferior GLA at 1,950 sq. ft. and by comparable property # 2 that has a superior GLA at 2,500 sq. ft.

Similarly, the subject’s 1-car garage amenity is bracketed by comparable property # 1 that has a superior garage count of 2-cars and by comparable property # 2 that has an inferior garage amenity of no garage.

The comparable sales’ inferior features in comparison to the subject property’s features were adjusted upward (positive) and conversely, the comparable sales’ superior features in comparison to the subject property’s features were adjusted downward (negative).
In this illustration, the subject’s sale price of $183,000 is also bracketed by the pre-adjusted sales prices of the comparable properties ($180,000 to $185,000). Both downward and upward adjustments are applied resulting in the adjusted sale price range of $183,000 to $184,500 (the value bracket of probable range) for the subject property.

When a sales comparison approach requires substantial and varied adjustments, the reconciliation should enable the reader to understand why the sales were used. Adequate reconciliation is a required and integral part of any value conclusion. Standards Rule 1-6(a) of the Uniform Standards of Professional Appraisal Practice states: “In developing a real property appraisal, an appraiser must reconcile the quality and quantity of data available and analyzed within the approaches used.”

Highest and Best Use: A necessary consideration for determining if a property is comparable is whether the highest and best use of the subject property and the competing property is the same. “Appraisers have a special responsibility to scrutinize the comparability of all data used in a valuation assignment. They must fully understand the concept of comparability and should avoid comparing properties with different highest and best uses, limiting their search for comparables, or selecting inappropriate factors for comparison.” Likewise, the Supreme Court of the United States in Mississippi & Rum River Boom Co. v. Patterson, 98 U.S. 403 (1878), states that the highest and best use of a property should consider a change in current use of a property “by reference to the uses for which the property is suitable, having regard to the existing business or wants of the community, or such as may be reasonably expected in the immediate future.”

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9 Ibid
future.” These factors can be applied to both the subject property and the selection of comparable properties.

IV. Market Area and Neighborhood Characteristics

Location is a primary consideration in the comparable property selection process. Ideally, a comparable property would compete with the subject property in location as well as other characteristics. When considering a comparable property’s location competitiveness to the subject property, the subject property’s local market performance and characteristics are measured alongside the comparable property’s local market. Preferably, the comparable property is located in the subject property’s market area.

While the terms market area and neighborhood are often used interchangeably, in truth, the two terms have distinctly different meanings, in both residential and non-residential appraising. Data and analysis related to a neighborhood is broad and general in nature, whereas data and analysis related to a market area is specific and related to a particular property type or category. The confusion between these two concepts arises in practice because the method of delineation for both a market area and a neighborhood follow the same four basic principles. Both can be defined by their physical boundaries (man-made and natural) and their intangible boundaries (social and political).

Appraisers make a distinction between the neighborhood in which a property is situated and the market area in which comparable properties will be found are located. Market area is formally defined as “the geographic or location delineation of the market for a specific category of real estate, i.e., the area in which alternative, similar properties effectively compete with the subject property in the minds of probable, potential purchasers and users. In contrast, a neighborhood is defined more generally as ‘a group of complementary land uses.’” In other words, the neighborhood boundaries in which the subject property is located may contain residential properties as well as non-residential properties that serve the residents of the neighborhood, whereas the boundaries of the market area for the subject property is based on the area in which similar properties compete with one another. In some cases, the subject property’s neighborhood and market area may have the same boundaries, but in other cases the market area may contain several neighborhoods or portions of different neighborhoods. A market area is defined by the type of property, the type of transaction (rental or sale), the geographic area in which competition exists, and the homogeneity of properties within its boundaries.

The geographic area used for selecting comparable properties depends on the property type. For a large industrial property, regional or national market areas may be relevant since this is the “market” in which buyers of similar properties effectively compete. For a (non-complex) residential property, adequate sales data may be available within a few blocks of the subject property. Neighborhoods tend to define the primary market area for most non-complex residential properties since homes in the area immediately surrounding a property tend to attract like-minded buyers. However, it is recognized that competitive neighborhoods within a larger market area might need to be considered. Care should be taken to analyze and align the specific neighborhood characteristics to ensure they are truly competitive.

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12 Ibid.
13 Ibid.
How a market area and neighborhood may be the same or differ: A subdivision comprised of tract housing of similar general design and covering ten square blocks may be a ‘neighborhood’ and the ‘market area’ if there are no other similar developments nearby. However, a ‘market area’ may also encompass other subdivisions that are suitable alternatives and draw from the same buyer pool as the subject, even if they are across town. The buyer pool ultimately defines the market area; if buyers consider the neighborhoods to have similar appeal, then it is likely the neighborhoods are suitable competition and could be considered within the same market area.

Non-residential properties may have demand drivers from diverse locations. “Thus, delineating the market areas for these uses usually starts with identifying the competitive cluster of buildings that compete for some of this diverse market of users.”

“The term market area may be more relevant to the valuation process than either neighborhood or district for several reasons:

- Using the umbrella term market area avoids the confusing and possibly negative implications of the other terms.
- A market area can include neighborhoods, districts, and combinations of both.
- Appraisers focus on market area when analyzing value influences. A market area is defined in terms of the market for a specific category of real estate and thus is the area in which alternative, similar properties effectively compete with the subject property in the minds of probable, potential purchasers and users.”

Delineating precise market area boundaries is challenging because markets may overlap and it may be difficult to decide how narrowly or broadly to define a market area. Therefore, this section is intended to assist in identifying potential market characteristics for identifying a market area, but not to present the techniques for delineating and segmenting a market area.

Market characteristics that delineate a market area: “The market area for the buyer/seller market is usually different from the market area for the user market. The market area for the buyer/seller market could be international, say, for a hotel, while the user market for the hotel could be within the country. Thus, market delineation for valuation has two main parts:

1. Analysis of the user market (owners, occupants, and the competition)
2. Analysis of the buyer/seller market.”

“The user market is identified before the buy/sell market is determined because the user market sets the basis of highest and best use, which in turn sets the parameters of the substitute property comparables identified in the buy/sell market.”

Possible demographic, socio-economic, lifestyle, geographic, and economic characteristics to consider in segmenting markets is listed below (not an exhaustive list and not in any specified order):

15 Fanning, Steven F., Market Analysis for Real Estate: Concepts and Applications in Valuation and Highest and Best Use, Appraisal Institute, Chicago, 2005.
18 Fanning, Steven F., Market Analysis for Real Estate: Concepts and Applications in Valuation and Highest and Best Use, Appraisal Institute, Chicago, 2005.
• the type of structures and architectural style
• current land use
• typical site size
• tenure and vacancy rates
• income levels (average/median incomes/range of incomes)
• geographic characteristics (climate, natural resources, natural recreational opportunities, etc.)
• population trends and rate of growth
• median prices and price range distribution
• economy (jobs, industries, diversification, growth, tax district, etc.)
• cultural and entertainment opportunities
• educational resources available (including school districts)
• infrastructure
• affordability
• availability of necessary services (hospitals, public transportation, utilities, etc)
• exposure to nearby properties (secluded or densely improved)
• absorption rates, demand, and market times
• condition and quality of residential and/or non-residential properties
• sustainability (green) features or characteristics
• rental rates
• historical renovations or newly built housing/non-residential properties
• typical building or housing size
• demographic components (family mix, age, purchasing power, etc.)

The segmenting of a market should take into consideration these or similar applicable data categories that are considered most relevant for the property type and use. Demographic, socio-economic, consumer behavior, economic, and lifestyle data can be retrieved or purchased through several available private and public resources, both locally and nationally.

V. Summary

• The identification of what constitutes a similar, or “comparable property” is critical to the proper application of the three approaches to value.
• The appraiser identifies the comparability of the property by determining whether it is a competitive substitute for the subject property. The quantity and/or magnitude of the adjustments do not dictate comparability.
• The appraiser has to adequately explain and support the rationale for using the comparable properties selected in the appraisal report. Such narrative assists in
demonstrating the reliability and credibility of the opinion of value. Where the comparable properties possess significant differences from the subject property, additional comparable properties may be included for additional support of the opinion of value.

- The appraiser cannot control the quality or suitability of the activity available in the market during the timeframe of analysis. Information could be limited in many markets, and many properties do not lend themselves to simplified comparison. In such cases, analysis of older transactions may also be required due to limited current activity in the market; however, such data should be cautiously considered. It is necessary for the appraiser to clearly express these limitations and to reconcile the reliability of the sales where a substantial number of the elements are sufficiently different.

- If the subject property has a significant element of comparison that competing properties lack or conversely, if the subject property lacks a significant element of comparison that competing properties possess, explanation is necessary. In such situations, generally recognized appraisal methodology would dictate an effort to use comparable properties that are both superior and inferior to the subject for that specific element of comparison (this process is often referred to as “bracketing”). Comparing properties with superior, similar, and inferior elements of comparison to the subject property may assist in validating the adjustments applied.

