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From the Editor-in-Chief
Stephen T. Crosson, MAI, SRA

Meeting Special Valuation Challenges

Dear Readers:

Welcome to the Fall 2021 issue of The Appraisal Journal. Despite continued pandemic-related challenges, the Appraisal Institute has carried on its important work in development of the profession’s body of knowledge. In this issue of the Journal, we are pleased to offer articles related to these latest efforts as well as on evolving topics.

We have three peer-reviewed feature articles aimed at helping appraisers who face unique valuation challenges. The cover article, “Appraising Restaurants: Highest and Best Use Analysis,” from the Institute’s Guide to Appraising Restaurants, informs readers about the opportunities and risks inherent in restaurant operations and how these factors affect the highest and best use analysis and ultimately the real property value. The second feature, “Wind Project Valuation and Repowering,” revisits an emerging topic addressed in the Winter 2021 issue: valuation of maturing renewable energy projects. In the current article, the author describes factors that impact the valuation of wind projects that are being considered for repowering. Repowered projects may be eligible for federal tax credits depending on the percentage of the project that is new after the repowering. The third article, “Valuation of Accessory Dwelling Units,” based on the Institute’s seminar Valuation Overview of Accessory Dwelling Units, discusses the emerging acceptance of this housing choice and its growth due to excess housing demand and decreases in housing affordability.

In this issue, we also present a “Notes and Issues” column with a behind-the-scenes look at what’s inside the new seventh edition of The Dictionary of Real Estate Appraisal. The updated Dictionary reflects wording adopted by the Appraisal Institute Board of Directors that has been integrated into The Appraisal of Real Estate, fifteenth edition. As usual, you will also find here the popular “Cases in Brief” column, with its discussion of the latest state court decisions on interesting and unusual issues.

Finally, I wish to recognize the significant contributions of the late Arthur Gimmy, MAI, to the valuation profession. Art served as both a member of the Editorial Advisory Board and a reviewer for The Appraisal Journal. Art was the author of ten Appraisal Journal articles and eight Appraisal Institute books. He was a friend and mentor to many in our profession.

As always, we encourage you to consider becoming a contributor to The Appraisal Journal.

Stephen T. Crosson, MAI, SRA
Editorial Board Chair and Editor-in-Chief
The Appraisal Journal
Lucille Ray purchased a house on College Avenue in Rock Hill, South Carolina (the City) in 1985. The house was built in the 1920s, and unknown to Ray, a 24-inch underground terra cotta pipe was located under the property. There is no recorded easement for the pipe or evidence of who installed it, but it is roughly 100 years old.

The property and the pipe are located at the topographical low point of a 29-acre watershed. The City installed and owned three stormwater pipes that collect and transport water into a catch basin under College Avenue directly in front of Ray’s house, and the pipe under her house is connected to the catch basin. So, when water reaches the catch basin, it is channeled through the pipe under Ray’s house.

Ray had some indications that something was unusual with her property. In 1992, a gardener fell waist-deep into a sinkhole in her backyard. And Ray twice had to hire a contractor to repair damage from bending and movement of the roof frame. Finally, in 2008, Ray noticed the steps on the front porch were sinking, and after contacting the City, she learned of the underground pipe.

In November 2012, Ray sued the City alleging inverse condemnation and trespass, as well as injunctive relief, alleging that the foundation shifting of her home was caused by water running through the century-old pipe. Just after Ray’s lawsuit was filed, the City began maintenance work on a sewer line beneath College Avenue. To access the sewer line, the City disconnected the three stormwater pipes connected to the catch basin, which temporarily stopped the flow of water into the pipe under Ray’s house. Shortly thereafter, Ray’s attorney sent a letter to the City demanding that it not reconnect the stormwater pipes since that would resume the flow of water under Ray’s property. The City reconnected them anyway. It was this reconnection that Ray alleged was an affirmative act forming the basis of her inverse condemnation claim.

After the city filed for summary judgment, the circuit court dismissed most of Ray’s claims, including the inverse condemnation claim on the grounds that the City committed no affirmative act. The court of appeals, though, reversed the grant of summary judgment, because there existed a genuine issue of material fact as to whether the City engaged in an affirmative act. The City appealed to the state supreme court.

An inverse condemnation occurs when a government agency commits a taking of private property without exercising formal eminent domain powers. The court of appeals held that there was a disputed issue as to whether the City’s reconnection of the pipes constituted an affirmative act after admitting it had no easement and after Ray told the City not to reconnect the pipes.
The City argued its refusal to comply with Ray’s demand was a failure to act, rather than an affirmative action, but the South Carolina Supreme Court disagreed. When the City reconnected the three pipes to the catch basin, it directed water into the basin and through the pipe. The court also concluded that Ray presented evidence that the reconnection resumed the flow of water through the pipe and caused damage to her property. That action could reasonably be considered an affirmative, positive, aggressive act by the City.

A twist in the case, though, was that Ray became aware of the potential damage in 2008 when her steps sagged and the City informed her of the pipe under her house. She filed suit more than three years later, so her claim for damages occurring before that point was barred by the statute of limitations. But because the City reconnected the sewer pipes days after the suit was filed, she had a new claim for damages for inverse condemnation. The court reiterated, though, that Ray’s damages are limited to damage occurring to Ray’s property as a result of the reconnection of the pipes to the catch basin, not to any damages occurring before that point.

The court observed that Ray had submitted a report from a structural engineer opining that the increased water flow into the pipe would create a risk of increased structural damage to the house. This report created a genuine issue of material fact as to whether the City’s reconnection of pipes caused damage to the property distinct from the damage caused by the flow of water into the pipe before that point. Thus, the state supreme court affirmed but modified the court of appeals’ decision remanding the case to the circuit court for a trial.

Ray v. City of Rock Hill
South Carolina Supreme Court
August 4, 2021
2021 WL 3378945

Transfer tax exclusion does not apply where deed executed before transfer of mortgage assignment in multistep foreclosure action

The First Savings Bank of Perkasie (Bank) loaned Robert and Rebecca Bodkin $755,000 evidenced by two promissory notes and secured by two mortgages on their commercial property in Sellersville, Pennsylvania. The Bodkins fell into default of the notes and mortgages. On July 31, 2015, the Bank executed two mortgage assignments to Tuna Management LLC (TM), and on September 8, 2015, the mortgages were assigned again to M6 Realty LLC (M6). Between those two dates, M6 agreed to accept the deed to the property as payment in full for the mortgages, as reflected in an undated “Deed in Lieu Agreement.” The deed was executed September 3, 2015, days before the mortgages were assigned to M6.

On November 5, 2015, M6 recorded all of the documents from the transaction: the mortgage assignments from the Bank to TM, the mortgage assignments from TM to M6, and the deed itself. No realty transfer tax was paid at that time. But the next year, Pennsylvania’s Revenue Bureau issued a notice of assessment of transfer tax due. M6 appealed to the Board of Appeals and then to the Board of Finance and Revenue, but those appeals were all denied, so M6 appealed to the commonwealth court.

On appeal, M6 argued that, when it recorded the deed, the county recorder properly imposed no transfer tax. M6 argued the transfer was exempt from transfer tax because foreclosure transactions are specifically excluded from the tax and that at the time of the recording M6 was a holder of a mortgage in default.

The court began by analyzing the tax’s enacting statute. That statute imposes a tax on “every person who makes, executes, delivers, accepts or presents for recording any document,” and the tax “shall be payable at the earlier of the time the document is presented for recording or within 30
days of acceptance of such document.” In an earlier case, the court held that the event that triggers the tax is the recording of the deed.

However, the court observed that it had also repeatedly held that the transfer tax is a tax “upon the transaction, the transfer of title to real estate as evidenced by a document that is presented to be recorded.” Thus, it is the transaction that is taxed, not the recording. Accordingly, the transaction’s nature at the time the transfer occurs is what determines whether the transaction is taxable. So, the exemption only applied in this instance if, when the transfer of the property to M6 occurred, M6 was the holder of a bona fide mortgage in default in lieu of a foreclosure.

Here, the evidence showed that the deed to M6 was executed five days before it was assigned the mortgages by TM. At the time M6 executed the deed, the mortgages were held by TM. Thus, at the time of the pertinent transfer, M6 was not the holder of a mortgage in default in lieu of a foreclosure, and the exception did not apply.

The court’s majority and a dissenting judge had significantly different views of the transaction. The dissent argued that all of the events were part of a single transaction that, when viewed as a whole, indicates M6 stepped into the shoes of the Bank and assumed the Bank’s rights under the Bodkins’ promissory notes and mortgages. And then, rather than commencing a judicial foreclosure against the Bodkins to obtain title, M6 entered into a deed in lieu agreement and accepted the deed in lieu of foreclosure. To the dissent, this was clearly a foreclosure transaction excluded from the transfer tax.

The majority disagreed with the dissent’s view of the transaction. Apart from the title of the document, the deed otherwise made no reference to the release from the mortgage obligations and, by its own terms, granted, bargained, and sold the property to M6. Given the deed’s substantive language, its title does not control. Moreover, the statute’s language plainly indicates that the sequence of the transactions matters. Thus, because M6 acquired the deed before it acquired the mortgage assignments, the court concluded that transfer tax applied to the transaction.

M6 Realty LLC v. Pennsylvania
Commonwealth Court of Pennsylvania
August 4, 2021
2021 WL 3377560

Rezoning denial may constitute a compensable taking if owner holds property interests that it claims were taken

For over fifty years, the Andrews family has owned three contiguous parcels of land in Mentor, Ohio, totaling about sixteen acres. The property is currently held by a family trust (Trust). It sits near the terminus of a parkway completed in 2006, which ultimately connects to an interstate highway via a nearby interchange. The completion of the parkway and interchange dramatically changed the character of the area. What was once a rural residential area is now a mixed-use area with industrial, office, medical, and residential uses.

Given this change, the Trust began to explore developing its property for residential use. Its property is presently zoned “Single Family R-4,” which allows for low-density single-family residences with lots of at least half-an-acre. A rezoning to “Village Green RVG,” however, would allow for higher-density residential development with designated open space. Under the Single Family R-4 zoning, the Trust could develop only 13 single-family residences, worth $1.56 million. Rezoned, the Trust could develop 40 single-family residences, worth $4 million.

In 2019, the Trust applied for rezoning of its property and approval of a 40-unit subdivision, with a plan nearly identical to that of another development approved in 2017. But the Mentor City Planning Commission recommended denial of the Trust’s application, and the city council
agreed. The Trust filed suit, alleging violations of the Fifth and Fourteenth Amendments and seeking compensatory and punitive damages for a taking. The City moved for judgment on the pleadings, arguing that the Trust’s lack of a property interest in its rezoned land was fatal to the Trust’s claims. The district court granted the City’s motion, reasoning that the Trust lacked a property interest in its land as rezoned because rezoning is a discretionary benefit. The Trust appealed.

Before the court of appeals, the Trust argued that the lower court erred because the Trust’s ownership of the sixteen acres is a sufficient property interest to support its takings claim. The Trust’s takings claim is a regulatory taking, a category of takings that concerns land-use regulations. A total regulatory taking occurs when a land-use regulation deprives the land of all economically beneficial use. A taking also occurs when the regulation allows for some beneficial use, but a complex of factors—the impact of the regulation on the claimant, interferences with investment-backed expectations, and the character of the governmental action—indicates a taking has still occurred. The Trust asserted both kinds of regulatory takings claims.

The lower court reached its conclusion by adopting due process case law that provides that a party cannot possess a property interest in the receipt of a state benefit when the state’s decision to award or withhold the benefit is wholly
discretionary. Applying that case law, the lower court held that the City’s discretion to grant or deny the Trust’s rezoning application meant the Trust lacked a property interest that could have been taken.

The court of appeals disagreed with the lower court. While it is true that a takings claim requires a valid property interest, the “discretionary benefit” theory had never been applied in the takings context to determine whether a plaintiff held the requisite interest to support their claim. Further, the property rights protected by takings law are broader than, or at least not coextensive with, the property rights protected by due process.

That left an open question, though, of how courts should determine whether the Trust had a property interest that supports its takings claim. Evaluating earlier US Supreme Court cases, the court noted that the deprivation of the right to use property for a particular purpose is not a taking if that right was never part of the owner’s bundle of rights to begin with.

In total, the court concluded it could not answer the question here, because the City’s motion depended entirely on the discretionary nature of its authority to deny a rezoning application. So, while the court was “skeptical” of the Trust’s claim that the City’s zoning had left the property “economically idle,” the court reversed the lower court’s ruling and remanded for further proceedings.

Andrews v. City of Mentor, Ohio
US Court of Appeals for the Sixth Circuit
August 25, 2021
2021 WL 3745343

Evaluating earlier US Supreme Court cases, the court noted that the deprivation of the right to use property for a particular purpose is not a taking if that right was never part of the owner’s bundle of rights to begin with.
Use inconsistent with terms of easement triggers easement abandonment clause

In the 1990s, the State of Florida initiated eminent domain proceedings against St. Joe Paper Company (St. Joe) to take certain beachfront properties in Walton County, Florida (County). The suit resulted in a consent judgment in which the state agreed to exclude certain parcels from the taking in exchange for St. Joe’s acceptance of land use restrictions, including the recording of a permanent easement allowing public pedestrian access laterally across the beach on 75 feet of the beach sand landward to the Gulf of Mexico’s mean high-water line. The judgment bound not only the parties to the eminent domain case, but also their successors and assigns.

In 2000, St. Joe established the WaterColor Community Association, a homeowner’s association, which included governing declarations affirming that the consent judgment was binding on all owners. St. Joe record the 75-foot easement, which had the stated purpose of providing to the County and its citizens, invitees, and licensees, “a way of passage, on or by foot only, over and upon the easement parcels.” The easement included an abandonment clause, stating that the easements would continue in effect for as long as the County “shall use the easements for their intended purpose,” but if the County were to use or attempt to use the easement for another purpose, all easement rights would terminate.

In 2017, the County enacted an ordinance to protect “the public’s long-standing customary use of the dry sand areas of all of the beaches in the County for recreational purposes,” including permitting members of the public to sit on the sand or in a beach chair with an umbrella, sunbathe, picnic, swim or surf off the beach, fish, and build sand creations, among other uses.

A Flock of Seagirls LLC and Valentines Heights LLC (the Owners) own separate beachfront lots in the WaterColor community, each of which contain the recorded 75-foot easement. The Owners sued in federal court, alleging that the ordinance triggered the easement’s abandonment clause because it attempted to use the encumbered property for purposes other than as a way of passage by foot.

The district court granted summary judgment for the County. The court acknowledged that the ordinance represented an “expanded purpose,” but determined that Florida law required the Owners to show evidence of an intent to abandon the easement. The court also held that uses that expand on, but are consistent with, the purpose of an easement do not evince such intent. Thus, the County had not abandoned the easement. The Owners appealed to the Eleventh Circuit Court of Appeals.

The court began by noting that it had to consider two separate questions: first, whether the ordinance triggered the terms of the easement’s abandonment clause, and second, whether sources outside the abandonment clause forestall or limit that clause’s operation.

