Valuation Methods and Dark Big-Box Theories

by Leslie P. Sellers, MAI, SRA, AI-GRS, and Paula K. Konikoff, JD, MAI, AI-GRS

Abstract

Widespread concern exists about the broad range in values presented by opposing experts in certain court cases where the subject is a single-tenant property. The relevant market participants—institutional investors, for purposes of this article—do not buy, sell, or use big-box retail properties that are not encumbered by bondable leases to credit tenants. Thus, when required to value these properties in the fee simple estate, valuers must attempt to reflect the thinking of market participants when there are virtually no participants in the relevant fee simple estate market. This article addresses the collection and analysis of data that are as similar as possible to what is being appraised, including any associated leases or other financial benefits or restrictions, and the making of credible adjustments so as to develop credible opinions.

Introduction

Courts, market participants, and valuation professionals have become increasingly concerned about the wide range in value opinions presented by opposing valuation experts in ad valorem tax and eminent domain cases where the subject is one or more single-tenant properties.[1] Although the issue is the same with regard to appraisal methods used for retail, industrial, and office properties, the most concern (and the main focus of this article) is related to single-tenant retail properties, from smaller stores to very large buildings housing credit tenant retailers such as Target, Walmart, and others.[2] The concern within the profession reached a level of debate that led the Appraisal Institute to host its 2017 "Property Rights Symposium" (September 6–7, 2017) to enable valuers, educators, attorneys, and market participants to consider ways in which the relevant body of knowledge might be enhanced to support appraisal results. The purpose of those discussions was to ensure appraisals that are more transparent and understandable to judges, juries, attorneys, and others who are not real estate professionals but must make decisions based on the valuation reports. The participants in the Symposium focused primarily on the definitions of ownership interests to be valued. The premise of this current article is that closer consideration of appropriate appraisal methods and techniques also serves a purpose to resolve this debate.

The origin of the current controversy is the relevant market itself. After World War II, commercial real estate came into its own as an investment asset class, truly arriving with the Employee Retirement Income Security Act of 1974 (ERISA). With the arrival of ERISA, real estate was no longer a "prohibited transaction" for pension plan investment. As more capital flowed into the investment-grade real estate market, it was desirable to create more investment vehicles for these institutional investors, including single-tenant properties leased to credit tenants on a triple net (NNN) basis with long lease

1. An overview of this situation is presented in Jillian Slaight, "Shedding Light on Dark Stores," Wisconsin Legislative Reference Bureau Paper, 1, no. 4 (Wisconsin Policy Project, October 2018), available at http://bit.ly/2PagZm8.

2. *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), describes a *credit tenant* as "a tenant in a retail, office, or commercial property with a long history in business, strong financial statements, or a large market presence that could be rated as investment grade by a rating agency. Because of the likelihood of honoring their leases, credit tenants are considered less risky to lease to, and developments with credit tenants as anchors are considered less risky investments for lenders."

terms. These NNN leases to credit tenants are often referred to as *bondable leases*. *The Appraisal of Real Estate*, fourteenth edition, describes the characteristics of these leases as follows:

> An extreme form of net lease is commonly referred to as a *bondable lease* (or sometimes as an *absolute net* or a *triple net lease*). In effect, the tenant is responsible for all expenses for the entire duration of the lease term, and is even obligated to continue to pay rent after a casualty or condemnation. The shifting of risk from landlord to tenant creates a lease with the obligations equivalent to a bond. Bondable leases are most often used in credit tenant leases.[3]

As noted, a bondable lease substantially reduces risk to the purchaser, and in this way bondable leases fit the bill for institutional investors. With these assets, investors can meet their fund allocation to real estate without taking on the management risk typically associated with real property.[4] The crux of the current problem is that these properties are often big-box properties, which are frequently required by taxing and condemnation authorities to be appraised without the attributes that make them attractive investment vehicles in their primary institutional investor marketplace.

Appraisers have been attempting to resolve this conundrum with different methodologies and methods. One area of disagreement is whether appraising property in the fee simple estate means that the property should be valued as if vacant and available for lease, or as if leased at market rents to market occupancy rates and terms. Another area of disagreement is whether it is appropriate to use sales of properties encumbered by leases as comparables when valuing the subject as if free and clear of any leases. The list of issues goes on, but the choice an appraiser makes is likely to affect the value conclusion.

Reliance on Judicial Opinions

An area of concern in valuation of single-tenant properties is the sometimes unwarranted reliance valuers may place on judicial opinions to support their decisions of methodology, highest and best use, and in turn, choice of suitable comparable data. Just because a judge wrote the opinion in a case does not mean it offers proper guidance on valuation practice. It may not be appropriate to assume that the parts of a court opinion addressing valuation methods are consistent with the "recognized methods and techniques"[5] required by valuation standards. Valuation professionals often read a court opinion and accord judicial statements on methodology weight that may not be warranted under the profession's recognized "methods and techniques." The unsuitability of judicial opinions on methodology may be due to the specific facts of cases; the fact that judges have widely disparate degrees of knowledge regarding valuation methods, techniques, and standards; or undue emphasis on the portions of the opinion commenting on appraisal theory and practice rather than the legal issues that were the primary purpose of the opinion.

Examples of Court Holdings on Valuation of Single-Tenant Properties

Users of valuation services and other market participants are examining the appraisal issues related to the valuation of single-tenant properties in fee simple for ad valorem tax, eminent domain, and other purposes.[6] Appraisers presenting opinions of value are looking to case law to support the two largely inconsistent points of view. The following discussion uses well-known court decisions to illustrate the issues that result in the divergent viewpoints.

3. *The Appraisal of Real Estate*, 14th ed. (Chicago: Appraisal Institute, 2013), 445.
4. For a fuller discussion, see Leslie P. Sellers and Paula K. Konikoff, "Big Box Divided," *Valuation* (Third Quarter, 2018): 20–23.
5. Standards Rule 1-1 in the Uniform Standards of Professional Appraisal Practice (USPAP), 2018–2019 ed., requires that "In developing a real property appraisal an appraiser must be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal." Appraisal Standards Board, *Uniform Standards of Professional Appraisal Practice*, 2018–2019 ed. (Washington, DC: The Appraisal Foundation, 2018), Lines 428–431.
6. A *fee simple estate* 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." *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), s.v. "fee simple estate."

