

Big-Box Appeals... Issues and Solutions

for

**Association of Municipal Assessors of New Jersey
2019 New Jersey League of Municipalities Conference
November 20, 2019**

By

Peter F. Korpacz, MAI, CRE, FRICS

Founder & President

Korpacz Realty Advisors, Inc.

Presentation Contents

- **Fee Simple Definition Issues**
 - **Fee Simple & Market Behavior**
 - **Legal Definition**
 - **AI Definition**
 - **AI Discussion Paper Definition**
 - **IAAO Setting the Record Straight on Fee Simple Position Paper**
- **Favorite Court Decision Quotes**
- **Build-to-Suit & Sale-Leasebacks**



Presentation Contents

- **Market Segmentation**
- **First- and Second-Generation Space**
- **Truly Comparable Sales**
- **Restrictive covenants**
- **Market Value Issues**
- **Cost Approach to Value**
- **Functional Obsolescence**
- **Sales Comparison Approach to Value**
- **Income Capitalization Approach**
- **Final Thoughts**



Fee Simple Definition Issues



Fee Simple & Market Behavior



“The elephant in the room”

Over 400 broker for-sale listings

- All are leased income properties (single tenant and multitenant)
- Big-box retail, office buildings, shopping centers, etc.
- Ownership to be conveyed – is stated in the listings as fee simple
- “Everything – the dirt, the bricks and mortar, leases, REAs, etc.”
- Not a single listing uses the term “leased fee”

That is the market talking!

Fee simple...broker listings



TENANT SUMMARY

Lessee Name	Walmart Stores, Inc.
Type of Ownership	Fee Simple/Building & Land
Lease Entity	Corporate
Lease Type	Absolute NNN
Roof and Structure	Tenant Responsible
Original Lease Term	20 Years
Lease Commencement Date	8/13/1997
Option 1 Expiration Date	8/12/2022
Term Remaining	5 Years
Increases	None
Options Remaining	Five, 5-Year Options

For sale to qualified investors is the fee-simple interest in Hawthorne Valley Shopping Center, a 93.33% leased regional power center in Oakwood Village, Ohio. The property is anchored by Sam's Club, The Tile Shop, Levin Furniture, and Ollie's, and is offered at an 8.5% cap rate on existing income, providing the investor with attractive in-place cash-on-cash return of over 11%.



Walmart Neighborhood Market, Albany, GA

PROPERTY OVERVIEW

Price	\$ 10,730,727
NOI	\$ 590,190
CAP	5.50%
Ownership Type	<u>Fee Simple</u>
Broker's commission	1.5% of sales price
Building Size	Approx. 41,953
Lot Size	Approx. 9.23 acres

Fee simple...broker listings

The subject offering is a fee simple interest in an absolute NNN leased Walgreens. The lease expires in June of 2032 and calls for zero landlord obligations. The subject property is well situated on a major commercial thoroughfare, surrounded by major national retailers.

TENANT NAME	WALGREENS
SQUARE FOOTAGE	14,820
LEASE BEGINS	7/1/2007
LEASE ENDS	6/30/2032
ANNUAL RENT	\$298,600
OPTIONS	TEN, 5 YEAR
INCREASES	RENT IS FLAT

LEASE SUMMARY	
Tenant:	Walmart
Lease Type:	NNN
Primary Lease Term:	7 Years

Annual Rent:	\$1,369,259
Rent PSF:	\$6.39
Landlord Responsibilities:	None
Taxes, Insurance & CAM:	Tenant Responsibility
Roof, Structure & Parking:	Tenant Responsibility
Rent Commencement:	January 25, 2000
Original Lease Expiration:	January 25, 2020
Extended Expiration Date:	January 25, 2027
Lease Term Remaining:	7+ Years
Rent Bumps:	Flat During Options
Renewal Options:	Six, Five Year Options
Lease Guarantor:	Walmart Stores, Inc.
Lease Guarantor Strength:	AA/Stable



PROPERTY SUMMARY	
Year Built:	1999
Lot Size:	21.8 Acres
Building Size:	214,172 SF
Construction:	Reinforced Concrete
Docks:	6 Ext
Ownership:	<u>Fee Simple</u>