Turning to the first question, the court observed that it gives easement terms their common and ordinary meaning. The easement’s plain language provided that the County will be deemed to have abandoned the easement if it used the easement for a purpose beyond that specified in the easement. The ordinance undoubtedly covers the easement land, and it also sets forth ways that the public may use that land. Thus, the real question was whether the County’s attempted use was for a purpose not specified in the easement.

Here, the easement names its purpose explicitly. Certain of the uses contemplated by the ordinance plainly entail purposes other than as a way of passage. While “incidental stopping” on the beach may not go beyond pedestrian use, sunbathing, fishing, swimming, picnicking, and building sandcastles are not so incidental that they can be deemed necessary for the full enjoyment of the easement’s terms.
Having concluded that the customary-use ordinance triggered the terms of the easement’s abandonment clause, the court then turned to the question of whether other sources of law might limit the abandonment clause.

The first of those sources identified by the County was Florida’s common law enshrining the public’s right to use the dry-sand areas of beaches for recreational purposes. That common law right of customary use applies if the recreational use of the beach has been ancient, reasonable, and without interruption. But if that doctrine ensured the public’s unlimited use of the beach, neither the easement nor the ordinance would serve any meaningful purpose. Thus, the doctrine of customary use would not control over a recorded easement.

The County also relied on provisions of the easement that refer to it as “perpetual,” arguing that perpetual rights do not expire. But the court noted that a perpetual easement is merely one that does not expire of its own force, not one that cannot be abandoned. An easement may be perpetual yet also specify a condition under which the easement will end. The easement at issue contains just such a condition.

Because the County’s ordinance triggered the terms of the easement’s abandonment clause, and because neither Florida common law nor other provisions in the easement itself limit the abandonment clause’s operation, the court ruled in favor of the Owners and reversed the decision of the district court that had held for the County.

A Flock of Seagirls LLC v. Walton County, Florida
US Court of Appeals, Eleventh Circuit
August 5, 2021
7 F.4th 1072

Easement holder may not grant use rights to third parties

Before 1960, B.L. and Zula Kiser (Kiser Grandparents) acquired land in the area of what would become Lake Norman, in North Carolina. In 1960, much of the bed of Lake Norman was dry, but Duke Power Company (Duke) intended to flood lands adjacent to the Catawba River with the construction of a dam. Duke obtained titles and easement rights to those lands now submerged under Lake Norman pursuant to the requirements of a Federal Energy Regulatory Commission (FERC) license. Most of the owners of the submerged land sold their property in fee to Duke, but the Kiser Grandparents chose to grant only easements to Duke.

The Kiser Grandparents granted Duke two easements: a flowage easement to 280.4 acres of land resting below an elevation of 760 feet above sea level, which would become the lakebed; and a flood easement for land resting between 760 and 770 feet above sea level that would remain dry land subject to flooding.

Following the creation of Lake Norman, the Kiser Grandparents retained an area of land that became an island. They subdivided the island into residential waterfront lots and conveyed fee simple title to most of those lots to third-party buyers (Third Parties), while retaining at least one lot for their continued personal use.

Consistent with its FERC license, Duke instituted a permitting process for the construction of shoreline improvements into the waters of the lake. Many of the Third Parties constructed docks that extended from the dry land of their lots over and into the waters of the lake and that are anchored to the submerged Kiser property beneath the lake.

In 2015, a dispute arose between ML Kiser (Kiser)—a grandson and successor of the Kiser Grandparents and subsequent owner of the land—and Duke relating to Kiser’s erection of a retaining wall and backfill into Lake Norman. In
the course of that suit, Kiser challenged Duke’s authority under the easements to issue permits to the Third Parties for the construction of docks on their lots. The trial court ultimately ruled that Duke had operated within the scope of its authority when it granted permission for the Third Parties to construct improvements over and into Kiser’s submerged land. Kiser appealed, arguing that Duke did not have authority to permit the use of the 280.4 acres by the Third Parties without Kiser’s consent.

The court of appeals first addressed whether Duke possesses authority under the flowage easement to permit Third Parties to erect and maintain structures over and into Kiser’s land. While the easement did grant Duke “absolute water rights,” the court declined to read the conveyance as a virtual conveyance of a fee simple interest in the property. The Kiser Grandparents clearly intended to retain title to the submerged 280.4 acres by granting an easement instead of a fee simple conveyance. The court held that the difference must be given meaning.

Unless the easement explicitly states otherwise, an easement holder may not permit strangers to the easement agreement to make use of the land, other than for the use and benefit of the easement holder, without the consent of the landowner where such use would constitute a burden. Here, the flowage easement makes no reference to the Third Parties, so they are strangers to the easement, and absent other considerations, Duke exceeded its scope of authority without obtaining consent from the owner of the servient estate.

Duke and the Third Parties asserted that, regardless of Duke’s authority under the easements, Duke maintained federally preempted authority to unilaterally permit third-party construction over the easement on account of Duke’s license with the FERC. The court, however, disagreed. The requirements of a FERC license do not abolish private proprietary rights, and while the FERC license gives the licensee the authority to regulate certain uses of land, it does not give the licensee the right to do so.

The court also observed that Duke had the authority and opportunity to seize the Kisers’ property in fee through eminent domain. Duke instead elected to negotiate an easement with the Kiser Grandparents, never acquiring fee title to the submerged land. Duke is thus limited in its uses and exercise of dominion over the property to those expressly granted in the easements.

The Kiser Grandparents clearly intended to retain title to the submerged 280.4 acres by granting an easement instead of a fee simple conveyance. The court held that the difference must be given meaning.

The Federal Power Act does not give Duke more rights than those it acquired in the easements. Duke did not have the authority to grant the Third Parties the right to permit others to use Kiser’s property without the assent of Kiser, because doing so would allow the taking of Kiser’s property without just compensation. Accordingly, the court held that the trial court erred in granting summary judgment in favor of Duke and the Third Parties and in granting use rights to the Third Parties upon a cloud-upon-title theory. To hold otherwise would authorize the taking of Kiser’s property without just compensation. Thus, the trial court’s decision was reversed, and the case was remanded for further proceedings.

Duke Energy Carolinas LLC v. Kiser
North Carolina Court of Appeals
October 29, 2021
2021-NCCOA-558
Insurance just compensation standard is reasonable measure of market value for tax assessment of unique special-purpose property

The Bodecker building in Portland, Oregon, is a unique structure. Originally built as an industrial building in 1952, Helms Deep LLC (Taxpayer) bought the property in 2014 and began to repurpose it. The property was specifically conceived and designed for the express purpose of creating a custom artists’ collaborative performance and event space.

The roof and some exterior walls were partially removed to modify the space into a geometric pinwheel framework. The building’s three stories total 14,095 square feet, of which half is heated living space. The first level includes a large warehouse with a skateboard pool, with the remainder of the building comprised of a kitchen, conference rooms, professional recording studio, skateboard park, bar, library, and two bedrooms designated as “crash pads” for artists in residence during their recording sessions. Outside, the property includes a bamboo garden, mini golf course, music stage, and playground slide. Throughout, the building features high-end finishes and unique architectural details.

The property is located in an area surrounded by residential and commercial uses, but the property’s occupancy permit issued in 2017 restricts the property to residential use. Taxpayer made plans to retrofit the building and seek a change in occupancy permits to allow for residential, business use, and assembly. The cumulative cost of retrofitting the property in order to qualify for all three categories was over $2 million.

The Multnomah County Assessor (Assessor) valued the property for 2018 at a market value of $17 million, which the local board of property tax appeals reduced to $9.1 million. Taxpayer appealed to the Oregon Tax Court, seeking a lower assessment.

The Taxpayer and Assessor each retained appraisers. The appraisers generally agreed that as vacant the site would likely be developed as a mixed-use property, but they differed in their conclusions of highest and best use as improved. Taxpayer’s appraiser testified that the subject was built for a specific purpose and was not intended to be resold as profitable; he concluded its highest and best use was as a mixed-use commercial property. The Assessor’s appraiser agreed it was built without concern for marketability but explained that it was being used for its intended purpose. Accordingly, the Assessor’s appraiser determined the property was special purpose with no comparisons.

Based on their respective highest and best use conclusions, the appraisers applied different methodologies to value the property. The Taxpayer’s appraiser identified comparable sales of creative office space, all of which were somewhat inferior to the subject qualitatively. He deducted the cost of retrofitting to conclude to an as-is value. He did not develop a cost approach because the actual costs were driven by the desires of the owner rather than market considerations, and the functional replacement of the property would be a fraction of its actual cost, given its many superadequacies.

The Assessor’s appraiser, on the other hand, valued the property using the cost approach, finding that the sales comparison and income approaches were inapplicable to special-purpose property. He used actual costs to determine the value of the improvements because cost estimators were too difficult to use for such a complex and unique building. The appraiser relied on the insurance replacement cost, declining to subtract any amount for obsolescence, explaining that finding evidence in the market to support obsolescence would be “extremely difficult and completely subjective.” Without a market for the subject, there was nothing by which to measure obsolescence, which by definition must relate to the market.

The tax court began by reciting Oregon’s value standard of real market value. By statute, real market value is defined as the amount that could reasonably be expected in an arm’s-length trans-
action. However, the definition continues that “if the property has no immediate market value, its real market value is the amount of money that would justly compensate the owner for loss of the property.” This is referred to as the “just compensation standard.”

The appraiser relied on the insurance replacement cost, declining to subtract any amount for obsolescence, explaining that finding evidence in the market to support obsolescence would be “extremely difficult and completely subjective.”

The court turned to the question of the property’s highest and best use. Whether an immediate market exists for a building at a particular use is separate from the question of whether that use is highest and best. In some instances, the lack of an immediate market for property is explained by the nature of the property and market forces. But the fact that a property is unique or specialized does not mean that its current use is not its highest and best use.

Whereas Taxpayer’s appraiser concluded the highest and best use was reconfiguration into creative office space, the Assessor’s appraiser concluded the property’s current use was its highest and best use. Whether the subject’s current use was economically viable is difficult to apply here because of the property’s purpose as an artists’ collaborative space, and the fact that the property was not intended to be used as part of a business operation. But the fact that it was being used for its intended purpose supports the conclusion its existing use was its highest and best use. The court found that the Taxpayer did not support a finding that the highest and best use was for conversion, and thus the tax court rejected the Taxpayer’s appraisal that was premised on that highest and best use.

The court then turned to the Assessor’s appraisal and its use of the just compensation standard. That standard is premised on the concept of a value in exchange but looks at value from the seller’s perspective rather than the buyer’s. Insurance replacement cost can qualify, because the objective of an insurance policy is to return the insured party to the same position occupied prior to the loss. The court concluded that the Assessor’s appraiser’s use of insurance cost was a reasonable measurement of just compensation given the lack of market-based cost estimators, though the court did adjust the value by $2 million to retrofit the property for code compliance and to allow the two additional occupancy categories, which would be necessary costs to allow the property to operate at its highest and best use.

Taxpayer raised one further argument against the Assessor’s appraisal, questioning whether his approach resulted in the property’s use value rather than its value in exchange. But the court cited a recent Oregon Supreme Court decision confirming that the just compensation standard “is not use value; it is still market value.” Accordingly, the court’s conclusion of real market value represented market value under Oregon law.

Impairment of access is appropriately considered in a takings case

Inland Products (Inland) owns a 17.9-acre lot in Columbus, Ohio, that was formerly the site of a rendering plant but now is vacant. The property sits near the intersection of I-71 and Frank Road.
Running closely parallel to I-71 is Jackson Pike, which has a signalized intersection with Frank Road at the northwest corner of Inland’s property. Because of the confluence of exit ramps from the interstate and the intersection, the Ohio Department of Transportation (ODOT) sought to redesign the intersection to make it less dangerous.

To complete this redesign, ODOT approved plans to relocate Jackson Pike, cutting a diagonal path through the middle of Inland’s property. ODOT sought to appropriate 3.8 acres of Inland’s property, resulting in two triangular-shaped residue lots: a left residue of 5 acres, and a right residue of 9.1 acres. Because the parties could not agree on the amount of compensation ODOT would pay Inland for the appropriated property or the value of damages to the remaining property, ODOT filed a petition in the trial court to appropriate the property and determine just compensation for the taking and damages.

Before trial, ODOT sought to exclude certain evidence Inland intended to introduce, namely evidence of the access the residue will have after the taking. Before the taking, vehicles could access the property through two driveways: one from Frank Road and one from Jackson Pike. But ODOT’s construction plans showed that it intended to eliminate the Frank Road driveway to the property, and the Jackson Pike driveway would only serve the right residue, and only at a different angle. ODOT’s plans provided for the construction of driveway stubs to each residue, but those stubs would affect the ability of semi-trailer trucks to access the property.

ODOT asserted that it did not seek to take Inland’s right of access to the abutting road, since that right was not included in the rights described in the petition for appropriation. But Inland responded that it was entitled to damages to the residues based on the effect of the appropriation on access to the residues and to present evidence establishing those damages. The trial court denied ODOT’s motion, and the case went to trial before a jury.

At trial, Inland’s appraiser testified that before the take the highest and best use of the property was for a highway-oriented commercial establishment like a travel plaza. A civil engineer designed a preliminary site plan for construction of a travel plaza and determined that that was a feasible use for the property. The engineer con-considered the existing driveways in those plans. In considering the value of the residues after the take, the appraiser downgraded his opinion of highest and best use to industrial use, citing, in part, the modifications in access shown on the property plans. The civil engineer conducted a turning analysis and opined that semi-trailer trucks could not safely use the driveways to access the property, making it inadequate for commercial uses requiring semi-trailer truck traffic. An ODOT project manager agreed.

ODOT relied on its own civil engineer, who created multiple conceptual designs for the potential uses of the residue, and he concluded both parcels could be used for commercial uses. But his conceptual plans included widened and reconfigured driveways. And while property owners in nonlimited access areas may construct and connect driveways to the road, they must receive ODOT’s permission, and multiple ODOT witnesses acknowledged there was no guarantee that ODOT would approve a permit to widen the residue driveways. Indeed, Inland had asked ODOT for additional driveways to the residues, and ODOT refused to modify the project plans.

If a partial taking affects the property owner’s access to the remainder of the property, that factor can be considered in determining the damage to the residue.
The jury ultimately awarded Inland $815,477 in compensation for the parcels ODOT sought to appropriate. $553,445 of that award was for damages to the residue, which included $403,333 for injury related to the size, location, and configuration of the driveways to the residues as provided on project plans. ODOT appealed, arguing that the trial court lacked subject matter jurisdiction to hear evidence of, and to compensate for, residue driveway access contrary to that described in ODOT’s petition, since ODOT did not describe its taking as that of a right of access.

The court of appeals began by observing that one of the elemental rights of property ownership is the right of access to any public road abutting the property. An owner of such a property possesses, as a matter of law, not only the right to use the highway with other members of the public, but also the private right or easement for the purpose of ingress and egress to and from the property. Any governmental action that substantially or unreasonably interferes with the right of access constitutes a taking. Since ODOT did not include Inland’s right of access in its petition for appropriation, that right remained with Inland. But Inland never sought to prove an additional taking—that of its right to access. Rather, Inland introduced evidence of how ODOT’s taking caused it injury by negatively affecting access to the residues.