Meijer Stores Limited Partnership v. Franklin County Board of Revision

The 2009 Ohio Supreme Court decision in *Meijer Stores Limited Partnership v. Franklin County Board of Revision; and Licking Heights Local School District Board of Education*[7] ("*Meijer Stores*") illustrates how court opinions can be construed to support valuation methodologies that are outside the appraisal profession's recognized body of knowledge. In the *Meijer Stores* case, the state supreme court upheld the Board of Tax Appeals' (BTA) decision finding for the taxing authority and against the property owner. The subject property was a newly constructed, 193,000-square-foot store, described in the court opinion as a "big-box retail store."[8] Some appraisers have looked to the court opinion in this case to support the appropriateness of not adjusting build-to-suit and credit-tenant rents used as comparables when valuing a subject property in "fee simple," and that big-box retail might appropriately be appraised as a "value in use," as these are "special-purpose properties." However, in *Meijer Stores* the state supreme court actually ruled on another issue. The court ruling in fact was that "the BTA did not abuse its discretion[9] when it adopted the value as determined by the school board's appraisal and we therefore affirm the decision of the BTA."[10] Remember that in *Meijer Stores*, and in other similar cases, the court is not performing an appraisal review to determine which party's appraisal expert submitted the more credible report. The judges base their decisions on the evidence presented to them, taking into account the persuasiveness of counsel and the credibility of expert witnesses—in other words, considering which side presented the most compelling arguments in support of its position. It sometimes happens that the side with the most "credible" report, as defined in valuation standards, may not present the most compelling case.

Like *Meijer Stores*, many appellate decisions address possible abuse of discretion by a lower tribunal. Courts have been fairly consistent in their explanations of abuse of discretion:

> Abuse of discretion does not necessarily imply a willful abuse, or intentional wrong. In a legal sense, discretion is abused whenever, in its exercise, a court exceeds the bounds of reason—all the circumstances before it being considered.[11]

> The term [abuse of discretion] as used in the decisions of courts and in the books, implying, in common parlance, a bad motive or wrong purpose, is not the most appropriate. It is really a discretion exercised to an end or purpose not justified by, and clearly against reason and evidence.[12]

The standard for a finding of abuse of discretion is a high bar; therefore, a court finding that the lower body did not abuse its discretion is not equivalent to agreement with the lower body. It is important to stay focused on what these court decisions actually decide. The court opinion in *Meijer Stores* had this to say about abuse of discretion, referencing a different matter a year earlier: "An abuse of discretion is 'more than an error of law or judgment; it implies that the court's attitude is unreasonable, arbitrary or unconscionable.'"[13] So the court decision in *Meijer Stores* was a determination that the BTA's attitude in arriving at its decision was not unreasonable, arbitrary, or unconscionable based on the evidence presented. The court did not find that the conclusions reached by the BTA were consistent with valuation best practices or the requirements of valuation standards. Valuation professionals, however, might have a different opinion of the reasonableness of the BTA's attitude and decision.

Some valuers have taken the *Meijer Stores* decision as support for using build-to-suit big-

7. *Meijer Stores Limited Partnership v. Franklin County Board of Revision; and Licking Heights Local School District Board of Education,* 122 Ohio St. 3d 447, 912 N.E. 2d 560 (July 22, 2009); available at http://bit.ly/2Ph93Qb.

8. *Meijer Stores*, paragraph 4.

9. "Abuse of discretion occurs when a court does not apply the correct law or if it bases its decision on a clearly erroneous finding of material fact. A court may also abuse its discretion when the record contains no evidence to support its decision." USLegal Inc., Legal Terms Dictionary, s.v. "abuse of discretion," https://definitions.uslegal.com/a/abuse-of-discretion/.

10. *Meijer Stores*, paragraph 28.

11. *Sharon v. Sharon*, 75 Cal. 1 (Cal. 1988).

12. *Murray v. Buell*, 74 Wis. 14 (Wis. 1889).

13. *Blakemore v. Blakemore*, 5 Ohio St.3d 217, 219 (1983), quoting *State v. Adams*, 62 Ohio St.2d 151, 157 (1980).

What Valuation Standards Tell Us about Big-Box Valuation

Valuation professionals serving as expert witnesses in ad valorem and condemnation cases have hard decisions to make, including (a) whether to accept a particular assignment, (b) proper identification of assignment elements, (c) identification of which definition(s) of value and ownership interest to be appraised and used, and (d) determination of the highest and best use of the subject. Underlying all these decisions must be compliance with professional ethical requirements.

To start, the definitions of *valuer* in the Standards of Valuation Practice of the Appraisal Institute (SVP) and of *appraiser* in the Uniform Standards of Professional Appraisal Practice (USPAP) are conceptually identical. SVP provides that a *valuer* is "one who is expected to provide Services in an **unbiased** and competent manner." (Page 4, emphasis added.) USPAP defines an *appraiser* as "one who is expected to perform valuation services competently and in a manner that is **independent, impartial, and objective**." (Lines 78–78, emphasis added.) This independence from clients and clients' objectives must underlie all valuation work. As stated in USPAP's Scope of Work Rule, "An appraiser must not allow assignment conditions to limit the scope of work to such a degree that the assignment results are not credible in the context of the intended use." (Lines 388–389) Appraisers are responsible for determining and performing a "scope of work ... necessary to develop credible [worthy of belief] assignment results." (Lines 379–380)

In big-box cases, some of the assignment conditions that valuers need to carefully consider, and not just accept from the client, include the concepts that case law indicates comparable data should not be adjusted, that the highest and best use is dictated by the existing tenant/user, or that fee simple analysis requires that the subject property is vacant and available for lease rather than that the subject property is leased at market-rent rates. These should be decisions made by the valuer after consideration of the client's opinions, and not automatic acceptance of instructions taken from the client. To do otherwise could be perceived as lack of appraiser independence.