Fee simple...broker ads

The Boulder Group is pleased to exclusively market for sale the fee simple interest in a single tenant absolute triple net leased Jewel-Osco grocery store (67,507 sf) located within the Chicago MSA in Romeoville, Illinois.



for sale the fee-simple interest in a multi-tenant shopping center

~~NET LEASE INVESTMENT OFFERING~~
exclusively market for sale the fee simple interest.



opportunity to acquire the 100% fee simple interest in

The Property is 98% occupied

Legal definitions of fee simple

The definition has not changed in meaning over time

- 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.⁽²⁾

⁽²⁾ *Black's Law Dictionary, 10th Edition, page 733*

Keeping real property estates in context

There are six legal 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

There are no other real property estates (i.e., leasehold, leased fee; they are interests)

Fee simple in the appraisal industry

Unlike the centuries old legal definition, the appraisal industry concept and definition has changed significantly.

- **Initially, it aligned perfectly with the legal definition**

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

Appraisal Terminology and Handbook (1954) fee simple. An absolute fee; a fee without limitations to any particular class of heir or restrictions, but subject to the limitations of eminent domain, escheat, police power, and taxation.

Appraisal Terminology and Handbook (1962) fee simple. An absolute fee; a fee without limitations to any particular class of heir or restrictions, but subject to the limitations of eminent domain, escheat, police power, and taxation. An inheritable estate.

Fee simple in the appraisal industry

- **The big change took place in 1984**

The Dictionary of Real Estate Appraisal (1984) fee simple estate. Absolute ownership unencumbered by any other interest or estate; subject only to the limitation of eminent domain, escheat, police power, and taxation.

- **While there were some slight revisions, the newly introduced words “unencumbered by any other interest or estate” continues to the present time.**

All Fee simple definitions

There are no references to specific encumbrances, such as leases, liens, mortgages, utility easements, occupancy, or vacancy in the definitions.

Deliberations at the AI Symposium

The symposium was held in September 2017 and included close to 50 valuers, attorney, and other interest parties. numerous issue topics were considered, including

- **Should a property typically leased and sold as leased be valued as through occupied or as though vacant?**
- **Does fee simple mean vacant and available for lease or occupancy?**
- **Are sales of vacant properties the best comparables for fee simple valuation? Is it appropriate to derive capitalization rates from sale leasebacks?**

AI Property Rights Symposium

Overwhelming support of the attendees at this symposium on September 8 and 9, 2017

(1) to replace the current fee simple definition with a legal definition

and

(2) to provide for fee simple to be subject to market rent or contract rent

AI Symposium Proposals

(dated December 21, 2017)

- **Proposed new fee simple definition**

Fee simple estate. The highest estate allowed by law. An inheritable ownership interest of indefinite duration.

- **Proposed the discontinuance of the terms leased fee and leased fee estate**

Source: AI “Property Rights Symposium Discussion Paper”

AI Symposium Rationale

“Symposium participants identified the phrase ‘unencumbered by any other interest or estate’ to be a source of potential confusion in the profession because some practitioners have interpreted that language to mean that the property is to be valued as though vacant and available to be leased or occupied while others have interpreted the phrase differently.”

Source: AI “Property Rights Symposium Discussion Paper”

AI Symposium Rationale

“Another potential source of confusion arises because the definition of *fee simple estate* may differ with how the term is defined in *Black’s Law Dictionary* and often used in other areas of real estate. For example, real estate agents typically list a property to be sold with a lease (or leases) in place as ‘fee simple’, not ‘leased fee’.”

Source: AI “Property Rights Symposium Discussion Paper”

Implications for Valuations

What is valued is the estate (i.e., fee simple, leasehold, life estate) subject to specified interests - easements, restrictions, encumbrances, leases, reservations, covenants, contracts, declarations, special assessments, ordinances, or other items of similar nature.

Source: AI “Property Rights Symposium Discussion Paper”

Implications for Valuations

- **By way of example, if the estate to be valued is the fee simple estate, it may be valued –**
 - **Subject to an existing lease,**
 - **Subject to hypothesized leases at market rates and terms,
or**
 - **As though vacant and available to be occupied or leased at market rates and terms.**

Source: AI “Property Rights Symposium Discussion Paper”

Title, estate, and interest

Title – is evidence of ownership

Estate – is what is owned

Interest – rights in real property that can burden the land
and affect the value of the estate

“What is valued is the estate subject to specified interests.”