In the case of a partial taking, the owner is entitled to a remedy consisting of two elements: compensation for the property taken, and damages for the injury to the property that remains after the taking. Generally, in determining pre- and post-appropriation market values, a jury considers every element that can fairly enter into the question of value and that an ordinarily prudent businessperson would consider when deciding whether to purchase the property. Thus, if a partial taking affects the property owner’s access to the remainder of the property, that factor can be considered in determining the damage to the residue.

That is precisely the type of evidence Inland introduced at trial. Because the residue driveways will be less functional than the driveways that previously existed on the property, Inland’s appraiser concluded that the post-appropriation value was less than the pre-appropriation value. The residue driveways are inadequate for highway-oriented commercial use. While ODOT introduced evidence that Inland could seek approval for better driveways in the future and claimed an award of damages based on the inadequate driveways was therefore unreasonable, Inland countered with evidence casting doubt on the likelihood that ODOT would grant that approval. The jury was more persuaded by Inland’s evidence.

The court concluded that, if a partial taking affects a property’s access, a jury should be able to consider that in determining the damage to the residue. The trial court, therefore, did not err in admitting evidence regarding the residue driveways. The judgment was affirmed.

Marchbanks v. Inland Products Inc.
Ohio Court of Appeals, Tenth District
August 3, 2021
2021 WL 3362266

No property tax exemption for building leased and occupied by state where state is not equitable owner

West St. Joseph Property LLC (WSJP) owned a 33,000-square-foot office building in Delta Township, Michigan. In early 2018, WSJP entered into an agreement with the State of Michigan (State) to lease the property to the State. The lease provided that the State, as lessee, would pay WSJP $10.8 million over 20 years, and then in 2038 the State would have the option to purchase the property for $1. The lease document had section headers
addressing the payment of property taxes, but those sections were marked “Deleted, Not Applicable.”

In September 2018, WSJP filed to obtain a property tax exemption on the property with the assessor for Delta Township (Township). The Township denied the exemption application, and WSJP appealed to the Michigan Tax Tribunal (Tribunal). Among WSJP’s contentions were that the property was public property which WSJP sought to have its property exempted. That statute provides that “Public property belonging to the state… is exempt from taxation” under the General Property Tax Act. WSJP argued that the lease met the statutory definition of a “transfer of ownership” and that the State was the equitable owner of the property under the lease, while also possessing, occupying, and using the property for a public purpose. Considering the interaction of several statutory provisions, the court disagreed.

The court found it appropriate that
the Tribunal referenced a dictionary
in defining [“belonging to”] to require
ownership, since it was not defined by
statute and statutory terms are given
their plain meaning when undefined.

that belonged to the State, and that the lease agreement constituted a transfer of ownership, either of which would entitle the property to an exemption. Both parties filed for summary judgment, and the competing motions were heard by the Tribunal’s designated administrative law judge.

After reviewing the arguments, the judge issued a proposed order denying WSJP’s motion and determining that the property was not entitled to an exemption. After consulting dictionary definitions, the judge concluded that the term “belonging to” equated to ownership by way of legal title, and that the property thus did not belong to the State. The Tribunal adopted the judge’s proposed order and denied the exemption. WSJP appealed.

The court of appeals began by considering the plain language of the exemption statute under which WSJP sought to have its property exempted. That statute provides that “Public property belonging to the state… is exempt from taxation” under the General Property Tax Act. WSJP argued that the lease met the statutory definition of a “transfer of ownership” and that the State was the equitable owner of the property under the lease, while also possessing, occupying, and using the property for a public purpose. Considering the interaction of several statutory provisions, the court disagreed.

First, a different statute provided that property acquired for the state through an installment lease agreement “is public property and shall be considered exempt” if the state as lessee “is required to pay any taxes or reimburse the lessor for any payments the lessor has made.” Neither condition was satisfied by the lease here. The lease was silent as to the payment of taxes or reimbursement for taxes.

Second, the statute provides a definition for a “transfer of ownership”—a definition that included conveyance by a lease if the lease term is more than 35 years or the lease grants the lessee a bargain purchase option. But while the $1 purchase option in the lease might meet this test, the court observed that the definition would apply only where the term “transfer of ownership” appeared in the statute. That term does not appear in the exemption statute referenced by WSJP, so it was not dispositive for that exemption.

Third, the court turned to the phrase “belonging to the state,” which was not defined by statute. The court found it appropriate that the Tribunal referenced a dictionary in defining that term to require ownership, since it was not defined by statute and statutory terms are given their plain meaning when undefined. Moreover, had the legislature intended the phrase “belonging to” to include broader situations than just ownership, it could have used specific language to do so. Other code provisions, for example, provided exemptions for...
“property owned by, or being acquired pursuant to, an installment purchase agreement by a county” and “property which is leased, loaned, or otherwise made available to a school district.” The omission of a provision in one part of a statute that is included in another should be construed as intentional.

The court finally noted that, even if the phrase “belonging to” encompassed equitable ownership, the facts that the purchase option in the lease was not binding, that the State was not obligated to pay taxes, and that WSJP held itself out as the property’s owner “tend to show that the State was not an equitable owner.” Accordingly, the court held that the Tribunal correctly denied WSJP’s exemption request because WSJP did not establish that the property was public property belonging to the State.

West St. Joseph Property LLC v. Delta Township
Michigan Court of Appeals
August 26, 2021
2021 WL 3820027

Holder of life estate cannot convey fee simple interest in property even where beneficiaries enter agreement

In 1974, Thomas Hill Coleman became the owner of two adjacent twenty-acre tracts of land in Alcorn County, Mississippi. Coleman and his wife, Evelyn, had four sons: Thomas, Mike, Frazier, and Larry.

Coleman died in 1977, and his will devised a life estate in several tracts of land, including the Alcorn County property, to Evelyn, with remainder interests to their four sons as tenants in common. In 1978, Thomas, as the executor of Coleman’s estate, signed and conveyed an executor’s deed, which provided that the estate conveyed the property “unto Evelyn S. Coleman, for her life, and at her death, in equal shares to” her sons.

Over time, three of the sons became indebted to Evelyn. In 1987, in an attempt to forgive a debt of Frazier and to give equally to her other sons, Evelyn drafted an agreement, signed by all four sons, that (1) forgave Frazier’s $10,600 debt, (2) forgave Mike and Larry balances of rent and joint notes in the same amount, and (3) gave Thomas land worth $10,600. Following the 1987 agreement, Evelyn gave a warranty deed to Thomas for all forty acres of the Alcorn County property.

Evelyn died in 2012, and Thomas served as the executor of her estate. In reviewing the documents, Thomas’s attorney discovered that Evelyn only possessed a life estate in the property, not a fee simple interest. So, in an attempt to cure the defect, the attorney sent a letter to Thomas’s three brothers, asking them to quitclaim their respective interests in the property. Frazier did, but Mike and Larry did not. Mike then sued to quiet and confirm title.

At trial, the parties agreed that they were all mutually mistaken in believing that Evelyn possessed a fee simple interest in the property. The trial court declared that the parties’ intent in the 1987 agreement was to make Thomas the sole owner of the property in fee simple, even though Evelyn possessed only a life estate interest. Mike appealed.

The issue raised before the court of appeals was whether the trial court erred in interpreting the 1987 agreement to grant a fee simple interest in the property to Thomas, even though Evelyn possessed only a life estate.

First, the court noted that a life estate expressly created by the language of a written instrument is not converted into a fee or other form of estate greater than a life estate merely by reason of there being coupled with it a power of disposition, whether general or extensive. Thus, Evelyn’s use of a warranty deed did not increase her interests in the property; a life estate cannot be enlarged to a fee simple through the use of a warranty deed. She was conveyed a life estate, and her four

West St. Joseph Property LLC v. Delta Township
Michigan Court of Appeals
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Holder of life estate cannot convey fee simple interest in property even where beneficiaries enter agreement
sons were conveyed a remainder interest in a tenancy in common. Regardless of the parties’ intention, Evelyn could not deed anything greater than what she possessed.

Next, the court acknowledged the parties’ agreement that there was a mutual mistake concerning the interest held by Evelyn. In 1987, Evelyn and the four sons all believed she had a fee simple interest in the property and had conveyed it to Thomas via a warranty deed. Mutual mistake between parties to a contract can result in an otherwise valid contract being set aside. Here, all parties were mistaken as to a material fact to their agreement, and because of this misunderstanding, the court concluded that there was not a meeting of the minds and assent due to the mistake.

This mutual mistake did not void the agreement in total, though. The court noted that the agreement sought to do two things: absolve debts of Frazier, Mike, and Larry, and convey land to Thomas. The debt forgiveness component of the agreement, though not before the court on appeal, was viable, but the agreement as to conveyance in fee simple is void.

Finally, the court addressed the issue of whether the other brothers, by signing the agreement, had functionally conveyed their property interest to Thomas. But the 1987 agreement did not have language attesting to any of the sons conveying their interests in the property to Thomas. The agreement simply stated that Evelyn had given Thomas his amount in land, rather than in debt forgiveness. The warranty deed also does not reflect a conveyance on behalf of any of the sons: it detailed a conveyance from Evelyn to Thomas. So, while Frazier quitclaimed his interest to Thomas after the mistake was discovered, the court concluded that the trial court had erred by interpreting that Larry and Mike intended to convey their interests as well.

Ultimately, the court concluded that Evelyn intended to bestow gifts of debt forgiveness to her sons and provide Thomas with land since he was not indebted to her. But debt forgiveness and land conveyance are separate things, and Evelyn could not have conveyed an interest in land that she did not herself possess. Thus, the trial court’s judgment was reversed.

 Coleman v. Coleman  
 Mississippi Court of Appeals  
 August 31, 2021  
 2021 WL 3877734

Waste stripping is valuable asset of mine and subject to taxation

Fairbanks Gold Mining Inc. (FGM) owns the Fort Knox Mine in northern Alaska. In January 2018, the Fairbanks North Star Borough Assessor (Assessor) valued the Fort Knox Mine at $673.1 million and assessed property taxes accordingly. Of that value, $17.8 million derived from the land, with the remaining $655.3 million derived from improvements.

Each year, the Assessor values mine improvements using the cost approach, which the Assessor described as appropriate because the mine site was a special use property for which cost information is readily available and because there are no other measurable means of calculating the property’s value. Each year, FGM provides a list of capital improvements completed at the mine. The Assessor adds the cost of those improvements, with the exception of non-affixed personal property, to the value of the mine. The Assessor then depreciated the value of the capital expenses by 5% annually over a 20-year period with a floor of 30% of the initial value.

The most valuable improvement assessed at the mine is “capitalized waste stripping.” Waste stripping is the process of removing economically barren surface materials and waste rock from the mine site to improve access to valuable ore. Fort Knox Mine has been mined in phases, with waste stripping occurring in each phase. The Assessor

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The most valuable improvement assessed at the mine is “capitalized waste stripping.” Waste stripping is the process of removing economically barren surface materials and waste rock from the mine site to improve access to valuable ore. Fort Knox Mine has been mined in phases, with waste stripping occurring in each phase. The Assessor
valued each phase of waste stripping in the same manner as the other mine improvements, by depreciating each year’s stripping expense by 5% annually. This process recognized that earlier waste stripping still carried value, but not as much as more recent waste stripping. After accounting for depreciation, the Assessor determined the total value of the mine’s waste stripping in 2018 was $295.4 million.

FGM appealed the Assessor’s initial value to the borough Board of Equalization (Board). FGM did not contest the value of the land but asserted that the value of the taxable improvements was under $359 million. The basis for this substantial difference in value was what FGM characterized as the Assessor’s erroneous inclusion of the costs of capitalized waste stripping.

In support of that position, FGM commissioned an appraisal report. That report did not actually value waste stripping but instead argued that the value of waste stripping cannot be taxed because, the appraiser posited, any value added by waste stripping must accrue to the ore body, which is exempt from taxation. The appraiser also argued that the value of waste stripping should decrease based on depletion of the ore reserve, so the Assessor should have tied the depreciation in value to the remaining life of the mine based on the amount of ore remaining. Applying that method, the appraiser calculated a 68.4% depreciation in the mine’s value, resulting in a full and true value of $315.7 million.

The Assessor defended his valuation of the mine by comparing capitalized waste stripping to the excavation done in preparation for a building. Just as excavation adds value to a property by making it easier to build on, waste stripping adds value to a mining property by making it easier to mine. He compared FGM’s argument to saying that a water well adds value to the water instead of the property itself. The Assessor did, however, update his depreciation schedule from 20 years to 10 years to be more reflective of the remaining economic life of the open pit where the waste stripping is occurring. This reduced the value to $549.5 million.

After a hearing, the Board concluded that waste stripping was an asset to the property that the Assessor had been properly assessing for years and accepted the Assessor’s revised valuation. FGM appealed.

On appeal to the Alaska Supreme Court, FGM first asserted that waste stripping is exempt from taxation under a statute preventing Alaska’s local governments from taxing certain natural resources, namely “natural resources in place including coal, ore bodies, mineral deposits, and other proven and unproven deposits of valuable materials laid down by natural processes.” FGM argued that any value added by waste stripping is untaxable because that value accrues to the tax-exempt ore body, and because the only reason to incur the expense of removing overburden is to enable mining of ore. But the Alaska Supreme Court observed that every expense incurred to improve the mine site is presumably to enable mining, and the statute does not suggest all of the mine’s physical assets are exempt from tax.

Alternatively, FGM argued that waste rock was itself an exempt natural resource which should be included because the “ore body” by definition may include low-grade ore and waste. The court disagreed. The text of the statute defines the scope of its terms, so the terms “ore bodies” and “mineral deposits” are limited to “deposits of valuable materials.” Because FGM insisted that
the overburden is valueless, the overburden cannot be classified as a deposit of valuable materials. Moreover, and more importantly, it was not the overburden itself that the Assessor sought to tax, but the improvement to the property resulting from the removal of overburden. Just as the Assessor can tax buildings, roads, and physical plants that facilitate mining on the property, it can tax waste stripping.

FGM also argued that the Assessor’s methodology was improper because it would result in the highest assessed value when a mine is closest to depletion. FGM posited that a hypothetical buyer would pay more for a mine with all its ore still in place. But the supreme court found this argument misconceives the issue.

An Assessor must assess property at its full and true value, defined as “the estimated price that the property would bring in an open market.” But in the case of a mine, the Assessor’s task is complicated by the tax-exempt status of the ore itself. To reach the taxable value of mine assets, the assessor must separate the value of the mine infrastructure from the value of the tax-exempt ore. And the test of whether an Assessor does so reasonably is not whether the method has received acceptance from the appraisal community, but whether the valuation method selected provides some reasonable estimate of the market value of the interest to be taxed. Thus, while FGM’s appraiser disagreed with the Assessor’s valuation method, it was not fundamentally wrong.

Because the Board had a reasonable basis to approve the Assessor’s valuation, and because the waste stripping unquestionably contributed value to the property, the Alaska Supreme Court affirmed the Board’s decision in favor of the Assessor.