Another ethical consideration is that the Competency Rule of USPAP requires "recognition of, and compliance with, laws and regulations that apply to the appraiser or to the assignment." (Lines 307–308) This means that valuers are required to ascertain if applicable laws or regulations include any definitions (of *fee simple*, for one example) or valuation methods that are required in that jurisdiction. The requirements may or may not be "jurisdictional exceptions"; that is a determination to be made on a case-by-case basis.

---

box stores as comparables without adjustment and for taking into account "the possibility that at some point the store could be held as a rental property subject to an above-market lease that would enhance its value."[14] The *Meijer Stores* court stated, "We have held that a recent arm's-length sale price should not be adjusted to remove the economic effect of such encumbrances when they exist… And we have also determined that a sale price does not have to be adjusted to remove the effect of above-market rent paid by a creditworthy tenant."[15] However, this is not support for the use of such properties as comparables without making any adjustments when appraising a property in the *fee simple estate* as that term is defined by the Appraisal Institute.

The *Meijer Stores* court accurately stated the difference between build-to-suit properties and the subject of that litigation:

> To be sure, the present case does not involve a build-to-suit situation. Meijer both owns and uses its property; it acquired the land and then constructed a store on it. By contrast, in the build-to-suit situation, the owner builds a structure to the tenant's specifications and then enjoys the benefit of rent under a long-term lease that provides the owner with recovery of the costs of construction and a profit.[16]

14. *Meijer Stores*, headnote 7.

15. *Meijer Stores*, paragraph 23.

16. *Meijer Stores*, paragraph 22.

The court did not base its decision on valuation theory when it held that build-to-suit properties and those leased to credit tenants should not be adjusted when appraising a property that was not a build-to-suit or rented to a credit tenant. It found these adjustments unnecessary based on the definition of *fee simple* the court applied in the matter, which was *not the same definition* used in the appraisal report in evidence. The *Meijer Stores* court did not state that it was opining on a particular valuation methodology, rather it stated it was applying a prior legal premise: "Moreover, by drawing the distinction between 'fee simple' and 'leased fee,' Meijer predicates its argument on a legal premise that our cases have rejected."[17] The court opinion then references footnote 4, which states as follows:

> 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. [Emphasis added.] 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.

The *Meijer Stores* court held that the comparable sale prices and rents should not be adjusted for differences in ownership interests or above-market rent rates based only on the court's having rejected the definition of *fee simple* used by the appraiser. That change in definition might arguably support the method preferred by the Ohio court, but it is not consistent with the body of knowledge of the appraisal profession.

Matter of the Equalization Appeal of Target Corporation

The analysis of the *Meijer Stores* opinion could also be applied to another retail store valuation appeal case, *In the Matter of the Equalization Appeal of Target Corporation, for the year 2015 in Sedgwick County, Kansas* ("*Target Stores*"). In *Target Stores*, the Kansas Court of Appeals held, among other things, that "[w]hen valuing property, an appraiser may determine the difference between the value of the property under a hypothetical vacant condition and its value as occupied in order to isolate the value of the taxable real estate separate and apart from the business being conducted on it."[18] However, before adopting this method as one recognized by the courts, a complete reading of the opinion is necessary. A close reading shows that this finding is based on the specific facts of this case. As discussed below, key factors in this court decision included the taxing authority's reliance on an earlier year's settlement values and reliance on carryover values to determine a current year's valuation.

In *Target Stores*, Sedgwick County appealed the Board of Tax Appeals' (BOTA) decision, arguing that the BOTA "erred in determining a proper value for the property." The appellate court found otherwise, as the BOTA relied on the appraisal evidence presented by the taxpayer and did not rely on the County's submission of carryover values from prior years. The County attempted to present oral testimony valuing the properties, but the appellate court appropriately held that an appraiser who had admittedly not appraised the properties could not present her opinions of value because those would not comply with USPAP. As stated in the *Target Stores* opinion, "BOTA found Target's evidence more compelling than the County's," and this was based on the fact that Target had presented appraisal testimony and the County had not.

As in *Meijer Stores*, the *Target Stores* court opinion held, in pertinent part, that the BOTA decision was not based on errors of fact and law, nor was it otherwise arbitrary, capricious, or unreasonable. The court's analysis found that the County had not met its burden of showing the BOTA had conducted itself inappropriately, concluding, "BOTA's valuation process was reasonable, and BOTA did not commit an error of law." It is possible, therefore, that the outcome of *Target Stores* might have been different if the County had presented appraisal evidence to BOTA, especially credible evidence, that served to refute

17. *Meijer Stores*, paragraph 23.

18. *In the Matter of the Equalization Appeal of Target Corporation, for the year 2015 in Sedgwick County, Kansas*, 410 P.3d 939 (Kan. Ct. App. 2017) ; available at http://bit.ly/2keEb49.

some or all of the appraisal evidence presented by Target. However, the County did not enter appraisal reports into evidence, and so the taxpayer's appraisal evidence prevailed.

Valuation Methods and Techniques for Single-Tenant Retail Properties

Perhaps the clearest way to sort the conflicting information from courts and expert valuation witnesses is to follow the guidance in valuation standards and begin with the identification of the appraisal problem to be solved. Both the Appraisal Institute's Standards of Valuation Practice (SVP) and USPAP direct valuers to start an assignment with problem identification. Problem identification is the basis for determining the appropriate type and extent of research and analysis for development of the opinion of value.