(Source: “Property Rights Symposium Discussion Paper”, The Appraisal Institute, December 21, 2017)



IAAO

SETTING THE RECORD STRAIGHT ON FEE SIMPLE



AUGUST 2019

Fee simple

This is a position paper.

The paper represents IAAO's stance on this subject.

Enter the IAAO Commercial Big-Box Retail: A Guide to Market-Based Valuation

Published in September 2017, the paper provided guidance for the valuation of big-box retail properties.

The theories and methodologies described in the paper -

- reflect market behavior**
- identified recurring issues in the controversy**
- clarified fundamental concepts in appraisal practice, and**
- explained the methodology to arrive at the appropriate value required by the jurisdiction for assessment purposes**

Definitions

- **Legal Definition**

**Emphasize absolute control, duration and inheritability
(existence of encumbrances irrelevant)**

- **Appraisal Definition**

**Relatively new 1984 AI Dictionary omitted reference to
inheritable and duration of the estate, added
“unencumbered by any other interest or estate”**

Estates and interests

- **Fee Simple Absolute Estate**

One of several estates (life estate, etc.) Not destroyed by the existence of a lease or any other encumbrance

- **Leased Fee Interest**

Is synonymous with “fee simple subject to a lease”; possession but not the ownership is temporarily transferred (AI 2015 Dictionary, page 128)

Real estate & the bundle of sticks

- The Bundle of Rights (Sticks) analogy describes *real estate, not fee simple.*
- Depicts real estate as containing a mixture of rights (right to possess, sell, mortgage, lease, use, etc.)

Not a value concept

- **Fee Simple is an ownership concept, not a value concept**
- **Fee simple is not synonymous with market value**
- **Some mistakenly use fee simple to imply “at market”**

IAAO big-box findings and conclusions

Among the many significant findings and guidelines, the paper includes –

- **Build-to-suit and sale leaseback transactions should not be automatically disregarded as improper comparables. They can be adjusted, if appropriate.**
- **Most big-box improvements are not unique. It is for the market to determine whether the improvements (1) are in demand as of the date of value, and (2) whether to purchase the property and retrofit, demolish, or continue to use the improvements.**

IAAO big-box findings and conclusions

- **Abandoned, vacant stores may or may not be evidence of functional obsolescence. Subsequent prices are often the result of deed restrictions or changing marketplace demand.**
- **Fee simple is not unencumbered. It may be subject to a lease.**

IAAO big-box findings and conclusions

- **A lease is a possessory right and a property may be held in fee simple subject to a lease.**
- **Thus, sale of leased properties can and should be used as comparables if adjustments are made for above- and below-market rents in jurisdictions where market rent is the criteria for the calculation of rental income.**

IAAO big-box findings and conclusions

- **The appraiser should be wary of arriving at an overly broad highest and best use conclusion of general retail. Market segmentation allows the appraiser to fine tune the highest and best use conclusion and appropriate comparables to consider.**
- **The legal definition is the appropriate definition to use in fee simple valuations for assessment appeals.**

Favorite Court Decision Quotes...