Fairbanks Gold Mining Inc. v. Fairbanks North Star Borough Assessor Alaska Supreme Court June 18, 2021 488 P.3d 959

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Appraising Restaurants: Highest and Best Use Analysis

by Bradley R. Carter, MAI, and J. Tyler Leard

Abstract
The restaurant business is risky, but many valuation professionals do not fully account for the risks specific to the turbulent restaurant industry. Appraisers who value restaurant properties should fully understand the opportunities and risks inherent in restaurant operations and how these factors affect real property value. This article looks at restaurant highest and best use analysis with special focus on restaurant life cycles and most likely buyers.

Professionals involved in designing, developing, financing, and investing in restaurants understand marketability and valuation issues relating to restaurant properties and what to expect from restaurant property appraisals. Trends in the restaurant industry, market, location, and property analyses, and the three approaches to value are all important in valuation of restaurants.

Special-purpose properties like restaurants are often misunderstood. For restaurant properties, there are differing views within the appraisal community about how key valuation issues should be addressed, and even confusion about what should be valued and when. Clear definitions help facilitate discussion of restaurant valuation.

What Is a Restaurant?

“What is a restaurant?” may seem like an easy question to answer, but perhaps it is not quite as easy as it seems. The terms restaurant and restaurant property are often used interchangeably by real estate professionals. They do have distinct meanings, though, and the differences between them are important to understand.

• Restaurant refers to a place where meals are served to the public, usually on a for-profit basis, encompassing real property (which may be owned or leased) as well as the business operation, equipment, and possibly trade fixtures.

• Restaurant property refers to the real property component of an enterprise that is a restaurant.

From a restaurateur’s viewpoint, the real property is the place from which the business operates, as opposed to the real estate investment. The real property is simply necessary to conduct the business.

To help clarify the distinction between a restaurant and a restaurant property, suppose a client told a valuation professional, “I need an appraisal of Jane’s Delicatessen.” Defining the scope of work and other assignment parameters is critical, and often a function of the intended use of the assignment. Would the request be for an appraisal of the restaurant enterprise known as Jane’s Delicatessen? If so, the appraisal sought would be of a going concern. A going concern is an established and operating business, encompassing all its tangible and intangible assets. The appraisal

This material originally appeared in Chapters 1 and 5 of A Guide to Appraising Restaurants (Chicago: Appraisal Institute, 2021).


2. “In real property valuation, the business entity is referred to as a going concern, which can include real property, tangible personal property (such as furniture, fixtures, and equipment), and intangible assets (such as franchise agreements, other business contracts, and business goodwill).” The Appraisal of Real Estate, 15th ed. (Chicago: Appraisal Institute, 2020), 663.
of a restaurant as a going concern includes real property, personal property, and any intangibles such as business value.

Or would the request be for an appraisal of the restaurant property that houses the enterprise known as Jane’s Delicatessen? If so, the valuation sought would be a real property appraisal, which would reflect all rights, interests, and benefits related to the ownership of real estate but exclude personal property and any intangibles such as business value.

Which would be appropriate? To answer that question, we would need to know more about the client’s needs, which identify the intended use of the appraisal.

Like most commercial real estate, restaurant properties are generally owned by either operators or investors (landlords). For properties subject to long-term leases with credit tenants, landlords are often large real estate investors with a national focus. Local investors are more commonly the landlords for “mom and pop” restaurants with shorter lease terms. Many restaurant landlords are former restaurant operators who sold their businesses and lease the properties back to the parties who purchased them. The following discusses the highest and best use analysis for restaurant properties.

Restaurant Property
Highest and Best Use

General Highest and Best Use Concepts

Highest and best use is the reasonably probable use of property that results in the highest value. The four criteria that the highest and best use must meet are legal permissibility, physical possibility, financial feasibility, and maximum productivity. We’ll proceed assuming that you are already familiar with the basic principles of highest and best use, and only touch on the general concepts lightly.

A thorough treatment of highest and best use issues provides a firm foundation for the appraiser’s analysis and helps the appraiser identify the most likely purchaser for the property being appraised.

The Stages in the Life of a Restaurant Property

Many restaurant properties begin their economic life designed for financially strong tenants who will pay rent sufficient to justify their specific requirements. These properties eventually transition through their life cycles until they are suitable only for conversion to an alternative use or redevelopment. To better understand this gradual transition, it is helpful to view the life of a typical restaurant property as having four distinct stages (see Exhibit 1). Next, we’ll take a closer look at each stage in this cycle.

Exhibit 1 Restaurant Property Life Cycle
Life Cycle Stage 1
Restaurant properties in Stage 1 of the life cycle are typically new (or first generation) and functional, with their entire (economic) life ahead of them. These properties are most commonly designed for a national operator and are often leased. However, properties that have been newly constructed by an independent restaurateur would also be classified as being in Stage 1, as would those newly constructed restaurant properties that are owner-operated (by either a chain or an independent restaurateur).

A common scenario for a restaurant property in Stage 1 of its life cycle would include the following characteristics:

<table>
<thead>
<tr>
<th>Life Cycle Stage 1 Characteristics</th>
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<tbody>
<tr>
<td>Occupancy</td>
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<tr>
<td>Remaining lease term</td>
</tr>
<tr>
<td>Design and appearance</td>
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<tr>
<td>Typical buyer profile</td>
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<td>Likely capitalization rate</td>
</tr>
<tr>
<td>Preferred valuation technique</td>
</tr>
</tbody>
</table>

Life Cycle Stage 2
Restaurant properties designed for national operators are best described as having transitioned into Stage 2 after a significant amount of the initial lease term has elapsed (with a remaining term of, say, five years or less). While a limited remaining lease term is often a defining trait of a Stage 2 property, owner-operated properties beginning to show their physical age would also be described as being in Stage 2.

A common scenario for a restaurant property in Stage 2 of its life cycle would include the following characteristics:

<table>
<thead>
<tr>
<th>Life Cycle Stage 2 Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occupancy</td>
</tr>
<tr>
<td>Remaining lease term</td>
</tr>
<tr>
<td>Design and appearance</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Typical buyer profile</td>
</tr>
<tr>
<td>Likely capitalization rate</td>
</tr>
<tr>
<td>Preferred valuation technique</td>
</tr>
</tbody>
</table>

Life Cycle Stage 3
Restaurant properties that are no longer sought by a national operator or well-capitalized independent operator are often best categorized as being in Stage 3 of their life cycle. These types of properties often inhabit second-generation space. Characteristics common to restaurant properties in Stage 3 of their life cycle include:

---

6. First-generation space is defined 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.” The Dictionary of Real Estate Appraisal, 6th ed., s.v. “first-generation space.”

7. The most likely ownership interest being appraised for a property meeting these criteria is leased fee. The capitalization rate, typical buyer profile, etc., would likely be different if the fee simple interest were to be appraised.

8. 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.” The Dictionary of Real Estate Appraisal, 6th ed., s.v. “second-generation space.”
Life Cycle Stage 3 Characteristics

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Occupancy</td>
<td>Local operator</td>
</tr>
<tr>
<td>Remaining lease term</td>
<td>Short remaining lease term or owner-operator</td>
</tr>
<tr>
<td>Design and appearance</td>
<td>• Typically dated</td>
</tr>
<tr>
<td></td>
<td>• Often retains characteristics</td>
</tr>
<tr>
<td></td>
<td>• Reminiscent of its original occupant</td>
</tr>
<tr>
<td>Buyer profile</td>
<td>• Owner-operator</td>
</tr>
<tr>
<td></td>
<td>• Possible interest from local investors, but limited by the uncertainty of the income stream</td>
</tr>
<tr>
<td>Likely capitalization rate</td>
<td>High, if applicable</td>
</tr>
<tr>
<td>Preferred valuation technique</td>
<td>Sales comparison approach</td>
</tr>
</tbody>
</table>

An example of a restaurant property in Stage 3 of its life cycle would be a property operated as a Pizza Hut for many years that is now known as JG Chicken & Seafood, the self-proclaimed home of “off the hook fried food.”

Life Cycle Stage 4

Stage 4 restaurant properties are those that are no longer suitable for use as a restaurant, with their highest and best use having transitioned to redevelopment of the site or significant rehabilitation (and often conversion to an alternative use). In this scenario, the most likely buyer may well not be a restaurant operator or landlord. The improvements are likely razed, and the site is ready for redevelopment.

It can be hard to determine if the highest net present value for an older property is repurposing or redevelopment without actually exposing it to the market to see what interest it draws. Therefore, highest and best use is often quite complicated as a restaurant property nears the end of its economic life. Furthermore, vacant or failing restaurants are not always well-suited for alternative uses. While there are many examples of restaurant buildings being converted to general retail space or even offices, these properties rarely generate rent levels anywhere close to what is needed to justify the replacement cost. Not surprisingly, these repurposing projects are often just interim uses until redevelopment occurs.

Life Cycle Stage Considerations

Some of the factors affecting which stage of its life cycle a restaurant property is in are its physical characteristics, the remaining lease term, and the sales generated by the business.

Physical Characteristics

As we’ve discussed, restaurant properties rarely age well unless they are fed a diet of capital improvements. Restaurant real estate expert Fred Campbell shares that not only is constant upkeep required, but a “fresh look” is typically needed every three to five years. Campbell adds that for a nice restaurant, a substantial reserve fund should be established, similar to what is done for hotels (with approximately 3%–5% of revenue being typical). Real estate expert D. Scott McLain expressed the opinion that a restaurant building operated by a corporate/national operator needs a “significant re-fit every 10 or 15 years.” Accordingly, it is not unusual for a restaurant property to slip into the next stage of its life cycle about five years or so after its last minor remodeling, with significant risk approximately 10 to 15 years after its last major remodeling.

Remaining Lease Term

The remaining lease term is correctly thought to influence what capitalization rate can be achieved, but it can also affect the profile of the most likely buyer. In fact, many institutional-grade buyers purchase only leased property with credit tenants, either by law or policy. Such buyers will not even consider a property with no lease, and many will not consider property with a remaining term of less than five years (unless it is a part of a portfolio purchase). Consequently, the remaining term can be a decisive factor in evaluating the life cycle stage and other marketability factors for leased properties.

---

9. McLain added that many corporate users “find it easier and cheaper to redevelop than retrofit” to meet their exact kitchen specifications and other current standards. He also added that local restaurateurs often operate from the same building for 40 years, and that those restaurants look like they’ve operated out of the same building for 40 years.
The best measure of investors’ enthusiasm for a given property type is usually the yield (or capitalization rate) they require. In Exhibit 2, note the clear correlation between the remaining lease term and the capitalization rate.

The impact of remaining lease terms on capitalization rates may be even more pronounced than is apparent in Exhibit 2, since the “Under 10” category is somewhat broad. For example, there is a big difference between a remaining lease term of nine years versus, say, three years. Investor surveys rarely capture rates that are applicable to properties with leases that are nearing expiration, since such properties are rarely of interest to investors. This in itself speaks volumes about how much further into their economic lives properties with short remaining leases are in comparison to their economic lives when their leases began. Not surprisingly, the authors’ experience suggests that the increase in the applicable capitalization rate is far more pronounced when the remaining lease term falls to just a few years.

Exhibit 2 Median Asking Capitalization Rate by Lease Term Remaining

<table>
<thead>
<tr>
<th>Lease Term Remaining (Years)</th>
<th>Capitalization Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>20+</td>
<td>5.35%</td>
</tr>
<tr>
<td>15–19</td>
<td>5.50%</td>
</tr>
<tr>
<td>10–14</td>
<td>5.85%</td>
</tr>
<tr>
<td>Under 10</td>
<td>6.45%</td>
</tr>
</tbody>
</table>

Source: The Boulder Group, 2nd Quarter 2020 Net Lease QSR Market Report

As we have seen and will continue to explore further, the remaining lease term can affect the capitalization rate that can be achieved and the profile of the most likely buyer. When the end of a lease is in sight, there is often significant risk that a period of vacancy may be near. How do investors assess the likelihood of an interruption of the income stream? One meaningful indicator of a restaurant operation’s prospect for continued viability is to analyze the sales per square foot being achieved.

**Restaurant Revenue**

The amount of rent a tenant can pay and the value to an owner-operator ultimately depend on the revenue that can be achieved at that location. Consequently, few things speak louder to a landlord, buyer, or appraiser about the viability of a restaurant than the sales being achieved. This information may or may not be obtainable. Many tenants are required to report sales to the landlord, and this data sometimes factors into the amount of rent they must pay.

So, how much does a restaurant need to gross to stay in business? A full-service restaurant would typically need to generate at least $150 of annual sales per square foot to meet expenses. At sales of $150 to $250 per square foot, full-service restaurants can usually achieve a small profit, if costs are kept in line. At sales of $250 to $325 per square foot, a full-service restaurant can usually expect to see moderate profits of 5% to 10% of total sales before income taxes. A large profit typically becomes attainable at a full-service restaurant when sales surpass $350 per square foot.

Limited-service/casual-dining restaurants typically have lower menu prices and therefore need to achieve higher gross sales to meet expenses. A limited-service restaurant that achieves less than $200 of sales per square foot is unlikely to be sustainable. At sales of $200 to $300 per square foot, a limited-service restaurant where expenses are adequately managed can typically achieve a small profit. At sales of $300 to $400 per square foot, a limited-service restaurant can usually expect to achieve moderate profits of 5% to 10% of total sales before income taxes. A large profit typically becomes attainable at a limited-service restaurant when sales surpass $400 per square foot.

---

10. As a practical matter, many savvy landlords will renegotiate or extend a lease with a short remaining term when possible prior to marketing a property for sale.

11. Beware: In some situations, sales volume tells more about the operator than the real estate.

12. The revenue figures presented are for illustration purposes and are generalizations that commonly apply as of the date of this writing. Updated, market-specific figures would be needed to develop a credible appraisal.

see moderate profits (5% to 10% of sales, before income taxes). A large profit often becomes achievable for a limited-service restaurant when sales are in excess of $400 per square foot.\(^\text{14}\) To see how well industry norms relate to whether a specific restaurant tenant can afford to honor or renew their lease, we must also look at occupancy cost. For example, if sales at a given property are low by industry standards, that does not necessarily mean that the operation cannot support a correspondingly low rental rate. Conversely, some rent levels would be too high even for a property achieving a high sales volume. An industry rule of thumb is that rent should generally equate to no more than 6% of total sales, with total occupancy cost being no more than 10% of total sales.\(^\text{15}\) Of course, rules of thumb are generalities (at best) and often change over time. Moreover, the relevance of this particular rule of thumb is heavily influenced by the food and labor costs associated with the type of restaurant being operated. For example, $1 in pasta sales is likely to yield a far better margin than $1 in wine sales (since the cost of goods sold at restaurants can vary greatly as a percentage of the price that can be charged, such as the notoriously low cost to create many expensive pasta dishes versus the higher cost of wine).

**Strengths and Weaknesses**

The restaurant business presents both opportunities and risks. Reviewing a property’s relative strengths and weaknesses, in addition to where the property lies within the previously discussed life cycle continuum, is usually a good way to begin assessing those opportunities and risks. As an example, Exhibit 3 lists the positive and negative influences on a hypothetical property appraised during the COVID-19 pandemic.