The SVP and USPAP list the same items to be identified; these are enumerated in SVP Standards Rule A-2 and USPAP's Scope of Work Rule. In each set of standards, the first four assignment elements to be ascertained are the client and any other intended users, the intended use of the report, the type and definition of value, and the effective date of value and other opinions. These elements usually are easily learned from the client and typically are not the cause of confusion or controversy. The focus of this article, however, is on identification of the other assignment elements specified in the standards: identification of "the subject of the assignment and its relevant characteristics" (USPAP) or "the property that is the subject of the appraisal and the interest in that property to be appraised; the characteristics of the subject property that are relevant to the type and definition of value and intended use of the appraisal" (SVP).

Valuation Considerations with Leased Property Interests

As discussed in *The Appraisal of Real Estate*, fourteenth edition, "sale of a property encumbered by a lease involves rights other than the complete fee simple estate, and valuation of those transferred rights requires knowledge of the terms of all leases and an understanding of the tenant or tenants occupying the premises."[19] For appraisal purposes, the simplest, most direct sales comparison is with sales of similar properties sold in the fee simple estate with the same highest and best use. If such sales are available, this method would require no adjustment for property rights. However, if there is a difference in the property interests of the subject and the comparable, then adjustments must be made. *The Appraisal of Real Estate*, fourteenth edition, advises:

> If the sale of a leased property is to be used as a comparable sale in the valuation of the fee simple estate of another property, the comparable sale can only be used if reasonable and supportable market adjustments for the differences in rights can be made. ...To compare [the] leased fee interest to the fee simple estate of the subject property, the appraiser must determine if the contract rent of the comparable property was above, below, or equal to market rent. ...Calculating an adjustment for differences in real property rights is also necessary when the subject property involves the fee simple estate but the comparable sale involves the leasehold interest. (Page 406)

Property Interests and Characteristics of Leased Single-Tenant Properties

The valuation of the fee simple interest of a leased big-box property is complex and challenging largely because the market participants are often institutional investors who do not typically participate in the market for properties that are not leased. There is existing guidance in the appraisal body of knowledge that can be helpful in this regard.

The single-tenant properties that this article addresses are commonly called "big-box stores" and are occupied by a national credit tenant. A *big-box store* is "a single-use store, typically between 10,000 and 100,000 square feet or more, such as a large bookstore, office-supply store, pet store, electronics store, or toy store."[20] These properties are typically either owner-occupied and (1) transferred through a non-arm's-length lease for financial reporting and risk-mitigation

19. *The Appraisal of Real Estate*, 14th ed., 381.

20. *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "big-box store."

reasons, (2) sold to an institutional investor as a sale-leaseback transaction,[21] (3) developed with a predetermined developer in a build-to-suit arrangement with the lease payment based on a cost-plus-return basis, or (4) sold as a part of the national triple net lease (NNN) institutional investor capital market, typically with a bondable lease with a credit tenant where the lease is the primary investment consideration.

The nature of the tenant in these transactions has financial implications, since a credit tenant is preferred by the investor-purchasers. As previously noted, a credit tenant has "a long history in business, strong financial statements, or a large market presence that could be rated as investment grade by a rating agency."[22] The appraisal process captures this positive attribute if the property is valued in the leased fee estate. The appraiser should identify the parties to each lease to ensure that the party responsible for rent payments is actually a party to the lease or the guarantor.

The challenge in appraising the fee simple interest of properties encumbered by leases is related to the fact that many available comparable sales of big-box properties include bondable leases where the lease reduces the risk of ownership and so increases value. As *The Appraisal of Real Estate*, fourteenth edition, notes, it is "important to ascertain that the lease represents a freely negotiated, arm's-length transaction. A lease that does not meet these criteria, such as a lease to an owner-tenant or a sale-leaseback, often does not provide a reliable indication of market rent. Since sale-leasebacks are actually financing vehicles, they should not be used in estimating market rent."[23]

Keep in mind, however, a cautionary note of *The Appraisal of Real Estate*, fourteenth edition, which states, "**Federal or state law often requires appraisers to value leased properties as fee simple estates, not leased fee estates, for eminent domain and ad valorem taxation.** When the fee simple interest is valued, the presumption is that the property is available to be leased at market rates."[24] (Emphasis added). When the ownership interest appraised is *fee simple*, defined for appraisal purposes 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,"[25] then any additional value created by lease terms or the guarantee of a credit tenant are not taken into account. Under this fundamental appraisal principle, "A lease never increases the market value of real property rights to the fee simple estate. Any potential value increment in excess of a fee simple estate is attributable to the particular lease contract."[26] However, this is only the case in jurisdictions that use the Appraisal Institute's definition of *fee simple*. Valuers must take care to learn the appropriate definition of *fee simple* in the relevant jurisdiction, and to analyze data consistently with the definition of the estate being valued.

Role of Risk

The investment nature of big-box properties is significant because the interest to be valued depends on the intended use and intended user of the appraisal. Investment-grade properties[27] typically transact within a specific market of buyers (institutional investors) with considerations (the lease and what it adds in value due to risk reduction) in addition to the underlying fee simple real property rights. The underlying real estate is only a portion of what the investor is purchasing; a long-term NNN lease with a credit tenant is also included in these transactions. An institutional investor is unlikely to consider purchasing a big-box property without a bondable lease with a credit tenant since this class of investor is seeking an investment that does not require intensive

21. A *sale-leaseback* is "a transaction in which real property is sold by its owner-user, who simultaneously leases the property from the buyer for continued use. Under this arrangement, the seller receives cash from the transaction and the buyer is assured a tenant." *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "sale-leaseback."

22. *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "credit tenant."

23. *The Appraisal of Real Estate*, 14th ed., 466.

24. *The Appraisal of Real Estate*, 14th ed., 441.

25. *The Dictionary of Real Estate Appraisal*, 6th ed., 90.

26. *The Appraisal of Real Estate*, 14th ed., 441.

27. An *institutional-grade property* is defined as "a property of sufficient size and stature to merit attention by large national or international investors." *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "institutional-grade property."

management. An institutional investor is usually seeking an investment with a stable cash flow that minimizes real estate risk due to the nature of the lease; this is accomplished through a bondable lease and the increased credit rating and liquidity that bonded leases provide.