- A necessary consideration for determining if a property is comparable is whether the highest and best use of the subject property and the competing property is the same. Likewise, an appraiser should consider a change in the current use of a property by reference to the uses for which the property is suitable, or such as may be reasonably expected in the immediate future. These factors can be applied to both the subject property and the selection of comparable properties.

- Location is a primary consideration in the comparable property selection process. Ideally, a comparable property would compete with the subject property in location as well as other characteristics. When considering a comparable property’s location competitiveness to the subject property, the subject property’s local market performance and characteristics are measured alongside the comparable property’s local market. Preferably, the comparable property is located in the subject property’s market area.

VI. Glossary of Terms and Definitions

Bracketing

“A process in which an appraiser determines a probable range of values for a property by applying comparative analysis techniques to data such as a group of sales. The array of comparable sales may be divided into three groups – those superior to the subject, those similar to the subject and those inferior to the subject. The sale price reflected by the sales requiring downward adjustments and those requiring upward adjustment refine the probable range of values for the subject and identify a value range (i.e., a bracket ) in which the final value opinion will fall.” Appraisal Institute, The Dictionary of Real Estate Appraisal, 5th ed. (Chicago: Appraisal Institute, 2010),

Comparable Property
“... properties that are similar to the property being appraised.” The Appraisal of Real Estate, 13th Ed., p. 168.

or

A comparable property is a “property that has been the subject of a recent transaction and is sufficiently similar that it can be used to measure the value of another property. A comparable property should be the subject of a recent arms’-length transaction and ideally should be similar in location; age and design; construction and condition; and size and layout to the subject property, i.e. what is or has been available in a similar market. In practice, an ideal comparable property hardly ever exists; instead a valuer or appraiser extrapolates information on values from similar properties, makes adjustments and allowances, and uses his judgment to apply the resultant figure to the property he is seeking to value.” Damien Abbott, Encyclopedia of Real Estate Terms: based on American and English Practice, with terms from the Commonwealth as well as the civil law, Scots law and French law, 2nd Ed., Delta Alpha Publishing, 2000, p. 200.

Comparable Property (Rental)

“A property that is representative of the rental housing choices of the subject's primary market area and that is similar in construction, size, amenities, location, and/or age. Comparable and competitive properties are generally used to derive market rent and to evaluate the subject's position in the market.” National Housing and Rehabilitation Association, National Council of Affordable Housing Market Analysis, Market Study Terminology (2012), NH & RA’s Housing Online.

Competitive Property (Competition)

“. . . among competitive properties, the level of productivity and amenities or benefits characteristic of each property considering the advantageous or disadvantageous position of the property relative to the competitors.” The Appraisal of Real Estate, 13th Ed., p. 38.

Competitive Property (Rental)

“A property that is comparable to the subject and that competes at nearly the same rent levels and tenant profile, such as age, family or income.” National Housing and Rehabilitation Association, National Council of Affordable Housing Market Analysis, Market Study Terminology (2012), NH & RA’s Housing Online. Retrieved from http://www.housingonline.com and http://www.bowennational.com/terminology.php on 08/26/2012.

District

“A type of market area characterized by homogenous land use, e.g., apartment, commercial, industrial, agricultural. The Appraisal of Real Estate, 13th Ed., p. 55.

Highest and Best Use

“The reasonably probable and legal use of vacant land or an improved property that is physically possible, appropriately supported, and financially feasible and that results in the highest value.” The Appraisal of Real Estate, 13th Ed., pp. 278.

Market Area

or

“The geographic or locational delineation of the market for a specific category of real estate, i.e., the area in which alternative, similar properties effectively compete with the subject property in the minds of probable, potential purchasers and users.” The Appraisal of Real Estate, 13th Ed., p. 55.

**Neighborhood**


**Principle of Substitution**

“The principle of substitution states that when several similar or commensurate commodities, goods, or services are available, the one with the lowest price attracts the greatest demand and widest distribution. This principal assumes rational, prudent market behavior with no undue cost due to delay. According to the principal of substitution, a buyer will not pay more for one property than for another that is equally desirable.” The Appraisal of Real Estate, 13th Ed., pp. 38-39.
### APPENDIX I: Examples of Physical Comparability Factors

<table>
<thead>
<tr>
<th>Major Asset Class</th>
<th>Comparability Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residential Homes</td>
<td>Home Size; Lot Size; Bedrooms/Baths; View, Amenities, Water-frontage, Garage; Basement, Architectural Style, Construction Quality/Finishes, Age, Type (Attached, Condo, Townhome, Detached), Special Features</td>
</tr>
<tr>
<td>Office</td>
<td>Owner v. Tenant Occupied; Single/Multi-Tenant; Medical/Professional; Ownership Type (Condo, Fee, etc.); Date of Construction; Mechanical; Architectural Style/Age; Construction Quality; Amenities, Tenancy Mix; Functionality; Floorplate Size; Land Size; Parking Suitability for Use</td>
</tr>
<tr>
<td>Retail</td>
<td>Single/Multi-Tenant; Class of Retail (Grocery Anchor, Neighborhood Strip, etc.); Tenant Quality; Tenant Tenure, Visibility, Proximity to Residential, Parking Suitability; Age, Construction Quality, Amenities, Support Uses driving demand for retail use, Floorplan/Layout, Land Size, Signage</td>
</tr>
<tr>
<td>Industrial</td>
<td>Single/Multi-Tenant, Tenant Profile, Suitability to meet industrial user demand, ceiling heights, dock and loading door sufficiency, power sufficiency Proximity to industrial demand generators, age, construction quality, land size, parking and loading circulation, floor loads, access to water/rail</td>
</tr>
<tr>
<td>Apartments</td>
<td>Unit Mix, Average Unit Size, Utility Metering and costs, proximity to demand drivers for rental demand, access and visibility, amenities Age; Architectural Style, Construction Quality, Tenant Mix, Rent Control, Parking, Storage, On-Site Amenities</td>
</tr>
<tr>
<td>Agricultural</td>
<td>Site Size, Topography, Soil Suitability, Crop Yield, Irrigation/Water Availability, Utility Availability, Age of farm buildings, Environmental regulations, Availability of subsidies, Plottage, Access to Storage, Farm House Divisible, Proximity to applicable markets</td>
</tr>
</tbody>
</table>

Note: Each class of property may have differing drivers which require further analysis; and there are segmentations amongst each of the above classes of property.
APPENDIX II: Suggested Further Reading


City of Pleasant Hill v. First Baptist Church of Pleasant Hill. 1. Court of Appeal of California, First Appellate District, Division One. 4 Nov. 1969. Print.


Ellis, Trevor R. “Sales Comparison Valuation of Development and Operating Stage Mineral Properties.” Mining Engineering, April 2011


Highest and Best Use and Property Rights—Does It Make a Difference?

by Stephen F. Fanning, MAI, Al-GRS, Larry T. Wright, MAI, SRA, Al-GRS, and Rick J. Muenks, JD, MAI

Abstract

Fee simple property rights application in tax appraisal is a continuing debate in the courts and taxing jurisdictions and among appraisers. The debate centers on the valuation assumption of fee simple interest in the appraisal of single-tenant properties like big-box retail. One side of this debate is that the property should be appraised considering its current use, while the other viewpoint is that the property should be appraised with the assumption that it is vacant and available for a secondary use. This article addresses the question of how highest and best use fits in this definitional debate and suggests that a supported and reasoned highest and best use analysis should dictate the methods and approaches applied in the valuation analysis—and not just definitional interpretation that assumes the property is vacant and available for a use. Big-box retail property is used as the example for this article, but other property types, such as drug stores, manufacturing facilities, or any property type that was built for use by the owner-operator, will have similar issues in tax court disputes.

Introduction

The application of fee simple property rights in tax appraisal is a continuing debate among courts, taxing jurisdictions, and appraisers. The debate centers on the valuation assumption of fee simple interest in the appraisal of single-tenant properties like big-box retail. A big-box retail property will be used as the example for this article, but other property types, such as drug stores, manufacturing facilities, or nearly any property type that was built for use by the owner-operator, have similar arguments in tax court disputes. One side of this debate is that such properties should be appraised considering their current use, while the other viewpoint is that such properties should be assumed vacant and available for a secondary use. This article addresses the question of how highest and best use fits in this definitional debate. Whether in tax appraisals or in any market value assignment, this article proposes that a supported and reasoned highest and best use analysis should dictate the methods and approaches applied in the valuation analysis—and not just definitional interpretation that assumes the property is vacant and available for a use, “because in any appraisal, it is the use that is being valued.” This is not an estimate of the value of a going concern, but the going concern use, and like any commercial use appraisal, it is analyzed to see if the market is supporting its type of operation in order to determine if the cost of creating the real estate component is justified and supported by the market.