Recognizing which stage of the life cycle a property is in as well as its strengths and weaknesses can be enormously helpful when comparing the subject property to comparables.

**Bridging the Gap: Most Likely Buyer**

It would be hard to support an opinion of what someone would pay for a given property if we did not have a sense of what that “someone” was like, or why he or she might want the property. Consequently, identifying the profile of the most likely buyer is the bridge that connects the highest and best use opinion with the selection of comparables in the valuation.

**Buyers New to Restaurants and Strategic Buyers**

Business enterprise appraiser Mary O’Connor describes two categories of restaurant buyers: those from outside the restaurant business looking to enter the industry, and those from within the industry looking to apply their skills or capital in a new venture. O’Connor explains that the first group of buyers are people who “for whatever reason… want to own a restaurant,” and these buyers typically offer “only money.” The second group, which O’Connor describes as “strategic buyers,” are operators with strong restaurant backgrounds who usually have excellent supplier relationships, outstanding menus, and so on.

It is important to understand which buyers are in which category because they will pay different amounts, according to O’Connor. Strategic buyers, who can use their expertise to enhance the enterprise “can, and may, pay more—especially if the location fits the demographic they seek.” On the other hand, buyers with no restaurant expertise who offer only money are more limited in what they can pay to achieve a good outcome. However, the risk that the enterprise will not be successful is far less with the strategic buyer, since expertise in this challenging industry can increase the probability of success immensely.

**Other Types of Restaurant Buyers**

The buyers O’Connor describes account for many restaurant property purchases. In addition, some purchases are made by large restaurant companies and by investors seeking an income stream without ever being involved in a restaurant’s operation. It is not unusual for large portfolios of restaurant properties with financially strong tenants to be sold in bulk to institutional buyers who then hire property managers (and sometimes asset managers) to handle most of the responsibilities typically borne by the landlord.

Next, we’ll take another look at restaurant properties at various stages in the life cycle and, this time, identify which type of buyers they might appeal to.

---

15. Source: Bloom Intelligence.
### Exhibit 3  Positive and Negative Influences on a Restaurant Property

<table>
<thead>
<tr>
<th>Topic</th>
<th>Positive Influences (Strengths)</th>
<th>Negative Influences (Weaknesses)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restaurant property type</td>
<td>Restaurant properties have a long, documented history of being in high demand.</td>
<td>• The restaurant business is challenging, and failure and turnover rates are high.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Restaurant properties often have short economic lives, which is particularly true of those with the highest land values.</td>
</tr>
<tr>
<td>National/local economy</td>
<td>• The strength of the national economy prior to the COVID-19 pandemic could result in a quicker and stronger recovery.</td>
<td>• The impact of the COVID-19 pandemic has led to a global recession; the US economy contracted at an annualized rate of 31.4% in the 2nd quarter of 2020—the sharpest contraction in at least 73 years.</td>
</tr>
<tr>
<td></td>
<td>• The local unemployment rate is well below state and national averages.</td>
<td>• Industry reports tracking the indices of the investment-grade segment and the general commercial segment of the market show that commercial real estate prices remain below pre-pandemic levels.</td>
</tr>
<tr>
<td>Local restaurant demand indications</td>
<td>• High sales volume documents the viability of this location for restaurant use.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The owner’s plan to renovate and expand the property is presumably a reflection of the profitability of the business, which further reflects restaurant demand at this location.</td>
<td></td>
</tr>
<tr>
<td>Subject site/location</td>
<td>• The site has a corner location with extensive frontage.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The volume of traffic passing the subject is favorable.</td>
<td></td>
</tr>
<tr>
<td>Subject improvements</td>
<td>The patio is attractive and offers additional seating for approximately half the year.</td>
<td>• Restaurant improvements have a specialized design and do not typically lend themselves well to an alternative use.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The improvements have a dated appearance and design, and most buyers or tenants would anticipate remodeling costs.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Parking is less than ideal to accommodate peak periods.</td>
</tr>
</tbody>
</table>
Life Cycle Stages and Most Likely Buyer Profiles

Life Cycle Stage 1
Restaurant properties in Stage 1 of the life cycle are often new or recently constructed. They are commonly designed for national operators, although some independent restaurateurs also build their own facilities. If the properties are leased, there would usually be a significant remaining term. If they are owner-operated, they would likely also have significant appeal to other owner-operators. However, it is unlikely that they would appeal to other owner-operators as much as they appeal to the property’s original occupant/designer.

Life Cycle Stage 2
Restaurant properties in Stage 2 of the life cycle are often properties that had been in Stage 1 until a significant amount of the initial lease term elapsed. Some Stage 2 restaurant properties are owner-operated; these are typically properties that had been constructed on a build-to-suit basis and a significant portion of their economic lives has since passed. For properties affiliated with a chain, image-compliance issues would often be a concern at this point.

Life Cycle Stage 3
Restaurant properties in Stage 3 of the life cycle are generally older, exhibit at least some obsolescence, and are no longer attractive to a national operator. They are typically owner operated or leased to local (“mom and pop”) restaurant tenants. It is also not unusual for such properties to be vacant.

Life Cycle Stage 4
Stage 4 restaurant properties are those no longer suitable for restaurant use without significant renovation, if at all. Instead, their highest and best use has transitioned to significant rehabilitation, often in conjunction with conversion to an alternative use, or redevelopment of the site.

Restaurant Property Buyer Profile Matrix
Let’s summarize what we have learned up to this point as it relates to what type of buyer is most likely to seek each type of restaurant property. A restaurant property buyer profile matrix is shown in Exhibit 4. This matrix incorporates scope of work considerations.

We previously defined the profile of the most likely buyer as the bridge that connects the highest and best use opinion with the selection of comparables. With the observations summarized in Exhibit 4, identifying what type of comparables are appropriate should be relatively simple once the life cycle stage and valuation premise have been established for the property being appraised.

Highest and Best Use Case Study
The following case study illustrates the highest and best use concepts discussed in this article.

The property: A local restaurateur operated a pub in a suburb of a major city. A large variety of gourmet beers were offered, along with a limited selection of food. Catering was also available.

The location: The property was in a pedestrian-friendly area that had become somewhat of a fashionable district for high-income diners. This was largely the result of an eclectic mix of popular restaurants that had opened in recent years and drew big crowds.

The improvements: The building contained 3,200 square feet, nearly half of which was a second-floor office. The floor plan for the main level was designed for restaurant use, although the kitchen was somewhat small. The first floor had been recently renovated, and most of the customer areas were in good overall condition. The mechanical systems, however, were fairly old. There was limited furniture, fixtures, and equipment (FF&E), which was also old.

The business: The business met its expenses but did not thrive the way most of the nearby restaurants did. The operator was new to the restaurant industry and never achieved the sales goals upon which his initial investment was based.

The disposition: Tired of struggling, the owner listed the property for sale. An offer of $1,400,000 was received and accepted shortly thereafter. The purchase price included the real estate, FF&E, and the business, but the real property accounted for almost all of it. The contributory value of the FF&E was minimal, and there was no discernable business value.

The buyer: The buyer was a small local restaurant group that had established an impressive record of
### Exhibit 4 Restaurant Property Buyer Profile Matrix

<table>
<thead>
<tr>
<th>Stage/Occupancy</th>
<th>Interest Appraised/Valuation Premise</th>
<th>Appeal to Investors</th>
<th>Appeal to Owner-Operators</th>
<th>Primary Valuation Technique</th>
<th>Comment(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stage 1/tenant-operated</td>
<td>Leased fee/real property only</td>
<td>High</td>
<td>Low</td>
<td>Direct capitalization</td>
<td>• Often a build-to-suit, with cost justified by rent</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Lease term is usually long</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Tenant quality is also key, and a financially strong tenant is not unusual</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Particular appeal to 1031 exchange buyers</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Institutional investors often interested in large portfolios of these properties</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Value can be more than cost</td>
</tr>
<tr>
<td>Stage 1/owner-operated</td>
<td>Fee simple/real property only, going concern, or real property only as a component of a going concern</td>
<td>Low</td>
<td>High</td>
<td>Sales comparison approach (or parsing income method or ratio of gross revenue for a business appraisal)</td>
<td>• Often a build-to-suit, somewhat reflective of the owner’s personal preferences</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Appeal to owner-operators is high, although they often opt for new construction of their own design</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Value sometimes less than cost</td>
</tr>
<tr>
<td>Stage 1/vacant</td>
<td>Fee simple/real property only</td>
<td>Low</td>
<td>High</td>
<td>Sales comparison approach</td>
<td>• Often a distress situation</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Appeal to owner-operators is high, although they often opt for new construction of their own design</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Value is often less than cost (may be far less than cost)</td>
</tr>
<tr>
<td>Stage 2/tenant-operated</td>
<td>Leased fee/real property only</td>
<td>Moderate</td>
<td>Low</td>
<td>Discounted cash flow (DCF) analysis or direct capitalization (with an adjustment to reflect risk at the end of the base lease term)</td>
<td>• Remaining lease term is a detriment to marketability</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Unlikely to appeal to institutional investors unless bundled as part of a portfolio</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Value likely to be far less than replacement cost</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Sales volume achieved by tenant could be a major enhancement to or detraction from marketability</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Image-compliance issues could be a concern if part of a chain</td>
</tr>
<tr>
<td>Stage 2/owner-operated</td>
<td>Fee simple/real property only, going concern, or real property only as a component of a going concern</td>
<td>Low</td>
<td>Moderate/high</td>
<td>Sales comparison approach (or parsing income method or ratio of gross revenue for a business appraisal)</td>
<td>• Value likely to be less than replacement cost, unless a successful business is part of the valuation</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Sales volume achieved could be significant to value</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>• Image-compliance issues could be a concern if part of a chain</td>
</tr>
</tbody>
</table>
### Exhibit 4 Restaurant Property Buyer Profile Matrix (continued)

<table>
<thead>
<tr>
<th>Stage/Occupy</th>
<th>Interest Appraised/ Valuation Premise</th>
<th>Appeal to Investors</th>
<th>Appeal to Owner-Operators</th>
<th>Primary Valuation Technique</th>
<th>Comment(s)</th>
</tr>
</thead>
</table>
| Stage 2/ vacant | Fee simple/ real property only | Low | Moderate | Sales comparison approach | • Often a distress situation  
• Value often far less than replacement cost |
| Stage 3/ tenant-operated | Leased fee/ real property only | Modest | Low | DCF, or direct capitalization (with an adjustment to reflect risk at the end of the base lease term) | • Lease usually has a short remaining term and/or a local tenant  
• Buyer is usually a local investor  
• Value often just a fraction of replacement cost |
| Stage 3/ owner-operated | Fee simple/ real property only, going concern, or real property only as a component of a going concern | Low | Modest | Sales comparison approach (or parsing income method or ratio of gross revenue for a business appraisal) | • Value likely to be far less than replacement cost, unless a very successful business is part of the valuation  
• Sales volume achieved could be significant to value |
| Stage 3/ vacant | Fee simple/ real property only | Low | Modest | Sales comparison approach | • Often a distress situation  
• Value sometimes just a fraction of replacement cost  
• Highest and best use determination can be complex |
| Stage 4/ vacant | Fee simple/ real property only | Low | Modest | Sales comparison approach | • Buyer may not intend restaurant use  
• Buyer could be a restaurant operator planning substantial renovation and therefore views the property as being somewhat competitive with a vacant development site  
• Value is sometimes similar to land value (and can actually be less, if demolition cost should be deducted)  
• Highest and best use determination can be complex |

*The parsing income method is an adaptation from the business valuation method called the excess earnings method and is explained further in Chapter 9 of A Guide to Appraising Restaurants (Chicago: Appraisal Institute, 2021).*
turning around struggling businesses. They were attracted to the property because of its location in a market they had sought to enter for some time.\textsuperscript{16}

**The vision:** Prior to making their purchase offer, the buyers developed a strategy to increase revenue and profits. They began this process by identifying what was wrong with the property, summarized as follows:

- There were limitations with the existing kitchen, which was small and had a choppy layout. The ventilation hood was too small, as it was apparently designed primarily for catering. Consequently, the kitchen would not accommodate a “full” menu without some modifications. The catering business never got much traction, so as a practical matter the kitchen was mostly used for appetizers.
- The amount of office space was far in excess of what was needed.
- The bar was too far from the kitchen.
- Few design changes could be accomplished without modifications to the sprinkler system, which meant upgrades and updates to the property's plumbing.

**The renovation:** The new owners designed and executed the following renovation plan:

- The kitchen was upgraded to allow for a “full” menu.
  - A new ventilation hood and related equipment were installed.
  - Additional sprinkler lines and heads were installed.
- A partial demolition of the second floor resulted in a first level with a much larger, more open feel. The remaining second floor area was used for additional seating and special events.
- The bar area was relocated to be near the kitchen for improved flow.
- Customer restrooms were refurbished.
- HVAC systems were upgraded as needed.

**The cost:** The cost was budgeted at $155,250, summarized as follows:

- Partial demolition of second floor: $30,000
- Engineering and design, permits, interest, and bank fees: $21,750
- Iron work, sheetrock, framing, vanities and countertops, paint, cabinetry, and case work: $21,230
- Entrepreneurial incentive (15% of cost): $20,250
- New ventilation hood and related equipment to be “bolted” to the floor: $19,000
- Plumbing, electric, and fire protection: $13,000
- Rental, cleanup, general contractor fees, and insurance: $11,700
- Mechanical and HVAC: $11,400
- Masonry and concrete: $2,500
- Miscellaneous: $1,550
- Contingency: $2,870

**The value:** An appraisal performed when the property was purchased confirmed that the $1,400,000 purchase price was reasonable at that time. An appraisal done after construction indicated a post-renovation value of $1,550,000. Both appraisals reflected real property only.

**Return on investment:** The contributory value of the proposed construction is the difference between the value of the property prior to construction and after, or $150,000 ($1,550,000 – $1,400,000). By comparison, the investment required to achieve this $150,000 increase in value was $155,250, which included entrepreneurial incentive of $20,250 (or 15% of cost). The capital investment (without entrepreneurial profit) totaled $135,000.

The profit/loss of this venture can be measured in a number of ways:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit from construction</td>
<td>$15,000</td>
</tr>
<tr>
<td>($150,000 – $135,000)</td>
<td></td>
</tr>
<tr>
<td>Return on investment</td>
<td>11%</td>
</tr>
<tr>
<td>($15,000 ÷ $135,000)</td>
<td></td>
</tr>
<tr>
<td>Recapture of investment</td>
<td>$1.11 per dollar of capital investment was recovered</td>
</tr>
<tr>
<td>($150,000 ÷ $135,000)</td>
<td></td>
</tr>
</tbody>
</table>

From a real estate investment perspective, the profit was somewhat modest and the opportunity for a $15,000 gain may not have interested many real estate investors. However,

\textsuperscript{16} This purchaser is an excellent example of what could be described as a “strategic buyer.”
many owner-operated properties are renovated without the incentive of any real estate profit at all and are often done at a loss (therefore not meeting the financial feasibility test of highest and best use). The motivation for the new owners was to reposition the property in such a way so that they could pursue greater business profits, which would be a result of the functional enhancements made.