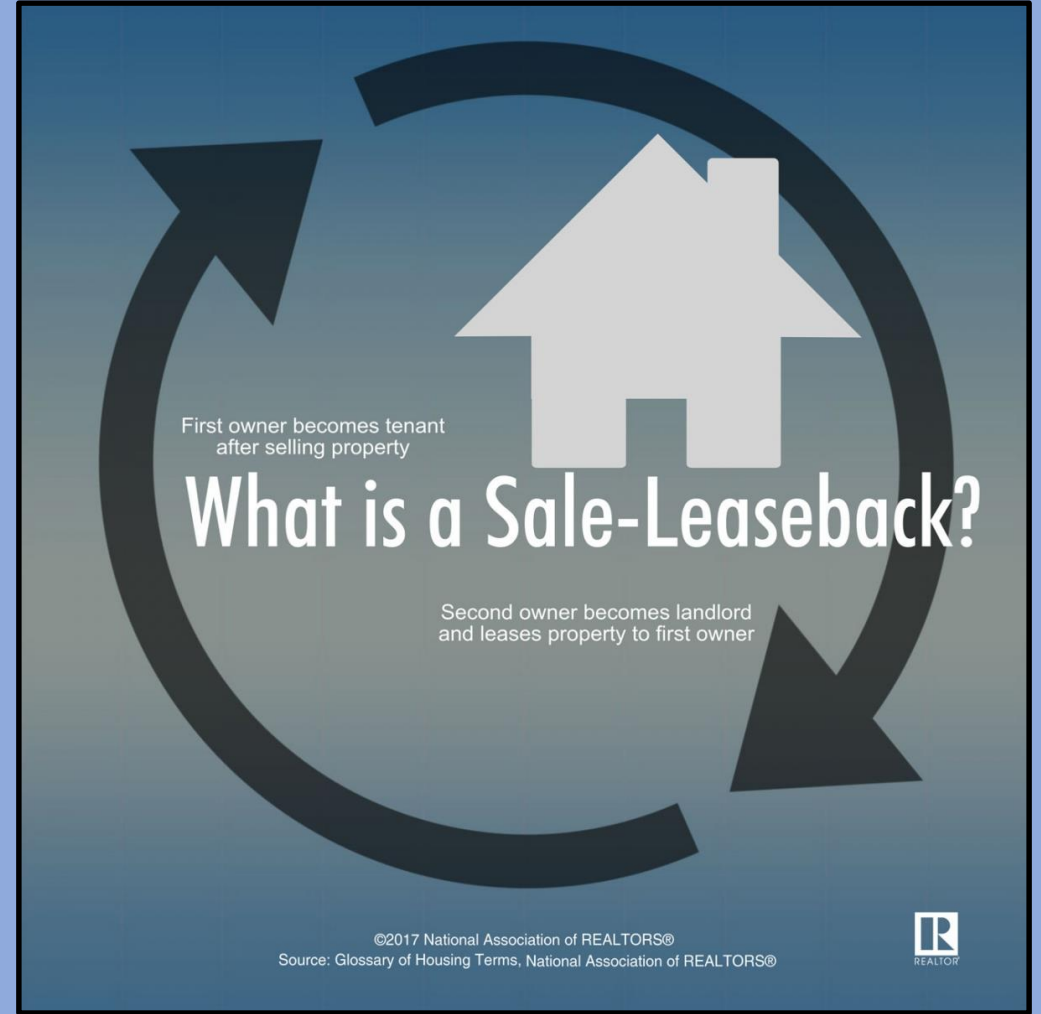
Excerpts from Meijer Stores Ohio Decision 2009

“The distinction between “fee simple” and “leased fee” is one drawn in the context of appraisal practice. See Appraisal Institute, *The Appraisal of Real Estate* (13th Ed. 2008) 114.

The appraisal industry uses the term “fee simple” to refer to unencumbered property – or to property appraised as if it were unencumbered. Id.

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. *Black’s Law Dictionary* (8th Ed.2004) 648-649.”

Build-to-Suit & Sale Leaseback



Build-to-suit

**All real estate building development is built to suit –
a specific user/tenant, or
a class of user/tenant**

Consider
single user office building
multitenant office building

What's so special about big-box retail buildings?

Big-box retail is not so complex

- **Big, open space with high ceilings**
- **Minimal fenestration along exterior walls**
- **Minimal façade treatment, except for logo designs and colors**
- **Minimal interior construction usually limited to restrooms, product receiving and storage areas usually along the side and back walls, small office for administration and staff break room**

Build-to-suit excessive costs

- **Costs, including customized features and FF&E that are user/tenant specific can be removed to reflect real estate assets only.**
- **Verification of actual costs can confirm a proper allocation of total costs to real estate, and personal property assets.**
- **It is up to the appraiser to test whether a build-to-suit lease reflects market or not!**

Build-to-suit excessive costs

When a big-box retailer's representative was asked if in build-to-suit leases, it makes a "conscious decision to incur an obligation for a rate of rent that it knows is above the market rate," he responded...

"No. We certainly don't want to incur a rate above market rent..."

Southlake Indiana LLC v. Lake County Assessor, State of Indiana Board of Tax Review, May 10, 2018

Build-to-suit excessive costs

The retailer indicated they were “cost conscientious” in regard to construction costs and was not aware of any situations where a contractor inflated or overcharged costs to their company.