1. Tax appraisals seem to be the main context where the divergent views play out as lenders and lending regulators, banks, and condemnation courts seem to be less concerned about this issue.
2. There is similar debate regarding how to assess built-to-suit leased facilities.
3. Two case opinions, one regarding a big-box store in Michigan and one regarding a GM auto plant in New Jersey, show the courts’ concern about how highest and best use is applied in market value appraisals. See Menards Inc. v. City of Escanaba 315 Mich. App. 512 (May 26, 2016) and General Motors Corp. v. Linden City, 22 N.J. Tax 95 (February 2, 2005).
There are two general schools of thought on the application of fee simple market value. One school of thought, the traditional way of handling an assignment of fee simple market value of a leased or owner-operated property, adjusts any below-or above-market leases to market-based rents for the valuation. For “owner-occupied properties, market rent estimates are used in the income capitalization approach.” For the traditional method, sales of leased properties can be included with adjustments to market rent and market rent capitalization rates. The cost approach indicates the value of the fee simple interest of the property based on land values from current land sales and costs for similar type buildings adjusted for physical deterioration and functional and external obsolescence, if any.

The second school of thought is sometimes called the “dark store theory.” Under this method, to estimate the fee simple market value of a property, such as a big-box retail property, the property is appraised assuming it is vacant and available for a secondary use. This “assumed vacant and available” fee simple theory involves a series of appraisal definitional interpretations. Examples of the definitional interpretations under the dark store theory include:

- The definition of market value precludes using sales of leased properties since they are not fee simple sales.
- Fee simple precludes using any sale lease-back transactions because they are considered a form of 100% financing and not speculative sales meaning they are not market value-in-exchange sales.
- Only generic properties can be used as market value-in-exchange sales, because custom-built properties do not meet the market value-in-exchange test.
- The current use of the property (i.e., build-to-suit) cannot be considered because it is value-in-use and not value-in-exchange. This thought maintained by some is also used to justify not utilizing the cost approach.

The results of these definitional interpretations by some leads to the determination that an appraisal for fee simple market value assumed vacant must be based on three principles:

1. The only comparable sales will be those representing vacant buildings that are similar physically to the subject and sold for second-generation use.
2. The income approach is based on the market rent of buildings for a secondary use.
3. The cost approach is not applicable because the building suffers from functional obsolescence that is difficult to estimate since it was built for an owner-user.

The definitional interpretations under the dark store theory disregard the existence of the current property use and its user or similar users; the market demand to support the current use, and the market activity of acquisition of land and construction of improvements for the use. These market realities are disregarded on the basis that no fee simple sale transaction for that use is found in the marketplace.

5. A discussion of the pros and cons of each school of thought is not the purpose of this article, but both schools of thought, as we understand them, are included to contrast how each viewpoint might impact the context of highest and best use.


8. Within this school of thought, most consider “current use” to mean the brand store like The Home Depot, whereas in this article the term “current use” means the retail category—in this case home improvement retail—and does not consider the store brand.

9. Note the term “use” means the use of property, like the retail home improvement center in this case, and the term “user” in market analysis refers to the user of the space, i.e., the retail customers, which in this case study are residents, home builders, and contractors within about 3 to 5 miles of the subject property.

10. It is our view that highest and best use does not depend on whether the property is built to suit for one user or many users. It can be a custom-built property if the improvement needs to be designed for a specific user. An owner-occupied, custom-built improvement can be the highest and best use and will be the highest and best use if that owner-occupant uses it. All real estate improvements are build-to-suit improvements to some degree.
The purpose of this article is not to resolve the debate of the two competing interpretations of fee simple but to show how the interpretations may not matter that much, if at all, in highest and best use analysis. Highest and best use is used to define the standard for the real property, disregarding any personal intangible property that may affect the value of the property but not the highest and best use of the property. The premise of this article is definitions do not determine highest and best use; instead, economic principles—such as the principles of anticipation, substitution, supply and demand, and contribution—are the basis of highest and best use.

Accordingly, the key question is, in any assignment, including property tax valuation assignments, is highest and best use the basis of a market value or is the basis the assumption of property rights being appraised? Do the interpretations of the assumption applied to property rights and related definitions set the criteria for valuation methods, such as the selection criteria of comparable sales—or does highest and best use set the criteria for the valuation methods?

### Application of Highest and Best Use Principles

*The Appraisal of Real Estate*, fourteenth edition, states, “The analysis of highest and best use is at the heart of appraisals of the market value of real property.” It seems logical, therefore, that highest and best use must be the first step in a market value appraisal regardless of how property rights are interpreted. Almost every state’s definition of market value for property tax and eminent domain purposes includes a reference that highest and best use is to be considered in valuing real property. Higher and best use and market value are tied to “use” since value is created through the use of the property.

The conclusion of a highest and best use study could very well be that the highest and best use of the property is to change the property’s current use to a new use, but this article suggests this conclusion should be determined by the highest and best use study and not definitions. To demonstrate this view, the following discussion will present a case study of the highest and best use process for a big-box retail property to see what changes to highest and best use, if any, result from different interpretations of fee simple estate.

*The Appraisal of Real Estate*, fourteenth edition, suggests that “the analysis of highest and best use can be thought of as the logical end of a spectrum of market analysis procedures, running from the macroeconomic overview of a general market study, through the more detailed marketability studies and analyses of financial feasibility, to the formal analysis of highest and best use.”

Market value of a property rests on the foundation of determining “the present value of all of the future benefits it brings to the owner.” The analyst, in measuring the market support for a property use, examines the current and future demand and competitive supply in the subject market. Therefore, the purpose of a highest and best use study is to forecast what is the most probable alternative use of the property that will produce the highest present value of future benefits that can be realized by the owner of the property.

No matter which property rights are appraised, the future benefits are forecast from the results of the six-step market and marketability study. The market and marketability study is based on economic (fundamental) demand over time by users of the real estate space under study.

The market and marketability six-step study is the process that highest and best use analysis uses. It is applied to each reasonably probable alternative market segment that the property is most likely to serve. The highest and best use study of a currently operating big-box retail

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11. Some state laws require value in use and thus highest and best use is not applicable, but the market analysis for that use is still applicable.
13. Some states have by law specified that the current use is to be valued; therefore, highest and best use would not be applicable in those situations.
would include the “assumed vacant alternative” for a second-generation use as well as the continuation of the current use of the property, and any other reasonably probable alternatives.

Each alternative use from the market and marketability six-step process then goes into a seventh step—the financial analysis of the alternatives—to determine which alternative provides the highest present value. The eighth and final step in highest and best use analysis is the study conclusion, sometimes called the maximally productive analysis. This step could also be called reconciliation. In appraisal, highest and best use reconciliation is the final analytical step in determining which alternative produces the highest value at the least risk. Risk determination is based on the reliability and confidence in all the data points used in the analysis. The results of the eighth step are then reported in the three-part highest and best use(s) conclusion on:

- Use
- Timing (economic demand/timing)
- Market Participants:
  - Most probable users of real estate space
  - Most probable buyer type (owner-operator, investor, developer, etc.)

Although appraisers traditionally have emphasized the physical use in the conclusion of highest and best use, all three of the above considerations are necessary to identify the highest and best use. Highest and best use determines who would be the most probable users of the space and over what time period. The second part of a market value appraisal measures the most probable market value of the subject’s highest and best use. The different interpretations of the property rights’ market value being sought might change some of the valuation techniques used, but it will not change the property’s highest and best use.

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**Case Study: Highest and Best Use in Market Value Appraisals**

To demonstrate the highest and best use analysis process, a simplified case study is presented next. The case study looks at a big-box home improvement center and will go through each step in the highest and best use analysis process to see if any differences result when the property is appraised as fee simple or leased fee. The case study will parallel the same six-step market and marketability study process shown in *The Appraisal of Real Estate*, fourteenth edition. This same six-step process is used for an existing multitenant shopping center case study model found in the Appraisal Institute’s *Advanced Highest and Best Use and Market Analysis* course and detailed in the book *Market Analysis for Real Estate*, second edition. Exhibit 1 outlines the major steps that will be described in the case study. A glossary of terms and definitions is located in the Appendix at the end of this article to aid the reader.

**Case Study Property Description**

The case study examines an actual property and uses data based on its location. Some data is modified for brevity, confidentiality, and to simplify the case study for article purposes.