**Conclusion**

The highest and best use analysis for restaurant properties requires more depth than is needed for many other types of properties, as restaurant properties can transition through their life cycles quickly. As with most retail properties, a restaurant can reach the end of its economic life suddenly with the construction of an overpass that redirects traffic, the closing of a local demand generator, or some similar event. Other challenges facing restaurant properties include turbulence within the businesses they house. Restaurants often operate at low margins and must contend with a perpetual influx of new competitors.

**Key Takeaways**

The following is a summary of the key points we covered in this article:

- Thorough treatment of highest and best use issues creates a firm foundation for the valuation analysis.
- Listing the strengths, weaknesses, threats, and opportunities of a property can be enormously helpful for assessing which stage of its life cycle it is in and for analyzing comparables. It can also provide useful information to the reader of the appraisal report.
- Many restaurant properties begin their economic life designed for financially strong tenants who will pay sufficient rent for a property that meets their specific requirements. Restaurant properties transition through several life cycle stages and eventually become suitable only for conversion to an alternative use or redevelopment. This gradual transition has four distinct stages.
- It is not unusual for a restaurant property to slip into the next stage of its life cycle about five years after its last minor remodeling and to be significantly at risk approximately 10 to 15 years after its last major remodeling.
- Corporate users often find it easier and cheaper to redevelop a site than to retrofit an existing restaurant building that no longer meets their current standards.
- Defining the profile of the most likely buyer is the bridge that connects the highest and best use opinion with the selection of comparables.
- The remaining lease term influences the profile of the most likely buyer.
- The sales per square foot being achieved at the business is particularly helpful in determining the highest and best use of a property with a lease that is approaching expiration.

SEE NEXT PAGE FOR ADDITIONAL RESOURCES >
About the Authors

Bradley R. Carter, MAI, CRE, CCIM, CDEI, has background in both the restaurant industry and valuation profession. Prior to beginning an appraisal career, Carter served as a corporate area supervisor for the Domino's Pizza Corporation, where he helped pioneer the company's efforts to enter the competitive Long Island, NY, market. He later owned and operated his own restaurant. As an appraiser, his experience with special-purpose retail properties includes having authored the Appraisal Institute book A Guide to Appraising Automobile Dealerships, winner of the 2016 George L. Schmutz Award, along with A Guide to Appraising Automobile Dealerships, second edition. He is also developer and instructor of the Appraisal Institute's Appraising Automobile Dealerships seminar. Carter has authored several studies and articles that have appeared in The Appraisal Journal as well as journals published by The Counselors of Real Estate, the CCIM Institute, and numerous industry magazines, including Pizza Today. He has significant court testimonial experience and has been interviewed by The Wall Street Journal as a real property valuation expert. Carter has appraised property in 48 states and served six years as an Appraisal Institute demonstration appraisal report grader. He currently serves as a managing director for Specialty Valuation Group.

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J. Tyler Leard has been a commercial real estate appraiser since 2007. Prior to entering the appraisal profession, Leard was a financial analyst. He has appraised properties in 26 states. In addition, he was co-author of the article “Counseling the Banks: What Is the Market for Branches?” published in the Spring 2009 issue of The Counselors of Real Estate’s Real Estate Issues.

Additional Resources

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

Appraisal Institute
Lum Library, External Resources, Resource Links [Login required]
Knowledge Base Bibliographies—Restaurants

National Restaurant Association—Resource Library
https://restaurant.org/education-and-resources/

Research and Markets.com—Restaurants, Bars and Cafés
https://www.researchandmarkets.com/categories/restaurants-bars-cafés

Restaurant Business—Consumer Trends
https://www.restaurantbusinessonline.com/consumer-trends

Restaurant Data.com—Products and Services
https://www.restaurantdata.com/product-services/
Wind Project Valuation and Repowering

by Richard K. Ellsworth

Abstract

Renewable energy standards mandating the purchase of electricity from renewable sources have increased the focus on wind-generated electricity as an environmentally friendly energy source. Advances in wind turbine technology and the opportunity for extension of the federal production tax credit have increased interest in the valuation of existing wind projects. A repowered wind project can qualify for the federal tax credit depending on the percentage of the project that is new after the repowering. This article discusses the issues associated with the valuation of wind projects considered for repowering.

Consumers view electricity produced from renewable sources as an environmentally friendly source of energy with economic and public health benefits relative to conventional forms of electricity generation. Greater awareness of environmental issues associated with conventional electricity generation sources and the adoption of government policies in the form of renewable portfolio standards that mandate a greater percentage of electricity to be generated from renewable sources have created a strong backdrop for the continued development of renewable energy projects including wind projects. Consumer preference for electricity sourced from renewable energy projects and renewable portfolio standards policies have led to the significant growth of wind projects.

Wind-generated electricity is a major source of renewable energy, and wind energy projects continue to be constructed to meet the demand for additional renewable energy. The emergence of wind projects as a generation source is positively impacting the goal of increased renewable electricity. The construction of wind projects is expected to continue as government mandates require renewable energy to comprise an increasing percentage of total electricity generation. Wind projects have undergone advances in design standards and technology in recent years, and newer projects are available with better performance characteristics relative to older projects.

Wind projects have scaled up since the early 2000s, and wind energy has become a more significant source for renewable electricity. However, the technological advances can present challenges when valuing older wind projects considered for updating or “repowering.” The valuation issue for appraisers is to help their clients identify the point at which wind project repowering becomes economically feasible to permit the extension of the federal production tax credit.

Wind Energy Resources

In the past two decades, wind turbines increased in size, with larger rotor diameters and increased tower heights that provide better access to available wind resources. In addition, numerous government incentives in furtherance of public policy favoring renewable energy contributed to the expansion of wind-sourced generation capacity. Capacity has also increased as wind projects often are constructed with more tur-
bines per site to take advantage of operational efficiencies and economies of scale; cumulative installed generating capacity grew from 2.5 gigawatts (GW) in 2000 to 105.5 GW in 2019 as illustrated in Exhibit 1.²

Wind projects, often referred to as wind farms, consist of individual turbines grouped together. Farms can range in size from a handful of turbines in a relatively small area to several hundred turbines covering an extended land area in a utility-scale wind project. Since wind does not blow continuously and its speed is variable, the geographical location and site selection for a wind project is an important element in maximizing electricity production and project economics. Wind turbine designs have been modified to improve performance during operation as measured by capacity factor, where the capacity factor reflects electricity output for a year divided by electric output at design capacity for a year. As previously noted, the larger turbine sizes and increased tower height of newer turbines have improved efficiency, and the increased scale of wind projects has lowered their cost per kilowatt according to Lawrence Berkeley National Laboratory’s research (Exhibit 2).³

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Existing wind projects include established elements such as a confirmed proven wind resource, land leases, transmission-grid interconnection, legal permits, environmental approvals, and other infrastructure assets that are currently in place. Existing wind projects typically lease the land where the infrastructure assets are sited, and depending on the terms of the lease agreement, there may be a leasehold value for the leasehold property rights that exist. In addition, wind projects are connected to the transmission grid through a transmission line that delivers their electricity to consumers. Legal permits and environmental approvals are typically required before a wind project can be constructed, and these permits and approvals can require lengthy studies and hearings before receiving the necessary approvals. In addition, the construction process involves the transport of the wind turbines using heavy equipment and the construction of substantial foundations to support the wind turbines. The construction process can be disruptive to the roads providing access to the project site and also may cause crop damage during construction, resulting in related expenses to restore any damage during construction activities.

**Wind Project Repowering**

Today’s wind turbines have evolved technologically; they are larger and more efficient than older turbines, rendering older wind turbines somewhat obsolete. Wind project repowering involves replacing aging wind turbines or other components with new equipment to qualify for the production tax credit. Repowering to increase efficiency and potentially extend useful life offers the benefit of increased electricity production and improved project reliability along with reduced operations and maintenance costs. Full repowering involves the decommissioning and removal of existing turbines and their replacement with new turbines. Partial repowering involves replacement of some existing wind turbines or replacing select components such as a new nacelle and longer turbine blades.

A repowered wind project qualifies for the federal production tax credit if at least 80% of the property’s value is new; this allows owners to repower existing wind projects without a complete replacement of project components. A repowered wind project qualifies as originally placed in service even though it contains some retained components if the fair market value of the retained components is not more than 20% of the total value. Wind projects where construction began during 2020 qualify for the production tax credit at a rate of 60% of the full inflation-adjusted per-kilowatt-hour credit for ten years after the date the project is placed in service for electricity generated by qualified energy resources and sold to an unrelated party during the taxable year.

**Wind Project Valuation Case Example**

When valuing a wind project, the analytical process should consequently reflect the physical decline of the project equipment as well as the technical, legal, and political permissibility and economic environment confronting the project as part of the valuation process. In this case study example, management is considering the repowering of an existing wind farm to claim the production tax credit that the project would be eligible to receive after the repowering. The wind farm is twelve years old and located in the interior of the United States. The wind farm has a generating capacity of 200 megawatts (MW). As part of the decision-making process, management needs a value estimate of the existing wind project; this is a first step in understanding the economic consequences of the proposed repowering.

**Cost Approach**

The cost approach relies on the consideration of construction cost estimates as a method to provide an indication of project value. The study of construction cost information for wind projects recently placed in service is well suited for estimating replacement cost. Wind project costs are estimated in terms of the current materials and labor to construct a project with similar utility.

Wind project construction costs are influenced by a multitude of factors including site conditions, geographic location, transportation access, labor availability, workforce productivity, design capacity, and technical specifications. Construc-
tion cost estimates are broadly categorized as direct and indirect costs related to project construction with an additional allowance for the entrepreneurial incentive expected to be realized by the project sponsor to compensate for the risks assumed in bringing the wind project to successful completion. The construction cost estimate represents the current cost to construct a comparable wind project that is the modern equivalent to the subject wind project.

Wind project construction costs are typically expressed as overnight construction costs that exclude the funding aspects associated with project construction. Capitalized interest reflects the cost of funding during the time it is being constructed and is recognized as an additional cost element to be included as part of project costs. Capitalized interest reflects an estimate of the financing cost associated with the construction loan used to fund construction activities during construction of the project. Capitalized interest is estimated by consideration of the disbursement pattern of construction expenditures during the anticipated construction period.

Wind project construction cost considerations also need to recognize entrepreneurial incentive as a cost element that reflects the amount a project sponsor expects to realize when a project is completed and accepted for commercial operation. Entrepreneurial incentive represents the premium a project sponsor expects to receive as compensation for their contribution to the project and the assumption of development risks associated with the project. Entrepreneurial incentive is influenced by project complexity and scale along with the knowledge needed to successfully complete each project stage as well as the perceived project risk characteristics. The project sponsor has invested capital that is exposed from the time of initial permitting and feasibility study through project completion and acceptance for commercial operation.

From project inception until completion, the project sponsor incurs the risk of capital loss as the capital is committed and consequently unavailable for deployment in other projects. Entrepreneurial incentive has been estimated to be between 5% and 20% of cost for office buildings and apartment complexes, based on the nature of the property and the economic development cycle. In addition, the US Treasury has indicated that the range for markup to reflect entrepreneurial incentive is typically between 10% and 20%. Entrepreneurial incentive reflects the economic reward expected to be realized by the project sponsor for the risk associated with project development, and its magnitude is correlated with the perceived project risk.

**Wind Project Replacement Cost Estimate.** An estimate of project construction cost is developed by referencing construction cost information attributable to previously constructed wind projects. In the power industry, project costs are frequently expressed as a dollar per kilowatt of generating capacity, since projects vary significantly depending on site conditions and the market served. The conversion of construction cost information to a unit of capacity basis provides a consistent framework from which to examine project costs. The cost per kilowatt of generating capacity is calculated by taking the estimated cost for the individual wind project and dividing that figure by its respective generating capacity.

In the current example, the wind project being considered for repowering is in the interior region of the United States with the current project capital cost estimated to be $1,310 per kilowatt (kW) of generating capacity exclusive of capitalized interest and entrepreneurial incentive considerations. Capitalized interest is incorporated in the project cost estimate through the expected cost disbursement pattern during an anticipated one-year construction period. Based on the wind

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project risk characteristics and the current interest rate environment, the interest rate for the calculation of capitalized interest is estimated to be 4%. For a one-year construction period, a 4% interest rate and a linear expenditure pattern during construction, capitalized interest is calculated as 2% of the project capital costs ($26/kW). After considering the US Treasury entrepreneurial incentive range of 10% to 20%, the entrepreneurial incentive selected was at the low end of the US Treasury range or 10% ($134/kW) and applied to the sum of project capital costs of $1,310/kW and capitalized interest of $26/kW. Consequently, replacement cost new is estimated for the wind project as the sum of project capital costs, capitalized interest and entrepreneurial incentive at $1,470 per kilowatt of generating capacity or $294,000,000.

Depreciation Estimate. After developing a replacement cost estimate for the wind project, depreciation influences from physical deterioration, functional obsolescence, and economic obsolescence are quantified through an analysis of the reduction in value that occurs as the project performs its intended purpose and its available service is consumed. The concept of depreciation recognizes the lessening in value that occurs over time relative to a new, substitute wind project. The value reduction experienced by the subject wind project is measured by comparison with an equivalent substitute that has not suffered any value detriment.

The depreciation rate is influenced by the expected useful life as well as the applied operation and maintenance policies. Wind projects experience diminished capabilities even when maintenance policies are applied so that they are unable to function as efficiently as when first placed in service. The decline in value is related to the consumption of available service life and the decline in productive service capability. Depreciation is quantified as the expected remaining services available from the wind project expressed as a percentage of the total expected services available reflecting useful life consumption and productive capability declines with operational use.

In the example, the wind project being considered for repowering has been operating for a number of years so that an adjustment to replacement cost new (RCN) is necessary to reflect depreciation relative to a new project. The adjustment to replacement cost new reflects the decline in useful life and serviceability relative to when the project was first placed in service. The current wind project is twelve years old and has experienced depreciation through operational use and exposure to the elements, and as expected it operates less efficiently and requires more maintenance than when it was first placed in service. This reflects a consumption of service life and reduction of serviceability. Its life expectancy is estimated to be thirty years based on previous Lawrence Berkeley National Laboratory research that indicated a 29.6-year life when calculating the levelized cost of energy for wind projects. Consequently, the project’s remaining life is estimated to be eighteen years.

The wind project also has experienced physical deterioration, here estimated as 40% of replacement cost (chronological age of 12 years divided by life expectancy of 30 years) or $118,000,000 (rounded). Functional obsolescence is quantified based on the relative capacity factor performance of the subject wind project (28%) in comparison to a current substitute wind project (45%) and calculated as one minus the wind project capacity factor divided by the current substitute wind project capacity factor (1 – 0.28/0.45) or $67,000,000 (rounded). Economic obsolescence is the loss in value caused by forces external to the wind project that are beyond the ability of the owner to control. In the time since the wind project was placed in service, the price for wind power has declined, negatively impacting the profitability of its operations. Economic obsolescence is estimated by comparing profitability at its placed-in-service date with profitability at the current valuation date. The original power purchase agreement (PPA) electricity price for the wind project was $50 per megawatt hour (MWh) while the current electricity price in the marketplace is $30/MWh. Operating expenses have remained con-

stant at $23/MWh so that the original EBITDA margin was $27/MWh, and the current EBITDA margin is $7/MWh. The economic obsolescence reflects a decline in profitability of 74% from the placed-in-service date to the current valuation date and is equal to $81,000,000. Depreciation for the existing wind project being considered for repowering is $266,000,000 as shown in Exhibit 3. After adjusting the RCN for depreciation from physical deterioration as well as functional and economic obsolescence, the wind project value is estimated to be $28,000,000.