In valuation of single-tenant big-box properties, the appraiser must have an understanding of the risks associated with the parties to the lease and the lease arrangement. In general, risk increases as the range of possible outcomes grows, and the rate of return necessary to attract investment increases as risk levels increase.[28] This point is specifically demonstrated with NNN (triple net lease) capitalization rate studies regularly published by national NNN brokerage firms,[29] which show rates increasing as the remaining term of the lease decreases. The credit quality of the tenant also impacts the capitalization rate, with the higher-credit, lower-risk national tenants indicating lower capitalization rates than local franchisees.[30]

The value of most traditional real estate investments is based exclusively on the real estate itself. A single-tenant, net-leased property's value, however, is influenced by the tenant's credit, the length of the lease, lease escalation clauses, and the real estate. Each of these characteristics will affect the property's value to investor-buyers.

The investment community has historically referred to bondable leases as "hell or high-water leases," meaning that no matter what occurs with regard to the leased property, the lessee is obligated to continue to pay rent even if the building is destroyed and may even be obligated to rebuild the building if it is destroyed. The payment of taxes, utilities, maintenance, insurance, and environmental and lease obligations are the responsibility of the lessee. The lease often includes provisions ensuring that the lease cannot be terminated without the consent of all lenders holding liens on the property. These characteristics provide sustainability and reduced risk for the institutional-grade investor that do not exist under a typical fee simple ownership. This shift of risk is what changes the underlying investment from a typical real estate fee simple or leased fee investment into an institutional-grade lease-backed investment suitable for inclusion in an institutional portfolio.

The "Go Dark" Valuation Theory

The term *go dark*[31] evolved from the "dark-store clause" historically found in many retail leases. A lease's *dark-store clause* is

> a clause that states that the tenant must continue to occupy the site throughout the term of the lease and is barred from opening a competitive store within a certain period after the expiration date of the lease. A dark store clause protects a landlord, whose property could be put in a poor releasing position if a tenant moves out and opens another store within the same trade area. A dark store clause may be especially important in a percentage lease involving an anchor or other major tenant.[32]

Non-occupancy by the anchor tenant creates problems for landlords because many small tenants choose the space they lease based on the major anchor tenant being in place and generating traffic to their location. If the anchor tenant leaves, the smaller or in-line store tenants lose the benefits of being in the same center.

This type of lease clause evolved into the "go dark theory," requested by lenders who recognized that the bondable lease created value over and above the typical fee simple rights in a property. The lenders wanted a value as if the property had been vacated and was available for lease in order to assess risk on the underlying real property mortgage loan collateral. The resulting assignment was commonly referred to as a "go dark" valuation. In other words, lenders would engage a valuer to appraise the property without consideration of the lease in place, as if the space had "gone dark."

28. *The Appraisal of Real Estate*, 14th ed., 158.

29. There is a recognized market segment comprised of buyers, sellers, and users of single-tenant properties encumbered by triple-net leases. See, for example, Net Lease Advisor, www.netleaseadvisor.com.

30. "Net Lease 101," https://www.calkain.com/net-lease-101/.

31. The terms "go dark" and "dark store" are used interchangeably by market participants.

32. *The Appraisal of Real Estate*, 14th ed., 475.

The go dark valuation method was subsequently adopted in appraisals for ad valorem property tax appeals for properties that typically sold subject to a lease where the fee simple is the estate required for the tax appeal valuation. There are complexities in the valuation of a fee simple interest in a property type that typically sells subject to its existing lease (leased fee), especially when the leased fee transfer includes a bondable lease, a build-to-suit, or a sale-leaseback situation. Any additional value created by the lease over the value of the underlying fee simple interest in the physical property needs to be considered. There are two valuation options generally used by valuation professionals for appraising such a property: either assume the property is available for lease or assume it is leased to market occupancy at market rents and terms. That said, there are some fundamental best practices to consider when using either assumption, and there are a number of tests of reasonableness that can help the valuation professional.

Tests of Reasonableness

As with any complex appraisal or review assignment, one or more tests of reasonableness can be used as a check of the preliminary conclusions and support of the final value opinion. Value opinions may best be supported in these big-box assignments with such checks because the ownership interest appraised (fee simple) is not what is typically sold in the marketplace. Keep in mind that none of the tests of reasonableness is best in every case, and none is available in every circumstance for various reasons. However, their use either individually or together as appropriate can provide a check and balance that may increase the credibility of opinions presented in an appraisal or review report.

Functional Obsolescence Test. In a functional obsolescence test, the valuer develops a properly prepared cost approach with consideration of any existing functional obsolescence, including that caused by specialty design or branding. The challenge with this test is that most improvements of this nature are not constructed on a speculative basis, and the principle of substitution—that purchasing vacant land and constructing a similar property is an alternative to purchasing the subject—has less credence. Nonetheless, the functional obsolescence test will assist in the allocation of total value to that part of the property not affected by the lease. *The Appraisal of Real Estate*, fourteenth edition, addresses the crux of the matter. It states as follows:

> The application of the cost approach produces a value indication of the fee simple estate of a property at market rent and stabilized occupancy. If a property is not at market occupancy or not at market rent, then an adjustment may need to be made to the indicated value in the cost approach. This is usually called a property rights adjustment. (Page 638)

Feasibility Rent Test. A properly developed cost approach can be used to derive a feasibility rent for comparison with the market rent applied in the appraisal report and for comparison with the contract rent. *Feasibility rent* is "the rent needed for a property to be worth its cost,"[33] and "in a balanced market, feasibility rent will be the same as market rent."[34] Not many markets are in balance, and no market is always balanced, so this is not a situation that is frequently seen.

Comparable Rent for Space Test. The valuer can examine the local market for similar properties that are leased and have similar uses and location but do not have a lease structured on a build-to-suit basis including cost plus a return with credit tenant company guarantees. In other words, the valuer uses market rents based upon comparable "rent for space" with a similar location and use.