- **Type:** Home improvement center (retail sales include, building material, appliances, hardware, paint, etc.)
- **Age:** Seven years; built specifically for current owner
- **Building size:** 130,000 sq. ft., enclosed, plus partially covered lawn and garden center
- **Garden center:** 27,000 sq. ft., canopy area
- **Ceiling height:** 22 feet
- **Building condition:** Good
- **Parking:** One space per 200 square feet of building

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17. Space constraints prevent an in-depth discussion of all the details of the highest and best use analysis process. The term risk in maximally productive is described in *Market Analysis for Real Estate*, 2nd ed., which states, “The test of maximum productivity could also be called reconciliation, another word for the final analytical step to assess the data to determine the risk or reliability and confidence in all the data points used in the analysis. If all the data and analysis techniques are considered equally reliable, then the highest and best use that is maximally productive is the alternative that yields the highest value to the land.” Stephen F. Fanning, *Market Analysis for Real Estate: Concepts and Applications in Valuation and Highest and Best Use*, 2nd ed. (Chicago: Appraisal Institute, 2014), 496.


19. Fanning, *Market Analysis for Real Estate*, 2nd ed. See especially, the retail shopping center example in chapter 13 and the eight-step outline of concepts on page 483.

20. This size is the actual gross area of the building, but it is recognized this is above the average store size reported for most home improvement centers in their annual reports. The annual reports typically state only what is considered the average gross sales area of the buildings and do not include auxiliary space such as offices, storage, etc. Most do not include outside sales areas, such as their garden centers.
• Owner-occupied
• Subject site is a separately owned super pad as part of a larger retail cluster of adjacent discount department stores, fast food pads, and small strip centers.
• Legal encumbrances: The subject property has numerous cross access easements, joint curb cut permits, joint and site-specific utility and drainage easements. There also are numerous joint operating agreements with adjacent retail, such as common area maintenance (CAM).
• Site size: 17 acres
• Zoning: Heavy commercial, which allows some outside storage. This zoning also allows multiple retail, service, and office uses. Alternative rezoning to apartment is also highly probable.

• Location: Suburban location in a major metropolitan area near a freeway with significant community retail and regional retail in close proximity

Case Study Highest and Best Use— Alternative Use Scoping
The foundation of an appraisal is the documented evidence that there is an appropriate level of market support for the existing use of the site or for alternative uses. This case study presents methods to establish the basis of market support for a highest and best use of the real property and whether the differing interpretations of the property rights theories change the highest and best use process or conclusions for an improved property.

Exhibit 1 Highest and Best Use Analysis Process

Alternative Use Scoping—Determine reasonably probable alternative uses for study

Market and Marketability Analysis—Analysis of most probable alternative uses

Property Analysis
Step 1: Property Productivity Analysis—Define the product
  1.1 Legal determinants of use
  1.2 Site and improvements determinants of use
  1.3 Location determinants of use and timing

Market Analysis
Step 2: Delineate the Market—Identify demand sources of property users
Step 3: Demand Analysis—Current and forecasted user demand
Step 4: Supply Analysis—Measure current and forecasted competition for demand
Step 5: Market Condition Analysis—Market cycle analysis

Marketability Analysis
Step 6: Subject Marketability Analysis—Determine market capture

Testing Highest and Best Use Alternatives
Step 7: Financial Analysis of Alternative Uses—Present value of future benefits

Reconciliation and Conclusions
Step 8: Highest and Best Use Conclusions—Most profitable alternative at least risk; conclusion specific as to
  • Use
  • Timing (occupancy, etc.)
  • Market participants
Highest and Best Use as if Vacant. For article brevity, the site-as-if-vacant is not covered in detail here. However, this does not suggest it is of less importance, as a site-as-if-vacant highest and best use can be a critical input into the highest and best use of the site-as-improved. For example, the site-as-if-vacant highest and best use includes the analysis of the site’s ideal improvement. The ideal improvement specifies things like size of building and use. As The Appraisal of Real Estate, fourteenth edition, notes, “an appraiser’s conclusion of the ideal improvement should be as specific as the market suggests.” The ideal improvement is a gauge to help determine an improved property’s obsolescence, if any, and comparable properties that might be analyzed in the sales comparison approach.

The case study concluded the site use was community retail as evidenced by the site’s physical features and the adjacent uses, which are all community retail uses like the subject as part of a community retail node at a major intersection. The site-as-if-vacant three-part conclusion is:

- **Use:** Big-box community retail
- **Timing for Use:** Current to three years in the future
- **Market Participants:** Users (customers) are moderate-income residents and businesses within 3 to 5 miles of the subject site. The most probable buyer of the land assumed vacant is a developer or owner-operator.

Highest and Best Use as Improved and Alternatives to Consider. The Appraisal of Real Estate, fourteenth edition, states that “highest and best use of property as improved pertains to the use that should be made of an improved property in light of the existing improvements and the ideal improvements described.” In appraisal of the market value of improved properties, appraisers consider alternative uses of the existing improvements. The alternatives considered may include:

- Demolish the existing improvements and redevelop the site.
- Convert, renovate, or alter the existing improvements to enhance or change the current use to a more productive use.
- Retain the existing improvements and continue the current use.

While many alternatives might be considered, when the property being appraised is improved an appraiser could first complete a market and marketability study of the property at its current use and then a preliminary general analysis of the most optimistic value of the subject property at reasonable alternative uses. If the property at its current use is forecast to continue to be occupied in a manner that ensures an indicated value at or above the values of the other optimistic alternatives, then the current use could comfortably be selected as the highest and best use and other alternatives would likely not need to be analyzed further.

**Market and Marketability Study of Current Use of Property**

The market and marketability study of the current use of the property is part of the highest and best use analysis that determines the fundamental economic demand for the current use, which will be used as the base alternative to compare to other uses of the property.

**Step 1: Property Productivity Analysis**

Property productivity analysis is the “analysis of the capacity of a property to house economic activities, supply services, and provide amenities to meet human needs.” The property productivity analysis consists of looking at the subject building and site improvements, the subject’s legal constraints and opportunities, and the location in order to determine what use the property is designed to serve. Part of this analysis is to determine if the property is the latest design for that use or if the latest market trends have made the improvements obsolete. In other words, is the building designed to best serve and attract customers for the property’s intended use.

**Property Analysis—Case Study Example.** Exhibit 2 shows the case study’s property rating as a home improvement center, which is the current use of the property. The market standard is based on the newest home improvement store designs in the property’s metro area and outside its metro area or anticipated new property criteria in the industry. In other words, it is the analysis to

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determine what is the market segment the property is designed to serve (site, improvements, legal, and location). The property productivity analysis is a comparison to the ideal improvement for this industry and what are the current industry trends in this market. The details of the criteria are beyond the scope of this article, but the illustration shows that if the store is designed to house the economic activity it was intended to serve, then the building does not have any functional obsolescence for this use; therefore, the building is experiencing only the normal physical depreciation for a seven-year-old building. Changing the building’s design is always a functional problem to deal with for any type of retail improvement and that is what property productivity is all about.

It should be noted that property productivity analysis in a market value appraisal is not a study of a specific brand but of a retail type. Different brands will often have different building designs to some extent, as that is a function of the cost generally applicable to any retail improvement. The property productivity analysis determines what is typical for this economic use in this market setting compared to the ideal improvement and the market demand for that use. (Demand is covered later, in Step 3 of the analysis process.) The property productivity analysis in Step 1 is used to assess whether the existing property and location can meet the economic expectations of the market segment that the property was designed to serve. The results of Step 1 analysis of property, analysis of site, and analysis of location provide the basis for physical depreciation and potential functional obsolescence.

The property productivity analysis does not change whether the subject is a home improvement center, like the subject case study, or a multitenant community shopping center or some other type of big-box discount center. The specific features of each building type or location that serves the retail market segment might change but not the analysis method of property productivity impact on property use. The property productivity analysis in most cases would recognize if the subject has any obsolescence whether it is caused by building design, site, legal, or location issues.

The potential economic obsolescence, if any, is covered in the demand section of the next steps. The highest and best use process determines the economic demand for the use not the brand. The example case here is a big-box home improvement center, but the same principle would be used for a market value appraisal of a grocery-anchored shopping center. Part of that highest and best use analysis would be to determine the current and forecasted demand for grocery-anchored shopping centers and not the grocery brand that is currently in the center.

Legal Analysis Impact on Use. Another aspect of property productivity analysis involves looking at all legal implications that impact (positively or negatively) any use, including the impact on current use. The impact of zoning, easements, and deed restrictions on the property are studied. Legal constraints can alter uses of the property. In the subject case, the property is owner-operated so its use can continue or the owner can change the use as long as it is consistent with the site’s zoning, deed restrictions, easements, etc. The property has curb cut permits, many cross access and utility easements, drainage easements, and a common area maintenance agreement so any alternative use would have to accommodate those restrictions. A big-box retail property, as part of a planned shopping center, also many times will have deed restrictions on alternative uses. In this case study, there are no restrictions that would prohibit continuing current use as a home improvement center or a change to an alternative use except for a department store use. Legal use also has to be compared to market demand. For example, if current leases are considered and the subject has a lease with twenty-three years remaining but the economic demand for the subject use is deteriorating over time, then the lease would

24. This does not mean there would not be some functional obsolescence issues to address in the valuation. Nearly any commercial property will have some functional issues when a new owner occupies or leases out a property. Almost every new owner or occupant wants to make changes to meet its specific needs.