Sale-leaseback transactions

There are two scenarios where retailers use sale leasebacks.

1. Sale leaseback at time of development

- Retailer engages a developer to develop all aspects of the process subject to the retailer's approval**
- At completion, retailer sells the property to an investor entity (i.e., REIT, private fund) and takes back a long-term lease (usually triple net) to occupy the property**
- Often, the retailer achieves a profit on the sale.**

Sale-leaseback transactions (continued)

2. Sale leaseback during economic life of the property

- The owner-occupant retailer sells the property to an investor entity buyer (i.e., REIT, private fund) and takes back a long-term lease (usually triple net)**
- Allows the retailer to raise cash for use in core operations, while maintaining control of the property**

Sale-leaseback advantages

- **Removes debt from the retailer's corporate books**
- **Avoids negative depreciation on their financial statement**
- **Improves the retailer's rate of return (earnings ÷ assets)**

Build-to-suit & sale-leaseback transactions

Property owner's position: Claims transactions are based either on financing or on customized excessive improvement costs, and a premium for land.

Response: Analyze transactions to determine if they reflect the market value of the fee simple estate. **Neither transaction should be automatically disregarded** as improper comparables.

If they are arms-length and verified to be reflective of market rent, price, and cost, they may be used as comparables.



Market Segmentation

Market segmentation

Investment Class	A	B	C	D
Type of Space	First generation	First generation, slightly older	Nearing end of economic life (may be second generation space)	At end of economic life for first-generation use likely second-generation space
Location	Very good	Good	Less desirable retail location	Less desirable retail location
Tenants	Original big-box retailer	Original big-box retailer	Original big-box retailer	Original big-box retailer or none
Leases	Long-term, NNN with many years remaining on lease	Remaining term exceeds 10 years	Remaining terms less than 10 years	Vacant or soon to be vacant
Investor type(s)	National investors, REITs, retirement funds	National investors, REITs, retirement funds	National or local investors	Second-generation users, speculative developers
Remarks	Best properties; demand high rents, highest prices, & lowest cap rates	May still be first-generation space in less desirable locations	Price toward low end & cap rates toward high end; continued use as big-box is interim use	Original demand moved to more desirable location, and/or building design no longer viable, possible redevelopment

First vs. second generation space

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’s *The Dictionary of Real Estate Appraisal, Sixth Edition, 2015, page 92.*)

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’s *The Dictionary of Real Estate Appraisal, Sixth Edition, 2015, page 210.*)

Second-generation space – “a building or space whose design is no longer functionally and economically efficient for the original tenant or a similar class of tenants. The space no longer retains its original utility and desirability and must now be used by a tenant other than the original tenant or similar class of tenant.” (*IAAO Commercial Big-Box Retail: A Guide to Market-Based Valuations, page 26.*)

Truly Comparable Sales



What makes a truly comparable sale?

“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.”

**- APB Valuation Advisory #4 Identifying Comparable Properties.
The Appraisal Foundation, August 14, 2013**

Comparable sales – characteristics to consider

- **Similar estate and specified interests that impact value**
- **Similar highest and best use**
- **Trade area demographics – population, housing density, household income**
- **Age and condition**
- **Remaining lease term, if leased**
- **Building size, height, condition, etc.**
- **Contract to market rent relationship**

Often ignored - the negotiating strengths and weaknesses of the seller and buyer, i.e. K-Mart as the seller.

Restrictive Covenants



Impact of Restrictive Covenants

Property owner's position: Deed restrictions have no significant impact on property value.

Response: Deed restrictions, by design, are imposed to limit competition. Often they **force a change** in highest and best use, and limit the potential pool of buyers.

Deed restricted comparable sales

Comparable sales with deed restrictions should not be used for subject properties that are not encumbered with deed restrictions unless their highest and best use is comparable to the subject.

Adjustments are almost impossible to support.

Market Value Issues



Market value definition

Market value **sets forth the conditions** required to indicate the most probable price reflective of market behavior. The definition can vary from jurisdiction to jurisdiction.