Exhibit 3  Wind Project Depreciation Analysis

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current RCN</td>
<td>$294,000,000</td>
</tr>
<tr>
<td>Physical Deterioration</td>
<td>$118,000,000</td>
</tr>
<tr>
<td>Functional Obsolescence</td>
<td>$67,000,000</td>
</tr>
<tr>
<td>Economic Obsolescence</td>
<td>$81,000,000</td>
</tr>
<tr>
<td>Replacement Cost New Less Depreciation</td>
<td>$28,000,000</td>
</tr>
</tbody>
</table>

Sales Comparison Approach
The sales comparison approach provides a value indication by identifying market transactions involving other wind projects. Market transaction prices are influenced by the future perceptions and expectations of buyers and sellers regarding the economic attractiveness of individual wind farms. Market participants may be driven by liquidity needs, incentives to divest assets, changing business and market environments, new generation construction, geographical diversification, and divergent opinions regarding future electricity pricing and prospects for wind projects.

The sales comparison approach relies on the availability of comparable wind project transactions as the basis for the analyses. A sales comparison approach analysis begins with the identification of observed transactions from which value perceptions can be developed. Transaction prices are impacted by location factors and specific operating characteristics like efficiency, environmental regulations, and future capital expenditure requirements. Wind project transactions may be adjusted to reflect differences in design characteristics, location, transaction date, and project economics. The transactional data is then converted to a price per kilowatt (kW) to compare wind farm metrics for projects of varying size.

Applying the price per kilowatt to the total generating capacity results in an indication of value for the wind project. Ideally, the sales comparison approach identifies transactions that possess characteristics similar to the subject wind project so that a consistent value indication may be developed. Transaction data for wind projects purchased with the intent to repower the project indicated a range between $50/kW and $250/kW. In addition, discussions with wind project developers indicated that development stage wind projects are typically purchased in the range of $25/kW to $200/kW. Based on a range of $50/kW to $200/kW, the value of the wind project is estimated at between $10,000,000 and $40,000,000.

Income Approach
The income approach begins with the development of a discounted cash flow analysis that details a pro forma presentation of expected future operations. Available cash flow is calculated as revenue less expenses, depreciation, and taxes to yield net income with depreciation added and capital expenditures subtracted to create cash flow. For each forecast year of wind project operation, cash flows are projected and converted to present value through the application of a present value factor that is calculated based on the estimated discount rate. A discounted cash flow analysis recognizes the expected future benefits associated with the wind project and converts the expected cash flows to be generated by the project into an indication of value.

Revenue depends upon the ability of the wind project to generate electricity for its expected remaining useful life. Revenue is forecast by considering the project’s capacity factor, generating capacity, and future demand for electricity. Electricity revenue is based on the sale of electricity, with projected revenue equal to the product of annual electricity output and average electricity price. In the example, the price paid for electricity is projected as $30/MWh in 2021. The electricity price is then expected to escalate 2%
annually consistent with the long-term forecast for inflation for the future years of operation.

The expenditures associated with wind project operation are broadly categorized into operation and maintenance expenses, general and administrative expenses, depreciation, income taxes and capital expenditures. Operations and maintenance expenses consist of the materials and labor expenditures necessary for operation and routine maintenance. General and administrative expenses are the costs incurred to manage and administer the project, as well as insurance expense and property taxes. Depreciation expense represents the systematic recovery of capital invested in the wind project. Income taxes are applied to pretax income, and capital expenditures cover investments for maintaining productive capabilities.

Expenses are forecast to be 60% of revenue for operating and maintenance expenses and 15% of revenue for general and administrative expenses. Depreciation expense is based on the modified accelerated cost recovery system (MACRS) rules and regulations. Income taxes are forecast based on a blended US federal and state marginal income tax rate of 26% of pre-tax income, while capital expenditures are projected to be 2% of revenue.

Economic benefits in the form of future cash flows for each year of expected operation are then converted to a present value using a discount rate that considers the risks inherent with project operation and compensates an investor for the associated ownership risks. A discount rate is typically calculated using a weighted average cost of capital with consideration given to the identification of a target capital structure, reflecting market-developed capital weightings and the estimated market costs for the debt and equity capital components. The cost of debt is estimated by considering the current yield on corporate bonds, while the cost of equity is developed using the capital asset pricing model. Given the cost of debt, cost of equity, and the target capital structure, a 9% discount rate was estimated.

Exhibit 4 illustrates the discounted cash flow analysis process for the expected remaining 18 years of operation using a mid-year discounting convention. At the end of the 18-year projection period, a reversionary value of $20,000,000 is forecast to reflect the value of land leaseholds, approvals, site location, etc. The secured property rights—in the form of a leasehold value because the land is not owned by the wind project as well as other site infrastructure and project approvals—represent valuable elements beyond the life of the existing wind project. After the various operational aspects have been examined and a discount rate developed to convert future cash flows to present value, the projected cash flows are then discounted and summed to provide a value indication. Based on the discounted cash flow analysis, the wind project value is estimated to be $30,000,000 with the income approach.

**Exhibit 4  Wind Project Discounted Cash Flow Analysis**

<table>
<thead>
<tr>
<th>Period</th>
<th>1</th>
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</thead>
<tbody>
<tr>
<td>Year</td>
<td>2021</td>
<td>2022</td>
<td>2023</td>
<td>2024</td>
<td>2025</td>
<td>2026</td>
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<tr>
<td>Electricity Revenue</td>
<td>14,716,800</td>
<td>15,011,136</td>
<td>15,311,359</td>
<td>15,617,586</td>
<td>15,929,938</td>
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<td>Expenses</td>
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<td></td>
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<td></td>
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<tr>
<td>O&amp;M Expense</td>
<td>8,830,080</td>
<td>9,006,682</td>
<td>9,186,815</td>
<td>9,370,552</td>
<td>9,557,963</td>
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<td>G&amp;A Expense</td>
<td>2,207,520</td>
<td>2,251,670</td>
<td>2,296,704</td>
<td>2,342,638</td>
<td>2,389,491</td>
<td>2,437,280</td>
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<tr>
<td>Total Expenses</td>
<td>11,037,600</td>
<td>11,258,352</td>
<td>11,483,519</td>
<td>11,713,189</td>
<td>11,947,453</td>
<td>12,186,402</td>
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<tr>
<td>EBITDA</td>
<td>3,679,200</td>
<td>3,752,784</td>
<td>3,827,840</td>
<td>3,904,396</td>
<td>3,982,484</td>
<td>4,062,134</td>
</tr>
<tr>
<td>Depreciation</td>
<td>42,061</td>
<td>114,985</td>
<td>168,764</td>
<td>208,902</td>
<td>239,364</td>
<td>270,406</td>
</tr>
<tr>
<td>Pretax Income</td>
<td>3,637,139</td>
<td>3,637,799</td>
<td>3,659,076</td>
<td>3,695,495</td>
<td>3,743,121</td>
<td>3,791,728</td>
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<tr>
<td>Income Tax @ 26%</td>
<td>945,656</td>
<td>945,828</td>
<td>951,360</td>
<td>960,829</td>
<td>973,211</td>
<td>985,849</td>
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<td>Net Income</td>
<td>2,691,483</td>
<td>2,691,971</td>
<td>2,707,716</td>
<td>2,734,666</td>
<td>2,769,909</td>
<td>2,805,879</td>
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<td>Capital Expenditures</td>
<td>294,336</td>
<td>300,223</td>
<td>306,227</td>
<td>312,352</td>
<td>318,599</td>
<td>324,971</td>
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<tr>
<td>Depreciation</td>
<td>42,061</td>
<td>114,985</td>
<td>168,764</td>
<td>208,902</td>
<td>239,364</td>
<td>270,406</td>
</tr>
<tr>
<td>Cash Flow</td>
<td>2,439,208</td>
<td>2,506,733</td>
<td>2,570,253</td>
<td>2,631,216</td>
<td>2,690,674</td>
<td>2,751,314</td>
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<tr>
<td>PV Factor @ 9%</td>
<td>0.9578</td>
<td>0.8787</td>
<td>0.8062</td>
<td>0.7396</td>
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<td>PV Cash Flow</td>
<td>2,336,273</td>
<td>2,202,667</td>
<td>2,072,138</td>
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<td>1,825,623</td>
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<td>PV of Cash Flows</td>
<td>30,087,000</td>
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<td>Value Rounded</td>
<td>30,000,000</td>
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CONTINUED >
### Exhibit 4 (continued)

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<tr>
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<th>9</th>
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<th>11</th>
<th>12</th>
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<tbody>
<tr>
<td>Year</td>
<td>2027</td>
<td>2028</td>
<td>2029</td>
<td>2030</td>
<td>2031</td>
<td>2032</td>
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<tr>
<td>Electricity Revenue</td>
<td>16,573,507</td>
<td>16,904,977</td>
<td>17,243,077</td>
<td>17,587,938</td>
<td>17,939,697</td>
<td>18,298,491</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>O&amp;M Expense</td>
<td>9,944,104</td>
<td>10,142,986</td>
<td>10,345,846</td>
<td>10,552,763</td>
<td>10,763,818</td>
<td>10,979,095</td>
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<tr>
<td>G&amp;A Expense</td>
<td>2,486,026</td>
<td>2,535,747</td>
<td>2,586,462</td>
<td>2,638,191</td>
<td>2,690,955</td>
<td>2,744,774</td>
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<tr>
<td>Total Expenses</td>
<td>12,430,130</td>
<td>12,678,733</td>
<td>12,932,308</td>
<td>13,190,954</td>
<td>13,454,773</td>
<td>13,723,868</td>
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<tr>
<td>EBITDA</td>
<td>4,143,377</td>
<td>4,226,244</td>
<td>4,310,769</td>
<td>4,396,985</td>
<td>4,484,924</td>
<td>4,574,623</td>
</tr>
<tr>
<td>Depreciation</td>
<td>302,098</td>
<td>321,268</td>
<td>327,693</td>
<td>334,247</td>
<td>340,932</td>
<td>347,750</td>
</tr>
<tr>
<td>Pretax Income</td>
<td>3,841,279</td>
<td>3,904,977</td>
<td>3,983,076</td>
<td>4,062,738</td>
<td>4,143,993</td>
<td>4,226,872</td>
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<tr>
<td>Income Tax @ 26%</td>
<td>998,732</td>
<td>1,015,294</td>
<td>1,035,600</td>
<td>1,056,312</td>
<td>1,077,438</td>
<td>1,098,987</td>
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<tr>
<td>Net Income</td>
<td>2,842,546</td>
<td>2,889,683</td>
<td>2,947,476</td>
<td>3,006,426</td>
<td>3,066,554</td>
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<td>Capital Expenditures</td>
<td>331,470</td>
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<td>344,862</td>
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<td>358,794</td>
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<tr>
<td>Depreciation</td>
<td>302,098</td>
<td>321,268</td>
<td>327,693</td>
<td>334,247</td>
<td>340,932</td>
<td>347,750</td>
</tr>
<tr>
<td>Cash Flow</td>
<td>2,813,174</td>
<td>2,872,851</td>
<td>2,930,308</td>
<td>2,988,914</td>
<td>3,048,692</td>
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<td>PV Factor @ 9%</td>
<td>0.5711</td>
<td>0.5240</td>
<td>0.4807</td>
<td>0.4410</td>
<td>0.4046</td>
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<td>PV Cash Flow</td>
<td>1,606,604</td>
<td>1,505,374</td>
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<td>1,318,111</td>
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### Exhibit 4 (continued)

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<td>Year</td>
<td>2033</td>
<td>2034</td>
<td>2035</td>
<td>2036</td>
<td>2037</td>
<td>2038</td>
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<td>Electricity Revenue</td>
<td>18,664,461</td>
<td>19,037,750</td>
<td>19,418,505</td>
<td>19,806,875</td>
<td>20,203,013</td>
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<tr>
<td>Expenses</td>
<td></td>
<td></td>
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<td>O&amp;M Expense</td>
<td>11,198,677</td>
<td>11,422,650</td>
<td>11,651,103</td>
<td>11,884,125</td>
<td>12,121,808</td>
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<td>G&amp;A Expense</td>
<td>2,799,669</td>
<td>2,855,663</td>
<td>2,912,776</td>
<td>2,971,031</td>
<td>3,030,452</td>
<td>3,091,061</td>
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<tr>
<td>Total Expenses</td>
<td>13,998,346</td>
<td>14,278,313</td>
<td>14,563,879</td>
<td>14,855,156</td>
<td>15,152,259</td>
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<tr>
<td>EBITDA</td>
<td>4,666,115</td>
<td>4,759,438</td>
<td>4,854,626</td>
<td>4,951,719</td>
<td>5,050,753</td>
<td>5,151,768</td>
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<tr>
<td>Depreciation</td>
<td>354,705</td>
<td>361,799</td>
<td>369,035</td>
<td>376,416</td>
<td>383,944</td>
<td>391,623</td>
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<tr>
<td>Pretax Income</td>
<td>4,311,410</td>
<td>4,397,638</td>
<td>4,485,591</td>
<td>4,575,303</td>
<td>4,666,809</td>
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<tr>
<td>Income Tax @ 26%</td>
<td>1,120,967</td>
<td>1,143,386</td>
<td>1,166,254</td>
<td>1,189,579</td>
<td>1,213,370</td>
<td>1,237,638</td>
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<tr>
<td>Capital Expenditures</td>
<td>373,289</td>
<td>380,755</td>
<td>388,370</td>
<td>396,138</td>
<td>404,060</td>
<td>412,141</td>
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</tr>
<tr>
<td>Depreciation</td>
<td>354,705</td>
<td>361,799</td>
<td>369,035</td>
<td>376,416</td>
<td>383,944</td>
<td>391,623</td>
<td></td>
</tr>
<tr>
<td>Cash Flow</td>
<td>3,171,859</td>
<td>3,235,297</td>
<td>3,300,003</td>
<td>3,366,003</td>
<td>3,433,323</td>
<td>3,501,989</td>
<td>20,000,000</td>
</tr>
<tr>
<td>PV Factor @ 9%</td>
<td>0.3405</td>
<td>0.3124</td>
<td>0.2866</td>
<td>0.2630</td>
<td>0.2412</td>
<td>0.2213</td>
<td>0.2120</td>
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<tr>
<td>PV Cash Flow</td>
<td>1,080,018</td>
<td>1,010,707</td>
<td>945,781</td>
<td>885,259</td>
<td>828,117</td>
<td>774,990</td>
<td>4,240,000</td>
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</tbody>
</table>
To summarize the analysis results, the cost approach indicated a value of $28,000,000 and the income approach indicated a value of $30,000,000 while the sales comparison approach indicated a range of value between $10,000,000 and $40,000,000, which corroborated the results from the cost and income approaches. Exhibit 5 presents the results from the cost, sales comparison, and income approaches.