25. This process is similar to the one that many retail market users employ. See, for example, Lowe’s 2016 Annual Report, describing its evaluation of “Long-Lived Asset Impairment,” http://bit.ly/Lowes2016.

26. If the fee simple assumption assumes no lease, then this analysis would not be required.
have to be analyzed in more detail to give a probability opinion as to whether it would be honored for twenty-three more years.

The table in Exhibit 2 shows the conclusions of the subject property rating for continued use as a home improvement center.

**Location Determinants of Use.** Real estate location attributes determine the type and location of land uses most expected in an area. In the next step of this study, the economic demand analysis will tell how much growth might be expected over time.

### Exhibit 2  Community Retail Home Improvement Center Property Rating

<table>
<thead>
<tr>
<th>Factors (Rate factors by inserting “X”)</th>
<th>Inferior</th>
<th>Industry Standard</th>
<th>Superior</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>High</td>
<td>Moderate</td>
<td>Slight</td>
</tr>
<tr>
<td>Site</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Size</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land-to-building ratio</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Parking</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Location</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interior circulation</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Site Improvements</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Topography impact on access</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Drainage</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exterior access (curb cuts, cross access easements)</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Landscaping</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building Improvements</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Condition of building</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Construction quality</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Layout (design, customer appeal)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Layout (storage ability, ceiling heights, etc.)</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building (delivery configuration and access)</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marketing Features</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Signage appearance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Street visibility</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adjacent retail (cumulative attraction)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Building exterior and interior appearance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legal</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Zoning/easements/CAM/deed, etc.</td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

**Rating Conclusions**

<table>
<thead>
<tr>
<th>Number of items rated</th>
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<th>0</th>
<th>0</th>
<th>17</th>
<th>2</th>
<th>0</th>
<th>0</th>
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</thead>
<tbody>
<tr>
<td>Times category score</td>
<td>0</td>
<td>2</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>8</td>
<td>10</td>
</tr>
<tr>
<td>Category score</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>85</td>
<td>12</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total subject score</td>
<td>97</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage above or below standard</td>
<td>2%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note, the industry standard score would be 95 and the bottom line is percentage above or below this standard.
Location determinants of growth consist of static and dynamic features. Static features include linkages and land use associations. Linkages refer to the movement of people, goods, services, or communication to and from the property site. Common linkages include roads and utilities. Land use association refers to the current types of development in the area and how they relate or support each other. Current land uses in an area set a pattern that is typically expected in the future.

Because location characteristics change over time, the dynamic aspects of location also need to be addressed. Dynamic location features are the land use growth patterns and the direction and rate of this growth.

Exhibit 3 shows the conclusion of the location analysis of the case study subject property by comparing other northeast metro area’s community retail nodes to the subject retail node. The subject property’s “Area A” is rated as one of the best locations in the city (city in northeast part of metro area). Of note for this article’s purposes is that the rating factors and method do not change because of the property rights appraised. The rating is of an overall area cluster (node) of land use and not the subject itself.

**Conclusion of Property Productivity Analysis.**
The property productivity analysis shows no property rights impact. The property productivity analysis does not change, whether the subject is a home improvement center, like the case study subject, or a multitenent community shopping center or some other type of big-box discount center. The specific features of each building type or location that serves the retail market segment might change but not the analysis method of property productivity impact on

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**Exhibit 3  Community Retail Location Rating**

<table>
<thead>
<tr>
<th>Factor</th>
<th>Rating Criteria</th>
<th>Area A (Subj)</th>
<th>Area B</th>
<th>Area C</th>
<th>Area D</th>
<th>Area E</th>
<th>Rank by Importance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Proximity to households in 3 miles</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>2</td>
<td>Proximity to new retail</td>
<td>3</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>3</td>
<td>Location in path of new residential growth</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>4</td>
<td>Median household income in 3 miles</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>5</td>
<td>Proximity to existing or approved major roads—access and visibility</td>
<td>3</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>6</td>
<td>Traffic count through node</td>
<td>3</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>7</td>
<td>Proximity to demand generators, such as hotels, offices, hospitals, etc.</td>
<td>3</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>8</td>
<td>Size and drawing appeal of anchors in the node</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>9</td>
<td>Tenant mix and compatibility in area</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>3</td>
</tr>
<tr>
<td>10</td>
<td>Effective age of centers</td>
<td>3</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>2</td>
<td>1</td>
</tr>
</tbody>
</table>

Total (Individual score times weighting)  
126 78 57 46 99

Percentage of Total Scores  
31% 19% 14% 11% 24%

For a more detailed explanation of location rating, see Market Analysis for Real Estate, 2nd. ed., 263–267 or Appraisal Institute course Advanced Market Analysis and Highest and Best Use, Exhibit 11.11.

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27. A node is “a cluster of properties with the same or complementary uses.” Appraisal Institute, The Dictionary of Real Estate Appraisal, 6th ed. (Chicago: Appraisal Institute, 2015). Here the node is retail and service land use that is community oriented. In this study, most nodes served a 3- to 5-mile submarket area.
property use. The property productivity analysis in most cases would recognize if the subject has any obsolescence caused by building design, site, legal, or location considerations.

**Step 2: Delineate the Market**

Several factors are involved in identifying the market area. In brief, this part of the study determines the area where most of the customers originate and where most of the competition is located. In general for community retail in a metro area, the market area is defined as the average halfway point between the subject community retail shopping node and the next major competitive retail node. In this case this was determined to be about 3 to 5 miles in an irregular shape.

**Step 3: Demand Analysis**

_The Appraisal of Real Estate_, fourteenth edition, explains that “for each particular type of property, demand analysis focuses on the end product or service that the real estate provides.” For retail space, the appraiser would “attempt to determine the demand for retail services generated by potential customers in the market area.” Consequently, this part of the highest and best use analysis regarding the continuation of the current use alternative is a demand study for home improvement retail.

**Inferred Demand Studies.** Various methods can be used to infer future fundamental demand for the subject home improvement retail property's future needs. The following are some inferred demand data found for the subject retail market type in the subject's delineated market area.

- **Subject Historical Performance**—_The Appraisal of Real Estate_ observes that “the performance of the subject property is likely to be the most reliable indicator of current demand for existing properties in the market.” In this case study, the subject has been 100% occupied for the last seven years as a home improvement center. Based on general observations of operations and review of historical aerials of subject parking lot, the subject seems to have an ample flow of customers for its current use.

- **Location Historical Trends**—Comparing the subject location to the location of new community retail found the subject is located in one of the better new retail development areas.

- **Population Growth Trends**—The property’s submarket area is one of the fastest-growing sectors in the city, with an ample stock of existing homes and new residential development.

- **Rent and Occupancy Trends**—The property’s submarket is compared to other community-type retail submarkets, and the results show the property’s submarket has rents and occupancy that are some of the best in the city.

- **Home Improvement Retail Sales Trends**—Retail sales in the property's submarket area are stronger than the sales for the metro area as a whole. The table in Exhibit 4 shows the market area has net in-migration of sales to the subject market area since the subject market area sales are higher than metro area sales.

**Exhibit 4** Per Capita Retail Sales for Subject-Type Retail

<table>
<thead>
<tr>
<th>Industry Group</th>
<th>NAICS*</th>
<th>Metro Area ($)</th>
<th>Subject Market Area ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building Material and Supplies Dealers</td>
<td>4441</td>
<td>657</td>
<td>725</td>
</tr>
</tbody>
</table>

*North American Industry Classification System

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28. For more detail see “General Procedures for Defining the Trade Area” in Fanning, _Market Analysis for Real Estate_, 2nd ed., 270.


30. Term inferred is sometimes confused with fundamental demand, which is calculated demand. However, both are focused on demand for future users of the space. See Fanning, _Market Analysis for Real Estate_, 2nd ed., 17–20 for more discussion on this terminology issue.

31. For article brevity, the full inferred data is not shown in this article.

Demand Analysis Measured by Market Fundamentals Methods—Population. Market fundamentals demand analysis derives specific demand calculations for the market area by analysis of drivers of retail demand—customers. Consequently, population forecasts are important considerations. In the case study of a home improvement center, the major demand generator is the population and growth forecast within 3 to 5 miles of the subject.\(^{33}\) For this case, a ten-year forecast was developed using five years’ data from the CCIM Institute’s Site to Do Business (STDB) and the local council of governments’ thirty-year Small Area Forecast and then reconciling these numbers.\(^ {34}\) The market area was forecast to grow for the next ten years, similar to the STDB trend forecast, and then level off with slower growth for the next twenty years according to the council of governments’ forecast.