“Must be based on the objective observation of the collective action of the market.” (Source: *The Appraisal of Real Estate*, published by the Appraisal Institute, page 58)

Components of the market value definition

- 1. Most probable price**
- 2. Cash, cash equivalent, or other precisely revealed terms**
- 3. Reasonable exposure time**
- 4. Fair sale condition – knowledgeable buyers and seller acting prudently for self interest and no undue duress**

AI market value definition

Market Value - the most probable price, as of a specified date, in cash, or in terms of 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.

(Source: The Dictionary of Real Estate Appraisal, supra)

Notice: There is no reference to property characteristics, including occupancy/ vacancy.

Market value of what?

The term market value needs to be tied to –

- Value in use
- Value in exchange
- Fee simple estate subject to –
 - Market rent
 - Contract rent
- Leasehold interest
- Fee simple subject to other property interest dictated by jurisdiction or client

Highest and best use should also be considered.

Market value **and** big-box retail

An appraiser's market value conclusion of a fee simple estate in a big-box property should reflect the actual market condition of the property on the date of valuation.

If occupied, value as an occupied property, using comps of similar occupied properties.

If vacant (unoccupied), value as a vacant property, using comps of similar vacant properties.



Cost Approach to Value

Cost approach

Strengths

- Inherently values the fee simple estate excluding specified encumbrances (interests) and eliminates the debate about leases and deed restrictions
- Reflects what retailers do for new store development
- Often the best approach for new or nearly new first-generation properties

Weaknesses

- Depreciation and entrepreneurial profit/incentive estimates are difficult to support

Functional Obsolescence



Functional obsolescence

If the property conforms to competitive standards dictated by demand in the marketplace, there is likely little or no functional obsolescence.

Some modifications 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 façade may be minimal and easily removed without significant damage to the underlying real estate.

Big-box functional obsolescence survey (385 properties in Kansas counties)

Age	Number of buildings vacant or with change in use/tenant	Percent of buildings vacant or with change in use/tenant
0 – 5 years	2	0.5%
6 – 10 years	2	0.5%
11 – 15 years	8	2.1%
16 – 20 years	9	2.3%
21+ years	50	13.0%

- **This compilation confirms the majority of obsolescence found in the big-box market is for older buildings, greater than 21 years old.**
- **Meanwhile, only approximately 5.5% of all the big-box buildings have had a change in the use, tenant or are vacant during the first 20 years after construction.**



Sales Comparison Approach to Value



Sales comparison approach

Strengths

- **Reliable when truly comparable properties are available in the market**
- **Widely understood and often relied upon by the courts**
- **Reflects the actions of buyers and sellers and is often used by them to estimate prices and market values**

True for any property type.

Sales comparison approach

- **Retailers rarely sell their first-generation stores in the early years.**
- **But, investors are a prime buyer-type for a sale-leaseback, if the retailer wants to cash in their equity to raise cash for any reason.**

Sales in the big-box market

Build-to-suit and sale leasebacks can be used when

- (1) the circumstances meet the market-value criteria,
and**
- (2) the parties agree that the sale reflects market
rent and value.**