Similar location and use are the most important criteria in this test. Seeking similar rents is no different from looking for similar sales with respect to highest and best use and location. Some appraisers have incorrectly described this as a "second-generation rent"[35] in expert appraisal

33. E. Nelson Bowes, *In Defense of the Cost Approach: A Journey into Commercial Depreciation* (Chicago: Appraisal Institute, 2011), 108.

34. *The Appraisal of Real Estate*, 14th ed., 639.

35. *The Dictionary of Real Estate Appraisal*, 6th ed., defines *first-generation space* as "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"; *second-generation space* is defined as "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*."

reports and related court testimony. The concept of the "generation" of the user can cause confusion and is not the determining factor for whether a property is an appropriate comparable or not. Some appraisers may eliminate "second-generation" user properties based on the assumption that retail demand within the neighborhood has diminished. However, this may not be true and should not be assumed without market evidence and sale verification. Appropriate due diligence should be undertaken to understand the motivations for the previous owner's decision to vacate the property as well as consideration of key locational factors within the area compared to the subject. Consider the case of a Walmart Marketplace retail store that sold to Hobby Lobby, with Walmart intending to construct a new Walmart Supercenter across the street because sales at the smaller store warranted the increased size. Walmart's motivations for vacating the space were related to location but in a positive way.

Conclusions developed in the market analysis process will reveal key locational attributes for comparison to potential comparables, including retail demand and other attributes within each market area. This comparison will support the conclusion regarding potential differences in location between the subject and potential comparables as well as adjustments to comparables with similar highest and best use but superior or inferior locational attributes that can be measurably distinguished. Therefore, a negative location change should not be assumed in a fee simple sale/transaction. The ultimate test is whether the sale location would be a suitable alternative in the eyes of the most probable user of the subject property. Sale verification with both buyers and sellers plus location analysis are imperative to understanding the motivations of the parties and transfer details. Further, rents obtained from properties that have similar attributes without the inclusion of any credit tenant company guarantees are more desirable comparables.

Capitalization Rate Test. Reasonableness can be tested using capitalization rates extracted from properties that have a similar highest and best use where the existing lease was not based on cost-plus-a-return with credit tenant guarantees. The effect that credit tenant company guarantees have on capitalization rates is well documented in national net lease broker published studies.

Two observations on capitalization rates are consistent and significant. The first is that rates increase as the lease term decreases due to the lease nearing expiration. The second is that transactions of otherwise similar properties leased by tenants with different credit ratings produce different capitalization rates. Simply put, remaining lease terms and credit ratings affect capitalization rates.

Research reports on institutional-grade property can be used to illustrate the relationship between capitalization rates and lease terms and tenant types. For example, the Boulder Group, a consulting firm specializing in single-tenant net lease properties,[36] provides research reports on institutional-grade properties, including its *Net Lease Tenant Profiles* report.[37] This report covers almost 80 tenants, reporting information such as current Standard and Poor's credit ratings, years remaining on the lease, and price information. The chart in Exhibit 1 uses data extracted from that report related to the big-box and small-box retail property tenants. Note that in each tenant profile the capitalization rates increase measurably as the remaining lease term decreases. For example, the tenant Walmart increases 160 basis points from 20 years remaining to 5 years remaining, and Lowe's and The Home Depot show 170 and 175 basis point increases, respectively, from 20 years to 5 years remaining on the lease.

The same trends appear in other research reports. For example, in the *2018 Quarter 4 Net Lease Big Box Report*, also published by The Boulder Group, the research likewise indicates increased capitalization rates for non-investment-grade versus investment-grade tenants.[38] The chart in Exhibit 2 shows capitalization rates for investment-grade tenants versus non-investment-grade tenants, with the rates ranging up to 50 to 80 basis points higher for the same remaining lease term. The report's data also indicates a

36. The Boulder Group, founded in 1997, reports that it has arranged the acquisition and disposition of over $5 billion of single-tenant net lease real estate transactions; see http://bit.ly/2LamqNL.

37. Report available at http://bit.ly/2019TenantProfiles.

38. Report available at http://bit.ly/Q4-2018NetLease.

Exhibit 1 Net Lease Tenant Profiles, Credit Ratings, and Capitalization Rates by Remaining Term

Tenant	S & P Credit Rating	Capitalization Rate (%) 5-Year Term	10-Year Term	15-Year Term	20-Year Term
Best Buy	BBB	8.25	7.25	N/A	N/A
BJ's Warehouse	B	7.40	6.85	6.40	6.00
Dollar General	BBB–	8.45	7.75	6.90	N/A
Dollar Tree	BBB–	7.50	6.85	N/A	N/A
Family Dollar	BBB–	8.50	7.50	N/A	N/A
Kohl's	BBB–	8.50	7.25	6.50	6.35
Kroger	BBB	7.25	6.75	6.25	6.00
Lowe's	BBB+	6.70	6.10	5.45	5.00
Sherwin-Williams	BBB	6.75	5.90	N/A	N/A
The Home Depot	A	6.75	6.00	5.40	5.00
United Rentals	BB	8.15	7.25	N/A	N/A
Walmart	AA	6.75	5.90	5.50	5.15
Whole Foods Market	AA–	5.50	5.15	4.60	4.25

Source: *2019 Net Lease Tenant Profiles*, The Boulder Group

Exhibit 2 Median Asking Capitalization Rates by Tenant Type and Remaining Term

Big-Box Tenants	Median Asking Capitalization Rate (%) 5 Years and Under Remaining	6–10 Years Remaining	11–15 Years Remaining	16–20 Years Remaining
Investment Grade	7.05	6.65	6.20	5.50
Non-Investment Grade	7.70	7.23	7.00	6.00

Source: *2018 Quarter 4 Net Lease Big Box Report*, The Boulder Group

similar trend for higher capitalization rates on shorter remaining terms for each category.