Demand Analysis Estimated by Per Capita Buying Power Method. The per capita method of demand analysis is a widely used and reliable method, and it adapts well for simplicity presentations like this article.\(^ {35}\) The per capita method is based on actual current home improvement sales in the subject market area compared to the population. The per capita sales are then used to calculate current demand and forecast future demand for home improvement sales for the property’s market area (also called the primary trade area). The following shows an estimate of the case study property’s capture of demand for subject-type retail.

In the case study, the demand estimate is for the current alternative use of the subject property, i.e., continued operation as a home improvement retail store. The subject retail property characteristics are based on the previous property productivity analysis of physical, legal, and location attributes. The determination of the typical sales for the subject property establishes the retail market segment that is the focus of this market analysis. Note that the subject-type retail part of the market and marketability analysis is not a study of a particular home improvement brand, such as The Home Depot or Lowes, but of the retail segment that is typically accommodated by a property that has certain building, site, and location characteristics described in the property productivity analysis (discussed in Step 1). This is the same as the market and marketability study for a neighborhood shopping center that has a grocery anchor. It is not a study of that grocery store brand but of the grocery store market segment as part of the shopping center the grocery store is associated with.

The procedure to determine the typical retail purchases is the same whether for a multi-occupied retail shopping center or a single-occupant property.\(^ {36}\) The focus is on the type of retail that is being sold, or could be sold, at the property; the brand and whether the occupant rents or owns the space is not important. A big-box home improvement center has many product lines arranged in separate departments, including lumber, home appliances, electrical supplies, plumbing supplies, hardware, lighting, etc. This retail format employs the retailing concept of cumulative attraction by combining multiple, complementary retail items in one location for the convenience of different types of customers, from homeowners to professional contractors. This creates the magnetic appeal of a complementary retail collection all in one location, as the subject functions as a single-building shopping center concept.

The table in Exhibit 5 shows the sales per square foot, comparing data for the metro area to the subject’s primary market area (also called primary trade area). The previous property productivity analysis found the subject was well suited for a home improvement center use as it is currently operating. This market analysis measures the demand for the retail category utilizing data of actual sales of the Building Material and Supplies Dealers segment in the North American Industry Classification System (NAICS).\(^ {37}\) Other retail categories are shown in the table to demonstrate the process and to show that it is the same process for all types of retail including multi-locations.

\(^{33}\) The market area (primary trade area) for the subject is an irregular area that varies from 3 to 5 miles from the property.

\(^{34}\) Forecasts range from low to high. Only the mid-point is shown in this article.

\(^{35}\) Detail of per capita method can be found in Fanning, Market Analysis for Real Estate, 2nd ed., 320–322.

\(^{36}\) For more detail description of the procedure referenced, see Fanning, Market Analysis for Real Estate, 2nd ed., 393–396

\(^{37}\) The data utilized is North American Industry Classification System (NAICS) 4441, which is retail primarily engaged in retailing new building material and supplies. This includes Retail Trade Home Centers (NAICS 444110) like the subject as well as stand-alone stores like hardware stores, paint stores, etc.
### Exhibit 5  Selected Per Capita Retail Sales for Subject-Type Retail

<table>
<thead>
<tr>
<th>Industry Group</th>
<th>NAICS</th>
<th>Metro Area ($)</th>
<th>Subject Market Area ($)</th>
<th>Amount Utilized for Study (Subject-Type Retail) ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automobile Dealers</td>
<td>4411</td>
<td>2,047</td>
<td>1,805</td>
<td></td>
</tr>
<tr>
<td>Other Motor Vehicle Dealers</td>
<td>4412</td>
<td>347</td>
<td>168</td>
<td></td>
</tr>
<tr>
<td>Automotive Parts, Accessories &amp; Tire Stores</td>
<td>4413</td>
<td>241</td>
<td>285</td>
<td></td>
</tr>
<tr>
<td><strong>Totals 441 - Motor Vehicle and Parts Dealers</strong></td>
<td></td>
<td>2,635</td>
<td>2,257</td>
<td>0</td>
</tr>
<tr>
<td>Furniture Stores</td>
<td>4421</td>
<td>295</td>
<td>394</td>
<td></td>
</tr>
<tr>
<td>Home Furnishing Stores</td>
<td>4422</td>
<td>168</td>
<td>213</td>
<td></td>
</tr>
<tr>
<td><strong>Totals 442 - Furniture and Home Furnishing Stores</strong></td>
<td></td>
<td>463</td>
<td>607</td>
<td>0</td>
</tr>
<tr>
<td>Electronics and Appliance Stores</td>
<td>4431</td>
<td>923</td>
<td>1,246</td>
<td></td>
</tr>
<tr>
<td><strong>Totals 443 - Electronics and Appliance Stores</strong></td>
<td></td>
<td>923</td>
<td>1,246</td>
<td>0</td>
</tr>
<tr>
<td>Building Material and Supplies Dealers</td>
<td>4441</td>
<td>657</td>
<td>725</td>
<td>725</td>
</tr>
<tr>
<td>Lawn &amp; Garden Equipment &amp; Supplies Stores</td>
<td>4442</td>
<td>54</td>
<td>120</td>
<td></td>
</tr>
<tr>
<td><strong>Totals 444 - Bldg Equip &amp; Garden Equip &amp; Supplies Dealers</strong></td>
<td></td>
<td>751</td>
<td>845</td>
<td>0</td>
</tr>
<tr>
<td>Grocery Stores</td>
<td>4451</td>
<td>2,211</td>
<td>3,110</td>
<td></td>
</tr>
<tr>
<td>Specialty Food Stores</td>
<td>4452</td>
<td>115</td>
<td>171</td>
<td></td>
</tr>
<tr>
<td>Beer, Wine and Liquor Stores</td>
<td>4453</td>
<td>179</td>
<td>232</td>
<td></td>
</tr>
<tr>
<td><strong>Totals 445 - Food &amp; Beverage Stores</strong></td>
<td></td>
<td>2,505</td>
<td>3,514</td>
<td>0</td>
</tr>
</tbody>
</table>

Data Source: US Census of Retail, which occurs every five years. ESRI updates data and it is distributed in this case through STDB Retail MarketPlace Profile Report. Numbers rounded.

### Exhibit 6  Home Improvement Center Sales Potential for Subject

<table>
<thead>
<tr>
<th>Line Factor</th>
<th>2016</th>
<th>2021*</th>
<th>2026*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Population in primary trade area</td>
<td>162,000</td>
<td>172,500</td>
<td>178,000</td>
</tr>
<tr>
<td>2. Home improvement retail sales per capita ($)</td>
<td>725</td>
<td>725</td>
<td>725</td>
</tr>
<tr>
<td>3. Home improvement retail sales potential in primary trade area ($)</td>
<td>117,450,000</td>
<td>125,062,500</td>
<td>129,050,000</td>
</tr>
</tbody>
</table>

*Forecast is in constant dollars.
tenant shopping centers. The only difference is the retail segment chosen for the property’s market and marketability study.

In Exhibit 6, the retail market segment data is applied to the market area population forecast to determine the fundamental demand for the next 10 years, which is increasing.

**Step 4 and Step 5: Supply Analysis (Competition for Demand) and Market Condition Analysis**

In the highest and best use analysis, Step 4 measures the current and forecasted competition for demand. In the case study, the subject property is one of two owner-occupied big-box (100,000+ square feet), multi-product home improvement stores in the market area. The market area also has numerous (40+) smaller stores with mostly single or narrow product-line stores like electric and plumbing supplies, paint and wallpaper, hardware, fencing, floor covering, glass, lumber retailing, etc.

Step 5, the next step in the highest and best use analysis, is analysis of the current market cycle. For the subject property, according to the STDB Retail MarketPlace Profile estimate, the subject market area is currently slightly undersupplied.

**Conclusion of Market Analysis.** Steps 2–5 summarized above are part of the market analysis phase of the highest and best use analysis process. The analysis of Steps 2–5 procedures and the case study conclusion do not change whether the subject of the study is a home improvement center or another retail property, such as multitenant shopping center, discount department store, or even if the subject is vacant. The market delineation, demand methods, supply and market condition analysis procedures remain the same for all retail property types and the analysis is not concerned with the property rights of the properties. There may be different demand factors for each type of retail, but the market analysis procedure does not change.

**Step 6: Subject Marketability Analysis (Capture Potential)**

Step 6 in the highest and best use analysis process is marketability analysis, which will indicate the market capture. *The Appraisal of Real Estate*, fourteenth edition, states,

> An appraiser should also consider the competition among various uses for a specific site…. Market demand is not infinite. Even though the subject may be physically and locationally suited for a use, better-located sites may satisfy the market demand for that use completely before the subject can realize its development potential.