Market segmentation of comparable sales

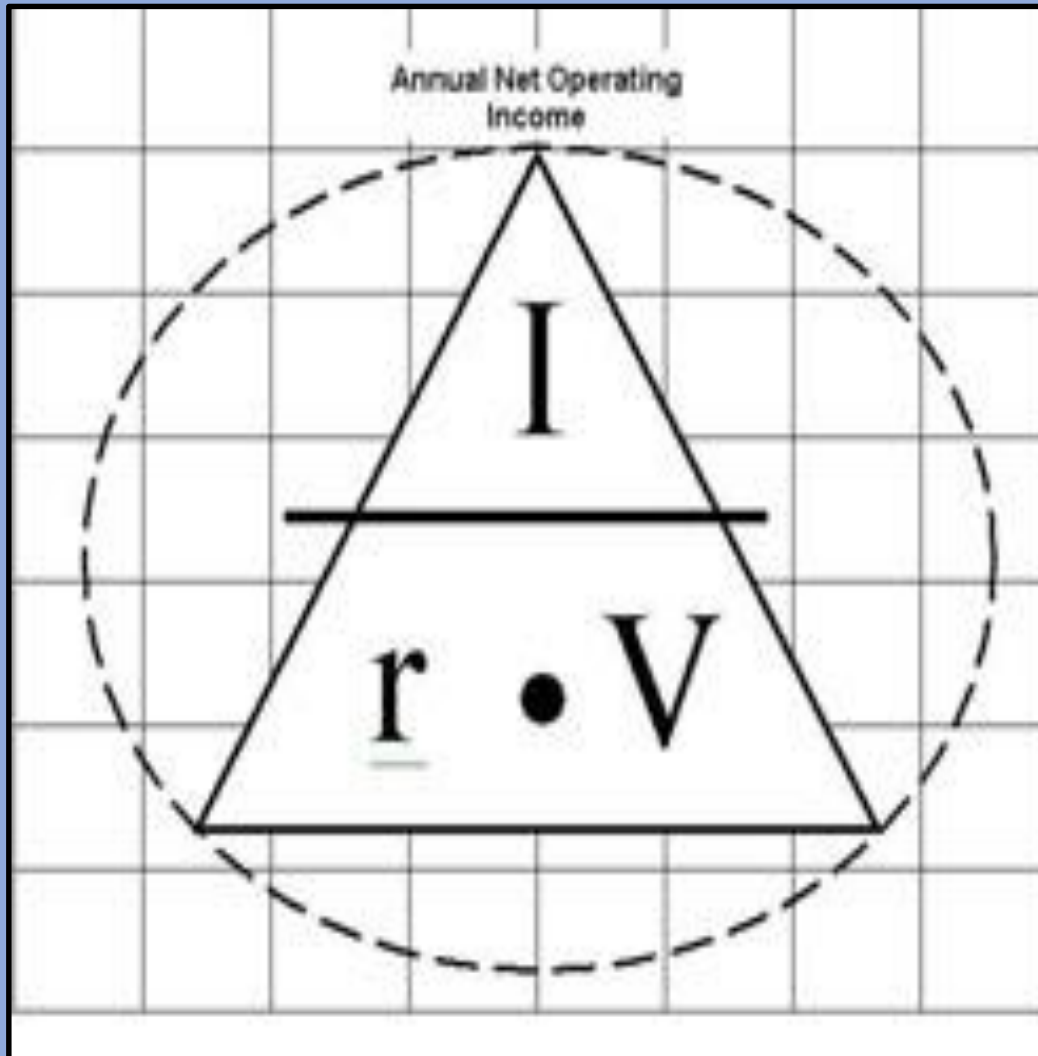
Differentiating the subject and comparable sales into segments, such as investment classes or retail types, creates a logical hierarchy. Ideally, first-generation space should be compared to a first-generation space and second-generation space compared to second-generation space.

Comp sale property economic adjustments

In jurisdictions where property is valued based on market rent –

1. A leased property does not automatically require an adjustment.
2. **But** might require an adjustment if the contract rent for the comparable property is above- or below-market rent.
3. Comparables leased at market **do not** require an adjustment

Income Capitalization Approach



e.g.

$$\text{Income} = \text{Rate (cap)} \times \text{Value}$$

$$\text{Rate} = \text{Income} \div \text{Value}$$

$$\text{Value} = \text{Income} \div \text{Rate}$$

Income capitalization approach

Fee simple owner of commercial big-box properties often lease their properties and this approach directly reflects investor market behavior, especially for Class A and B properties.

Income capitalization approach

Cap rates are often significantly related to building age and remaining term of an existing lease.

Use of leased property sales for cap rates

Sales of leased properties can and should be used as comparables for cap rates.