The preferred leases in the institutional investment world are those with no management responsibilities, investment-grade credit tenants, and leases guaranteed by those credit tenants. These three factors reduce risk, stabilize cash flow, and increase liquidity. Historically, institutional investors have been attracted to such investments as they believe the lack of management and reduced real estate–related risks make these investments more similar to a bond than other real estate investments. This is why the assignment to appraise one of these properties without these three attributes in place (i.e., as fee simple unencumbered by a lease) can be very challenging indeed.

What Type and Definition of Value?

Identifying the type and definition of value in an assignment is a basic element in problem identification as required by valuation standards. There are thousands of ad valorem tax districts in the United States and each one has its own rules. Most jurisdictions require market value to be appraised, but some jurisdictions require "use value."[39] Some other jurisdictions rely on market value in most cases but specify use value for certain property types. The requirements run the gamut, and this is only as to the type of value to be appraised. Once the valuation professional is certain of which type of value is required in an assignment, the next question is, which definition of that type of value should be employed. Each type of value (*market value*, *fair market value*, *value in use*, and so forth) has more than one definition. The distinctions may be subtle, but they do influence the outcome.[40]

What Effective Date of Value?

In most instances, assignments for ad valorem tax appeal require a retrospective effective date of value, which may increase the complexity of the assignment. The farther in the past the date of value, the more difficult verification of data becomes. In addition, appraisers must not allow their knowledge of market trends subsequent to the date of value to influence their analyses and conclusions; it is often difficult to draw a sharp line delineating conditions at the date of value. And, while most ad valorem tax assignments require the date of value to be January 1 of any given tax year, some dates of value are on a fiscal-year basis. Because many taxpayers appeal more than one year at a time, particular care must be used in selecting comparable sales and rents that occurred after the earliest date of value in the assignment. Sometimes that data can be used for additional support or to demonstrate a trend that would have been perceived in the market before the date of value, but some or all of the data may not be appropriately used in the development of a value conclusion.

When developing an appraisal with multiple dates of value, appraisers should use caution in selecting comparable data. Data may be appropriate to support the conclusion for one date of value but not for one or more of the others. Further, if market trends were changing over the relevant period, the data used for different dates of value may create the impression of internal inconsistencies within the expert appraisal report.

The Ownership Interest Appraised and Comparable Selection

The issues that cause most of the complexity in single-tenant retail assignments are identifying the ownership interest to be appraised and selecting appropriate comparables. As previously mentioned, many jurisdictions specify valuation of the fee simple interest, some specify the leased fee, and some require the fee simple to be valued but require consideration of existing leases. When the ownership interest appraised is the fee simple estate of a property occupied by a credit tenant and generally sold as leased, there are best practices to consider. *The Appraisal of Real Estate*, fourteenth edition, notes that

> Income-producing real estate is often subject to an existing lease or leases encumbering the title. By definition, the owner of real property that is subject to a lease no longer controls the complete bundle of rights, i.e., the fee simple estate. If the sale of a leased property is to be used as a comparable sale in the valuation of the fee simple estate of another property, **the comparable sale can only be used if reasonable and supportable market adjustments for the differences in rights can be made**. (Page 406, emphasis added.)

The use of leased fee sales as comparables can be a challenge in the appraisal of a fee simple interest. To summarize what was discussed earlier, fee simple sales would generally be preferable for the appraisal of the fee simple interest on a leased property, but that raises questions regarding highest and best use. Market analysis and highest and best use analysis are the basis for selection of appropriate comparable sales. The three-part conclusion of use, user, and timing in the highest and best use analysis is the basis of the sales comparison approach.

Many properties are sold with deed restrictions on use, which must be considered, and many properties are sold because the business location demographics have deteriorated to the point that the retailer has moved to another retail location. As a result, comparable sale verification is critical to

39. *The Dictionary of Real Estate Appraisal*, 6th ed., uses the same definition for *use value* and *value in use*. That definition is "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/Use value] may or may not be equal to market value but is different conceptually."

40. See, Michael V. Sanders, "Market Value: What Does It Really Mean?" *The Appraisal Journal* (Summer 2018): 206–218 for a discussion of some of these distinctions.

understand the motivations of both the buyer and seller. Additional work is required to compare the business location suitability for the retail use of the subject and the properties selected as comparable sales. Interviews of institutional investors indicate that their purchase criteria include a preference for a leased property with a credit tenant rather than a property that is available for lease.

Most demographic services provide the data needed if the appraiser has the skills to perform the analysis to determine if the comparable sales have the same highest and best use as the subject. Market analysis is inseparably linked to highest and best use analysis. The Appraisal Institute teaches that "since highest and best use analysis establishes what is being valued, it is the foundation of all market value appraisals."[41] For example, in the cost approach, "an accurate and detailed analysis of highest and best use is critical … because the comparison of the existing improvement and the ideal improvement based on the highest and best use identifies any forms of depreciation that are present in the building."[42]

Market analysis is a critical part of a highest and best use analysis. In the case of a leased property being appraised in the fee simple estate, market analysis is used to ensure that the comparable sales have a highest and best use similar to that of the subject property. As *The Appraisal of Real Estate*, fourteenth edition, notes,

> For each type of property, demand analysis focuses on the end product or service that the real estate provides. For example, a demand analysis for retail space would attempt to determine the demand for retail services generated by potential customers in the market area. (Page 303)

In some cases, the demand can be measured by inferred analysis with use of subject historical performance, historical location trends, population and income growth trends, and similar retail use sales trends—in other words, forming opinions of future market behavior based on past behavior. Fundamental demand analyses may also be needed in those cases where inferred analysis is not conclusive. Fundamental demand analysis quantifies future market behavior by developing a forecast based on a determination of the primary trade area and estimates of sales per capita for a similar category of retail use. Not all valuation professionals have the skill set to perform this analysis.

When developing an income approach analysis for such properties, care should be given to both the appropriate market rent and the capitalization rate applied. "In fee simple valuations, all rentable space is estimated at market rent levels. Any rent attributed to specific leases is disregarded in the income analysis."[43] The same caveat applies to the selection of an appropriate capitalization rate. Therefore, the use of rates extracted from leased fee sales where the lease is bondable without appropriate adjustment would not be appropriate for the valuation of the fee simple ownership interest in a property.