Fundamental analysis in a marketability study looks at the specific property’s economic well-being. Fundamental methods can include forecasting subject capture by pro rata share and forecasting subject capture using a competitive rating comparison. On the other hand, “inferred analysis is a starting point for the forecast of subject capture, using methods such as

- historical capture of the subject property
- capture of comparable properties
- secondary data surveys and forecast
- effect of marginal demand on the subject property
- local economic analysis”

The results of the inferred analysis and fundamental analysis are then reconciled to determine the future occupancy and expected rent levels for the specific property.

In the case study, the market area has two major big-box home improvement stores, the subject being one. As stated previously, there are a large number of other stand-alone single-product and narrow-product home improvement stores. The two major big-box stores dominate the market as of the date of the analysis.

In this study, business locator data for the market area estimated that these two big-box stores' sales account for nearly 90% of the home improve-

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39. *The Appraisal of Real Estate*, 14th ed., 329. Note, the term marginal demand has been changed to residual demand in current Appraisal Institute courses and books.
A competitive property rating of the competitive stores, including the smaller retailers selling home improvement products, concluded the subject should capture in the 40% range of all home improvement sales in this market area. Even if the interpretation of fee simple is to assume the building is vacant on the effective appraisal date, this assumed vacant building in Step 1 was rated good for this use and the location was rated the best in town. With this competitive advantage, and the strong demand found in this market for home improvements sales, the subject building should probably capture close to its historical share immediately, or at worst, it would take only a few months to get back to the operation volume the subject was generating the day before the effective appraisal date when it is assumed suddenly vacant and available on the effective appraisal date. Exhibit 7 applies the capture conclusion for the subject to estimate its sales potential over time.

### Conclusion of Subject Marketability Analysis and Market Capture

Even with an interpretation that fee simple means the subject is assumed vacant and available on the effective date there is no impact on market capture in the appraisal process. There is no impact because the as-if-vacant assumption does not change the demand in the market, it does not change the competition in the market, and it does not change the capture analysis method. On the effective date of the appraisal there is the same amount of demand in the subject market area, and that demand must go somewhere.

Step 1 in the market analysis determined the subject building is rated above typical industry standards for a home improvement center. The location analysis determined the subject’s location is the best retail location in the city. The subject is rated for capture against the competition based primarily on building design and location factors. There are limited alternatives for where the demand could go on the effective date of the valuation. The demand is determined by the capture rating analysis for the subject property on the effective date, no matter what fee simple interpretation is applied.

### Case Study Analysis: Alternative Use of the Property—Second Generation Use (Go Dark)

An alternative use of the subject property would be a use other than as a home improvement center. This is sometimes called a second-generation use. In the highest and best use study, a second-generation use is a different alternative than the alternative of continuation of current use. Any number of

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42. This is an economic estimate, as economically it may be the previous occupant or a new business taking advantage of the opportunity to fill a large market void.
reasonably probable alternative uses of the property can be studied and if determined to produce a higher value than the current use after considering cost and time to generate new use of the property, then the secondary use would be the highest and best use. Second-generation uses could be co-highest and best uses if the second-generation use value is virtually the same as the first-generation use.

As shown throughout the previous six-step process, the property rights that are being appraised (fee simple, leased fee, etc.) or alternative use of property is not a factor in reaching the highest and best use conclusion for the subject property. Whether an appraisal assignment is of the fee simple interest or of the leased fee interest does not dictate or influence the highest and best use conclusion. Application of the six-step process can, however, provide conclusions that suggest an alternative use to the original building-designed use or even its current use.

**Alternative Conclusions.** Consider the result if alternative conclusions were reached in the various steps. For example, suppose there had been the following conclusions:

- **Step 1:** Building is in below-average condition and located in a less desirable retail node due to construction of a new bypass.
- **Step 3:** Subject market area sales are below the levels found in the region.
- **Step 4:** Subject is one of four stores in the market area.
- **Step 5:** Market area is oversupplied with home improvement stores.
- **Step 6:** Subject capture is 15% of the market area.

With these changed findings, the subject’s sales would be forecasted at $136 per square foot. Research indicates that the average sales per square foot should be $300 for a home improvement center. If this situation is what is found, the subject would not be performing well as a home improvement center. This would likely indicate a highest and best use other than the current use or that the current use will probably have a short remaining economic life and become an interim use. The enterprise management of this property, either as tenant or owner-occupant, would classify this long-term asset as an impairment and would close it and relocate. Under this changed set of conclusions, application of the six-step process would also lead one to support and conclude a change in use, or a go-dark conclusion for the subject property. A definition does not lead to this conclusion, however; it is the highest and best use process that leads to the go-dark conclusion.

**Step 7: Financial Feasibility Analysis of Alternatives**

This part of highest and best use analysis tests the financial rewards of alternatives that are physically possible and legally probable and whether the economic demand for the uses are supported by the factors in the six-step marketability study. In the case study, three alternatives were studied—demolition, continued current use, and remodeling for a second-generation use.

**Alternative 1: Demolition.** The site is assumed vacant. Analysis of this alternative finds the subject site as-if-vacant value was not remotely close to the value of the property as improved.

**Alternative 2: Continued Current Use.** The site continues as a home improvement center. The estimated sales potential as improved is higher than most big-box home improvement centers and is above the national average. The occupancy cost ratio (rental) analysis (Exhibit 8) indicates the subject occupancy affordable rent is above most other rent for comparable stores in the submarket area, and commands economic rent similar to feasibility rent for new construction.

Feasibility rent is the threshold rent needed for a developer to realize its minimum incentive (profit) for purchasing the location and developing a new building on the site for the use considered. This rent reflects the costs of acquiring the land, building the improvements, and finding a tenant that would use the property to its optimum potential. Feasibility rent can be equal to market rent but is usually less than market rent as it reflects the minimum a developer would accept for the use of the property by a tenant.

Owner-occupants also consider feasibility rent in determining whether they should build their property or rent. Owner-occupants save the rent expense and therefore their occupancy costs are lower, and their business profits can be higher. Feasibility rent would also represent the minimum rent an owner-occupant would save by developing the property for its own use. Owner-occupancy removes control of the property by a landlord, and the owner-occupant has more options in managing the property.
All successful retailers consider the options they have as to whether to rent or build. Publicly traded retailers publish the methods they use in selecting their locations and research the market to identify their customers’ characteristics. The method used in this article is very similar to what successful retailers do to determine whether a location will be successful or not, and they periodically evaluate each of their locations as to what current market conditions are and how well those locations are performing to meet their operating standards.43

When a retailer’s location is not performing to its standards, the retailer makes a decision to close the store or relocate. In the case of a rental property, the retailer may not have the choice to immediately close or move depending on the terms of the lease. If the location is owner-occupied, then the retailer-owner can move whenever it decides that is to its advantage.

**Exhibit 8 Occupancy Affordability Rent**

<table>
<thead>
<tr>
<th>Subject estimated sales per square foot ($)</th>
<th>361</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occupancy cost ratio NNN (%)</td>
<td>3.0</td>
</tr>
<tr>
<td>Indicated NNN rent per square foot ($)</td>
<td>10.84</td>
</tr>
</tbody>
</table>

National data averages indicate home improvement centers pay about 6.48% gross sales on occupancy cost, which includes CAM, insurance, and taxes but not utilities. Note the deduction from 6.48% occupancy cost to 3.0% accounts for the CAM + insurance + RET to get to a NNN lease estimate. The 3% is making the data net of taxes, CAM, etc. The source is an industry association like the International Council of Shopping Centers and older publications like the Urban Land Institute’s Dollars and Cents of Shopping Centers 2008. It has been shown by many that this ratio stays constant over time.

For more discussion on this topic, see Fanning, *Market Analysis for Real Estate*, 2nd ed., 302–304.

**Alternative 3: Remodeling for Alternative Use of Property.** Other alternative uses, sometimes called “second-generation uses” of the property as improved, require remodeling the store to varying degrees depending on specific use, and more importantly, remarketing the property for a different use, which requires additional cost and time. As *The Appraisal of Real Estate* notes, “a crucial element in highest and best use analysis is the timing for a specific use.”44

When the cost and time is factored into the financial analysis, no other use was found in the case study that could generate the sales volume of the current operation and location. However, if in another case the conclusion were that the store sales would be about $136 per square foot as discussed previously, the rent that could be paid would be reduced significantly. This would then lead to consideration of the alternative use, and whether higher rents would be paid by an alternative user instead of the current use of the building.