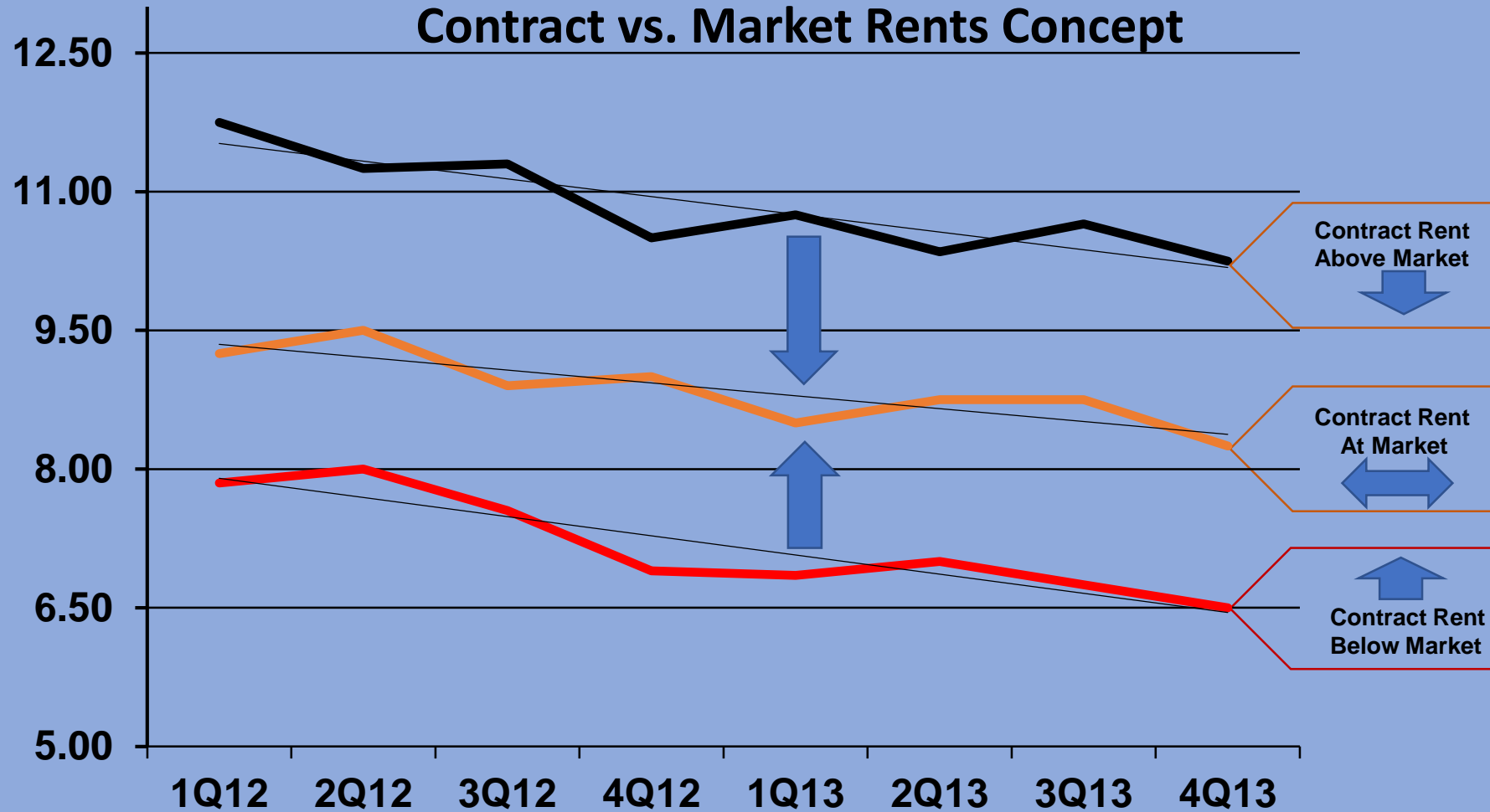
If the NOI is at market, the sale is likely a good proxy for a fee simple cap rate at market rent.

If not, the indicated sale cap rate can be adjusted.

Use of leased property sales for cap rates

- 1. Sales with contract rents above or below market can be used to show direction.**
- 2. Cap rates on sales with above-market contract rent should be adjusted downward.**
- 3. Cap rates on sales with below-market contract rent should be adjusted upward.**

Relationship of contract-to-market-rent re: cap rates



Final thoughts

The term “fee simple” –

- Is a term of ownership
- Is **not** a term of value or occupancy

So, says market behavior!

Fee simple ownership may be valued

- **Subject to market rent**
- **Subject to contract/actual rent**
- **Assuming the property is vacant and available for sale or lease at market rent**
- **Assuming the property is occupied and at market rent**

Big-Box Appeals... Issues and Solutions

for

**Association of Municipal Assessors of New Jersey
2019 New Jersey League of Municipalities Conference
November 20, 2019**

By

Peter F. Korpacz, MAI, CRE, FRICS

Founder & President

Korpacz Realty Advisors, Inc.

pkorpacz@korpaczra.com