Finally, a repeated word of caution on assumptions about what fee simple means. The Appraisal Institute definition of *fee simple* is centered on having control of the entire bundle of rights associated with property ownership. However, the relevant tax jurisdiction may require a different definition to be used that is specified by regulation, statute, or case law. If that is the case, the appraiser should use the appropriate definition for that jurisdiction. USPAP's Competency Rule requires "recognition of, and compliance with, laws and regulations that apply to the appraiser or to the assignment."[44] Simply put, the appraiser has the obligation to learn if the relevant jurisdiction has specific definitions of *market value*, *fee simple*, and other terms that are used when appraising property for specified purposes.

Conclusion

The reason valuing big-box properties in fee simple is so complex is that big boxes are not typically constructed for speculative purposes or transacted in the institutional-investor marketplace without a lease in place. Since valuation professionals are charged with reflecting the

41. Appraisal Institute Course Manual, *General Appraiser Market Analysis & Highest and Best Use* (Chicago: Appraisal Institute, 2008), Part 1-4.

42. *The Appraisal of Real Estate*, 14th ed., 565.

43. *The Appraisal of Real Estate*, 14th ed., 447.

44. USPAP, Lines 307–308. The Jurisdictional Exception Rule of USPAP includes "constitutions, legislative and court-made law" within term *law*. Lines 418–420.

activity of market participants when appraising market value, it makes their work that much more difficult when they are required to value something that the market participants—the institutional investors described in this article—do not buy, sell, or use. But if valuation professionals remember the basics and maintain their professional independence, determine the acceptable scope of work, and reach credible assignment results, they can maintain the public trust in the profession. One way to support and increase credibility is to include one or more tests of reasonableness in the analyses and reports. It is when appraisers abdicate their basic responsibility of independence and competency, and follow client instructions that may not be supported by recognized methodologies or law, that they risk producing work that appears to be biased. Remember that in litigation matters attorneys are the clients, and as legal counsel they have an ethical requirement to seek the best result for their clients. That required advocacy is in direct opposition to the valuer's requirement to remain objective and unbiased. USPAP requires appraisers to "be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal."[45] If a valuer accepts the client-attorney's interpretation of required methods, techniques, and definitions, he or she should do so only after consideration of the appropriateness of the client's interpretation. Automatic acceptance of instructions from the client could be perceived as lack of appraiser independence.

About the Authors

Leslie P. Sellers, MAI, SRA, AI-GRS, is principal appraiser and owner of Sellers and Associates Valuation and Advisory Services in Clinton, Tennessee. He holds a bachelor of science degree in real estate and urban development from the University of Tennessee at Knoxville. He has been an active real estate appraiser, broker, and developer since 1973, and his work has included the development of office complexes, multifamily residential, industrial, and single-family subdivisions through his company, Sellers Land and Development Company LLC in Clinton. Sellers is a long-standing member of the Appraisal Institute education faculty and has taught real estate valuation courses and seminars for the Appraisal Institute in nineteen states, Puerto Rico, Kuwait, and the People's Republic of China. He has served as chair of the Appraisal Institute Body of Knowledge Committee, the Professional Standards and Guidance Committee, and the International Committee. He is an author and coauthor of seminars and has acted as a reviewer on Appraisal Institute courses, seminars, and publications. He was an author-contributor to the fourteenth edition of *The Appraisal of Real Estate* and was the recipient of the Appraisal Institute's Lifetime Achievement Award in 2018. Sellers served as president of the Appraisal Institute in 2010. He has testified before the US Congress and presented to the United Nations on real estate valuation, and he has served as a resource in the national press for stories in CNBC, CNN, the *Wall Street Journal*, and numerous other publications. He also served from 2011 through 2016 on the International Valuations Standards Council Advisory Working Group. **Contact: leslie@sellersvaluation.com**

Paula K. Konikoff, JD, MAI, AI-GRS, holds bachelor of science and law degrees as well as the MAI and AI-GRS designations. She is a real estate consultant providing clients with expert litigation/arbitration and other real estate consulting services nationwide. Her expert testimony includes damages claims, the bankruptcy of an international theater owner, SEC actions regarding bond funded developments, portfolios of securitized residential loans for plaintiffs and defendants, and appraiser liability cases for plaintiffs and defendants, and she has qualified as an expert in pension real estate investments. Konikoff serves as an arbitrator and is a member of the AAA and FINRA rosters of neutrals. She is an adjunct professor at New York Law School, a certified USPAP instructor, and a certified instructor for the Appraisal Institute. Konikoff has served as chair of the Appraisal Institute's Professional Standards and Guidance Committee, as a member of the development team for the *Review Theory—General* and *Review Case Studies—General* courses, and as a reviewer of Appraisal Institute books. She is author of the Appraisal Institute's text *Appraisers in Arbitration* and authors articles for the Appraisal Institute and other professional publications. She also contributed two chapters to the legal treatise "Negotiating and Drafting Office Leases." She served on the Appraisal Standards Board (ASB) from 2003 to 2009 and was twice vice chair of the ASB. **Contact: pkonikoff@psnyc.us**

45. USPAP, Standards Rule 1-1, Lines 430–431.

Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute

- **Education**
  http://www.appraisalinstitute.org/assets/1/7/aiedcat.pdf
- **Lum Library External Resources Knowledge Base [Login required]**
  - Information Files—Taxation and assessment
  - Information Files—Value
- **Property Rights Symposium Discussion Paper**
  http://bit.ly/SymposiumPaper

Calkain—Net Lease Investments Explained
https://www.calkain.com/net-lease-101/

CCIM Institute Site to Do Business
https://www.stdb.com/

Federal Reserve of St. Louis, FRED Economic Data
https://fred.stlouisfed.org/

National Real Estate Investor—*Net Lease Trends Reports*
https://www.nreionline.com/nrei-research-series/net-lease-trends