As reflected in this alternative use example, a secondary use of the property could be found if there was a property deficiency found in the Step 1 analysis, an indication that the location features were forecast to deteriorate over time. A secondary use also would be considered if some downward market demand was found for home improvement retail sales in the market in Steps 2–5 or if Step 6 showed the subject capture was low.45

**Step 8: Highest and Best Use Conclusion of Maximally Productive Use**

*The Appraisal of Real Estate* notes that “if all the alternative uses are eliminated and the current use remains financially feasible without modification of the improvements or redevelopment of the site and retains the highest value of the alternative uses, then the current use will remain the highest and best use of the property as improved.”46

The conclusion of the case study in this article was that demand data for both inferred and fundamental calculations found the current use had strong demand at this location. The time, cost, and risk of changing uses to a second-generation use was judged to have more risk without producing a higher return. Consequently, no other use, consistent with the rate of return warranted by the market for the subject property, performs as well as the current use. The highest and best use conclusion for the subject is therefore:

45. For an example of Level C analysis of a shopping center for second generation use see chapter 19, “Highest and Best Use of a Vacant Shopping Center” in Fanning, *Market Analysis for Real Estate*, 2nd ed.
Highest and Best Use and Property Rights—Does It Make a Difference?

- **Use:** Big-box home improvement store
- **Timing:** Current with remaining economic life of twenty to thirty years
- **Market Participants:**
  - **Users:** Moderate to higher income home owners and home builders
  - **Most probable buyers:** Owner-occupant or investor

Property Rights Impact on Highest and Best Use

Conclusion. Regardless of the interpretation of the meaning of fee simple or market value, the highest and best use process is the same and the definitional interpretation does not change the final conclusion of highest and best use. The market data in this case study all supported the conclusion that the use that would produce the highest present value of future benefits to the owner of this property is the continued use of the property as a home improvement retail center. No matter which interpretation of property rights and market value are applied to the appraisal, demand in the market is still demand and competition in the market is still competition, and the alternative use of the subject property that would produce the highest present value of future benefits is as a home improvement center.

Valuation of the Highest and Best Use

Appraisal Institute materials emphasize the importance of highest and best use analysis. It is axiomatic that “whenever a market value opinion is developed, highest and best use analysis is necessary.”47 Highest and best use analysis establishes what is being valued and is the foundation of all market value appraisals.48 The highest and best use of the property considered in this article was demonstrated to be continued use as a home improvement center with a remaining economic life of twenty to thirty years. In other property assignments, the highest and best use might be different, such as a second-generation use. Whatever the highest and best use conclusion is determined to be, “the conclusions reported in the highest and best use section of a report should be consistent with conclusions and applications in the other parts of the report. ...and the market analysis and other report sections must support the highest and best use conclusions as well as the sections discussing the application of the approaches to value.”49

Consequently, the highest and best use three-part conclusion establishes the basis for the market value opinion, setting the stage for the selection of appropriate comparable sales.50 The three-part conclusion of highest and best use also is the basis of the cost approach, since “the cost approach reflects market thinking because market participants relate value to cost.”51 The three-part highest and best use conclusion is also the basis of the income approach, because “all income capitalization methods, techniques, and procedures forecast anticipated future benefits and estimate their present value.”52 Retailers constantly reevaluate their assets in terms of the market. For example, The Home Depot in its annual report, states,

“We evaluate our long-lived assets each quarter for indicators of potential impairment. Indicators of impairment include current period losses combined with a history of losses, management’s decision to relocate or close a store or other location before the end of its previously estimated useful life or when changes in other circumstances indicate the carrying amount of an asset may not be recoverable. ...The assets of a store with indicators of impairment are evaluated by comparing its undiscounted cash flows with its carrying value.... If the carrying value is greater than the undiscounted cash flows, an impairment loss is recognized for the difference between the carrying value and the estimated fair market value.”53

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47. *The Appraisal of Real Estate*, 14th ed., 42. Also see USPAP Standards Rule 1-3.
Market Value Methodology Interpretation and Highest and Best Use. The central point of this article is that highest and best use sets the basis of market value, no matter what the interpretation of property rights, it does not change the highest and best use analysis procedures or conclusions. The highest and best use study does not assume a transaction, it is only concerned with which one of the alternative uses of a property creates the highest present value of future benefits to the owner. The valuation section then is to measure the market value of that use.

Conclusion

This article’s conclusion is that the highest and best use process is the same no matter which property rights school of thought is utilized in an appraisal. The process is the same regardless of whether there is a vacant or occupied assumption. The highest and best use analysis starts with one of the alternatives analyzed being the use to which the property is currently or was formerly used and/or the use(s) that the property was designed to serve. "The performance of the subject property is likely to be the most reliable indicator of current demand for existing properties in the market." The highest and best use analysis discussed herein is very similar to what an owner or tenant of a big-box retail operation does in assessing whether a store should remain open, be closed, or be relocated.

The case study example for this article demonstrates that an appraisal of a big-box retail property needs a highest and best use analysis just like any other property type. All properties' highest and best use analyses consider alternative uses, including the current (or former use) or second-generation use, to establish the basis of highest and best use to be valued.

The differing opinions of the meaning of fee simple and its application is a debate of different interpretations of words and not a debate of the study process needed to determine which alternative use of a property is most likely to provide the highest present value of future benefits to the owner of the property. The dark store theory view is to disregard the current use because it is the result of a lease, or specific business enterprise (property use unique to the business), which in essence disregards the highest and best use conclusion and the existence of a market that supports the use.

The premise of this article is that the interpretation of what the definition of fee simple means does not change a property’s highest and best use from its current use to a secondary use, only the fundamental user market can do that.

The case study in this article demonstrated the use that would produce the highest return to the real estate, which is its highest and best use. This confirms the maxim that: “The market determines the use; the use determines the value.”

54. There are exceptions like in a bubble market; the speculative sale to a market of hyper-exuberant buyers may produce a higher present value than the fundamental use of the property and in that case the speculative sale maybe the highest and best use. Also, financial analysis of alternative fundamental use of property can sometimes be analyzed by user end sale prices. But sales are not the exclusive method to analyze alternative highest and best use.


About the Authors

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SEE NEXT PAGE FOR APPENDIX >
Appendix  Glossary of Terms and Definitions

**Big-box store**—A single-use store, typically between 10,000 and 100,000 square feet or more, such as a large book-store, office-supply store, pet store, electronics store, or toy store. Source: International Council of Shopping Centers, Dictionary of Shopping Center Terms, 4th ed. (New York: International Council of Shopping Centers, 2012).

**Fee simple estate**—
- 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. Source: Appraisal Institute, The Dictionary of Real Estate Appraisal, 6th ed. (Chicago: Appraisal Institute, 2015).

**Fundamental demand**—The quantity of a particular type of real estate product that is desired by and affordable to the space users in a given market at a particular point in time. Source: The Dictionary of Real Estate Appraisal, 6th ed.

**Go dark**—To vacate retail space prior to a lease expiration. The space may remain vacant or “dark” for an extended period of time. Source: The Dictionary of Real Estate Appraisal, 6th ed.

**Highest and best use**—Many definitions of highest and best use can be found in The Dictionary of Real Estate Appraisal, 6th ed.; The Appraisal of Real Estate, 14th ed. (see especially page 333), and other literature. All definitions center around determining the alternative use of a property that will create the highest present value to the owner. In The Appraisal of Real Estate, 14th ed., the two definitions that best describe the term as used in this article are as follows:

1. “The probable use of land or improved property—specific with respect to the user and timing of the use—that is adequately supported and results in the highest present value.”
2. “The reasonably probable use that produces the most benefits and highest land value at any given time.”

**Intangible property**—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. Source: The Appraisal Foundation, “Definitions,” in Uniform Standards of Professional Appraisal Practice, 2018–2019 ed. (Washington, DC: The Appraisal Foundation, 2018).

**Risk**—There are numerous types of risk, but for this article the primary risk, but not the only one considered, is market risk, i.e., risk that the forecasted user market conditions of demand or supply and the subject market capture potential will shift outside the forecasted range.

**Second-generation space**—A building or space used by a tenant other than the original tenant; often functionally obsolete before refurbishment but sometimes containing tenant improvements that can be reused by a new tenant. Also called relet space. Source: The Dictionary of Real Estate Appraisal, 6th ed. Second-generation use is sometimes called secondary use. In this article, any secondary use or second-generation use is considered a different alternative in the highest and best use study.

**Space user market**—The fundamental market of the users of the real estate’s physical space; the market for the right to use real estate over time. Source: The Dictionary of Real Estate Appraisal, 6th ed.
**Additional Resources**
Suggested by the Y. T. and Louise Lee Lum Library

**Appraisal Institute**
- **Education**
  [http://www.appraisalinstitute.org/assets/1/7/aiedcat.pdf](http://www.appraisalinstitute.org/assets/1/7/aiedcat.pdf)
- **Lum Library External Information Sources [Login required]**
  Information Files—Taxation and assessment
- **Property Rights Symposium Discussion Paper**

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[https://fred.stlouisfed.org/](https://fred.stlouisfed.org/)

**US Census Bureau Data**
[https://www.census.gov/data.html](https://www.census.gov/data.html)