Exhibit 5  Wind Project Valuation Indications

<table>
<thead>
<tr>
<th>Approach</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost Approach</td>
<td>$28,000,000</td>
</tr>
<tr>
<td>Sales Comparison Approach</td>
<td>$10,000,000–$40,000,000</td>
</tr>
<tr>
<td>Income Approach</td>
<td>$30,000,000</td>
</tr>
</tbody>
</table>

After considering the results from the individual valuation approaches, the value for the subject wind project is estimated to be $29,000,000.

Conclusion

Renewable portfolio standards that require a higher percentage of electricity from renewable sources have served as a catalyst for the significant growth of installed generation capacity for wind projects. These projects are an attractive generation source as technological advancements and cost reductions continue to encourage capital investments. Wind projects now account for a significant percentage of new generation capacity as a zero-emissions generation source and have the ability to assist states in meeting their renewable portfolio standards.

Advances in wind turbine technology and changing industry economics can present valuation challenges when studying older wind projects being considered for repowering. Wind project valuation related to repowering and the opportunity for extension of federal production tax credits necessitates an understanding of the intricacies of the power generation market as well as the unique and challenging technical issues associated with these projects. Appraisers have long played an important role in advising clients concerning the financial feasibility of projects with the repowering of wind projects presenting another opportunity to perform such services.

About the Author

Richard K. Ellsworth, PE, CFA, ASA, CCP, has over thirty years of global experience in the valuation of power and infrastructure assets including renewable energy projects. He is a licensed professional engineer (PE), an accredited senior appraiser (ASA), a chartered financial analyst (CFA), and a certified cost professional (CCP). Ellsworth received a BS in civil engineering and an MBA from Lehigh University. Contact: rickkellsworth@gmail.com
Additional Resources
Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute
Lum Library, External Resources [Login required]
Knowledge Base Bibliographies—Energy Efficiency/Wind Energy

Lawrence Berkeley National Laboratory
- Land-Based Wind Market Report
  https://emp.lbl.gov/wind-technologies-market-report/

- Publications
  https://emp.lbl.gov/publications

- Research
  https://emp.lbl.gov/research

US Department of the Treasury—1603 Program: Payments for Specified Energy Property in Lieu of Tax Credits
https://bit.ly/3otFY3s

US Office of Energy Efficiency and Renewable Energy (EERE)—Wind Turbines: The Bigger, the Better
https://www.energy.gov/eere/articles/wind-turbines-bigger-better
Valuation of Accessory Dwelling Units

by Sandra K. Adomatis, SRA

Abstract
Accessory dwelling units are on the rise amid ongoing shortages of housing inventory, particularly in the affordable housing sector. In a growing number of states and urban metropolitan centers, excessive market demand for housing is driving up prices of homes and pushing out more affordable housing options. Markets such as San Francisco, California; Portland, Oregon; Seattle, Washington; and others have adopted zoning changes to provide relief to the housing challenges. Increasingly, municipalities are updating their zoning to legally and relatively easily allow single-unit housing to add one or more accessory dwelling units (ADUs). This article will focus on the ADU trend within the context of changing zoning, lending, and appraisal guidelines, and its valuation niche for the appraiser.

Introduction
Accessory dwelling units (ADUs) are not new and can be traced back to the early twentieth century, when they were a common feature in single-family housing (i.e., today known as one-unit housing) throughout cities in the United States, prior to the implementation of zoning ordinances.¹ Currently, ADUs are a growing trend in large metropolitan cities. Recent changes in the secondary mortgage market appraisal guidelines give more guidance and flexibility in valuing and financing these units. Prior to the 2020 Fannie Mae Selling Guide update, it was next to impossible for appraisers to meet federal Agency appraisal guidelines, because three sales of comparable ADU properties were extremely difficult to find in the local market. Consequently, ADU property owners found it necessary to seek financing from private lenders, small banks, or credit unions that did not sell to the secondary mortgage market.

ADU Definitions
The best place to start any discussion of ADUs is to look at how this housing choice is defined. As the following discussion shows, the definitions of ADUs vary. This highlights the importance of knowing not only lending and appraisal guidelines for secondary mortgage markets but also the local zoning definitions.

The Dictionary of Real Estate Appraisal defines an ADU as “a small, self-contained dwelling, typically with its own entrance, cooking, and bathing facilities, that shares the site of a larger, single-unit dwelling. ADUs may be attached or built in, such as a basement apartment, or detached, such as a backyard cottage. The owner of the accessory dwelling unit is the same as the owner of the primary dwelling.”² The federal government agencies define ADU as noted below.

• **Fannie Mae**—An ADU is “typically an additional living area independent of the primary dwelling that may have been added to, created within, or detached from a pri-

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2. “Agency” as used throughout this article refers to Fannie Mae, Freddie Mac, US Department of Veterans Affairs (VA), US Department of Housing and Urban Development/Federal Housing Administration (HUD/FHA), and US Department of Agriculture (USDA).
4. The USDA does not define ADU.
Valuation of Accessory Dwelling Units

The ADU must provide for living, sleeping, cooking, and bathroom facilities and be on the same parcel as the primary one-unit dwelling.5

- **VA**—An ADU is “a living unit including kitchen, sleeping, and bathroom facilities added to or created within a single-family dwelling, or detached on the same site. A manufactured home on the site could be an ADU. The dwelling and the ADU together constitute a single real estate entity.”6

- **Freddie Mac**—An ADU is “an additional living area that includes at least a kitchen, a bathroom, and a separate entrance and is independent of the primary dwelling unit.”7

- **HUD/FHA**—An ADU is “a habitable living unit added to, created within, or detached from the primary one-unit, single-family residence, which together constitute a single interest in real estate. It is a separate additional living unit, including kitchen, sleeping, and bathroom facilities.”8

While the ADU definitions may be worded differently, their common component attributes include the following:

- Kitchen
- Bath
- Sleeping area
- Separate entrance
- Shared site with single-family structure

Keep in mind that ADU definitions in local zoning ordinances may vary from the Agency descriptions. It is the appraiser’s responsibility to address not only Agency appraisal guidelines or requirements, but also the zoning as it applies to the space. When they conflict, the appraiser must analyze the market and how it reacts to this space, and clearly describe the findings in the appraisal report to avoid being misleading. Having a good understanding of the Agency appraisal guidelines and lenders requirements that may exceed the Agency guidelines is a must.

This article focuses on the three areas that are important specifically to users of valuation services in the area of ADUs as well as in the valuation of all properties:

- Zoning classification and description
- Zoning and highest and best use analysis
- Appraisal report documentation versus workfile support

### Zoning Classification and the Master Plan

In the past, financing was not the only barrier to utilization of ADU residential housing. Local land use, zoning ordinances, and planning controlled by local governments also presented barriers for ADUs. These barriers resulted in ADUs being added illegally. When not properly permitted, the public property record does not identify the ADUs and often multiple listing services (MLSs) do not code them, which complicates the search for comparable sales. As a result of these factors, past ADUs built without proper building permits were given no value in the market value appraisal.

However, changes in state and local zoning regulations are taking place around the country to address affordable housing and housing shortages in densely populated areas. These changes in law are having tremendous impacts on the highest and best use of properties in these neighborhoods. Appraisers must be aware of and understand the implications that zoning changes have in the valuation process; this ensures competent completion of an appraisal assignment in these markets. For instance, on January 1, 2020, new zoning laws went into effect in Minneapolis. Subsequently, the Minnesota Department of Commerce (the regulatory body for appraiser licensing and enforcement in Minnesota) reviewed 135 appraisal reports of Minneapolis properties. It found that only 117 of these

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appraisals had the correct specific zoning classification, only 15 included the correct zoning description, only 3 had a highest and best use analysis that conformed to USPAP, and none of the appraisals had data in the workfile to support the highest and best use analysis or conclusion. This is a cautionary tale about staying abreast of the education and training to avoid such non-compliance issues and to complete these assignments competently.9

ADU Recognition and Rationale. A combination of the housing shortage and the rising cost of single-unit houses has created affordability challenges. As a result of these challenges there has been increased interest in accessory dwelling units. One benefit of adding an ADU or purchasing a home with one is rental income that may improve the affordability of the homes by adding an income stream. Although many zoning ordinances allow for an ADU to be rented, recognize that rental income from an ADU cannot be considered in qualifying a buyer for a Fannie Mae or Freddie Mac loan.10 However, institutions offering alternative loan products or not selling to the secondary mortgage market may consider the rental income in qualifying the buyer.

Another pro for adding ADUs in one-unit housing neighborhoods is the ability to construct them in less time and with fewer restrictions than building the primary dwelling structure on the subject’s site. Properties with sufficient lot sizes to accommodate these smaller units can be ideal for an ADU if they meet setback and other zoning requirements.

Proponents of ADUs suggest the addition of ADUs will not change the character of a residential neighborhood. Historical homes often had a carriage house over a garage, or a servant’s quarter, without negative consequences to values. Each market will have its own experience with ADUs as the following examples show.

- **Washington, DC**, has a number of old alley apartments, many of which date back to the 1700s. These alley apartments met a housing need at the time and still do. While many have been removed (most likely due to condition and quality of construction), approximately 20 alleys with alley apartments still exist.11

- **Chicago** at one time prohibited ADUs, but due to the housing shortage and affordability concerns, the city council passed an ADU ordinance on December 16, 2020, that allows ADUs in five districts (North, Northwest, West, South, Southeast); within those districts, the ordinance includes all R zones, except RS-1.12 These areas are part of a pilot project.

- **California** passed legislation in 2017 that superseded local zoning ordinances regarding ADU permissibility. The intent behind this sweeping legislation was to provide a form of relief to the housing affordability challenges in the state. Under this law, local jurisdictions could no longer prohibit ADUs within residentially zoned districts. In 2019, California made additional changes to the law that made it easier for previously non-permitted ADUs to obtain a permit. In 2020, the law made some additional significant modifications. Consequently, California appraisers must know and understand the laws regarding ADUs at both the state and local level and appropriately apply such requirements to the valuation of properties with ADUs.

In addition to affordability, ADUs are thought to have a lower impact on the environment than a single-unit or multifamily structure. They lessen urban sprawl, which requires more resources and

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9. Minnesota Dept. of Commerce Report, June 1, 2020. The real underlying problem was the lack of summarizing the analysis in the appraisal report.

10. Fannie Mae Selling Guidelines, Section B2-3-04, Special Property Eligibility Considerations (September 2020).

11. The Intelligencer reported in 1865 that many “were made of cut-rate lumber and covered with tar or felt.” See Nina Tristani, “History: Capitol Hill Alley Dwellings,” Hill Rag (March 8, 2018), https://bit.ly/3TFWyp.

services that impact the environment and housing costs. ADUs can be designed to blend in with the surrounding architecture and primary dwelling unit, be compatible with established neighborhoods, and preserve community character. In some markets, however, resistance to ADUs is based on concerns related to parking requirements, overcrowding, loss of residential neighborhood character, and/or negative effect on existing and future property values.

**Zoning and Highest and Best Use Analysis**

The first step in developing the highest and best use analysis is knowing what is legally permissible. The appraiser needs to investigate what is legally permissible related to ADUs, which brings us to examination of the jurisdiction's master plan and zoning designations. When investigating what is legally permissible, look to the master plan for the subject's jurisdiction to understand how the community is currently dealing with residential properties and ADUs—and its plans for the future. The following items should be researched.

1. Do changes over time increase the ability to add such units to existing or new construction markets?
2. What time frame are changes expected?
3. Have ADUs been discussed at the government level, e.g., board of supervisors, county elected officials, etc.?
4. What has been the tenor of such housing change discussions—favorable, not favorable, neutral?

This type of information is part of the neighborhood description regarding trends, the site section when discussing zoning description of trends, and the approaches to value, specifically the tenor of the elected officials toward the ADU housing option. Lenders need to know if this is a common improvement addition in other homes in the subject's market and the political attitude going forward for this housing product type based on the master plan and other zoning data collected.

A misconception by some residential appraisers is that it is acceptable to simply state or paraphrase the zoning and not include a description of the zoning. It is not sufficient to simply state the zoning as “RSF.” It is not sufficient to paraphrase the zoning as “residential,” “rural,” or “multifamily.” None of those are actual zoning designations in most, if not all, jurisdictions. Instead, they are commonly considered zoning categories. The actual zoning designation and description for the subject—meaning the zoning classification and details of that zoning—must be researched and analyzed to determine if the appraised property is legal, legal conforming, legal nonconforming, illegal, or constructed without building permits in the subject's jurisdiction. In many jurisdictions, zoning information is accessible online, making it easier to research and document the appraisal report and workfile. If it is not, an appraiser should be aware of how to obtain this information, for example, purchasing the ordinance data or making a trip or call to the building/zoning department in charge of the subject's site data. In other words, this data must be verified with a primary data source to ensure accurate information is reported rather than simply taking the zoning reference in public records or MLS.

Remember, the zoning provisions may not—and likely will not—define an ADU the same way as the secondary mortgage market, although both are important to the lender. In the appraisal report, it is necessary to identify and describe (1) the applicable zoning for the ADU based on the zoning ordinance, (2) the analysis applied to determine the subject's highest and best use conclusion that includes whether the subject meets the zoning ordinance or not, and (3) how the data collected, verified, and analyzed applies to the lender's guidelines or requirements based on the engagement (e.g., are Fannie Mae or Freddie Mac appraisal guidelines or FHA or VA appraisal requirements applicable in the assignment). Completing and reporting these steps will make it clear to the lender how the subject does (or does not) comply with the subject's zoning, how the highest and best use conclusion is supported, and thereafter how to proceed with the underwriting requirements of the loan.

13. The Dictionary of Real Estate Appraisal, sixth edition, defines a master plan as “a comprehensive, long-range official plan that guides the physical growth and development of a community, combined with the basic regulatory and administrative controls needed to attain the physical objectives; includes land use plan, thoroughfare plan, community facilities plan, and public improvements program. Master plans are usually revised periodically. In some jurisdictions, the master plan takes precedence over the existing zoning.”
Mortgage Market Guidelines
The following overview of the lending appraisal guidelines for single-unit properties with ADUs illustrates the importance of understanding the intended use and user of the appraisal. Not all appraisal guidelines are the same, and a lender/client may have a different guideline that is not the same as the Agency guideline. The table in Exhibit 1 compares the appraisal guideline differences among the government-sponsored enterprises (GSEs) and the Agencies and illustrates how complicated an ADU appraisal assignment might become. It is extremely important to research the zoning, master plan, and lending guidelines before moving forward with the assignment. The primary differences between zoning and the secondary mortgage market and government agencies most often fall into three categories: (1) rooms required (GSEs and Agencies require kitchen, bath, sleeping/living area); (2) separate entrance (Fannie Mae and Freddie Mac require a separate entrance); and (3) legal status (VA and FHA require legal status)

Keep in mind, the guidelines in Exhibit 1 are for lending purposes and would not apply to a client outside the lending world. The intended use and intended user are important to understand the appraisal guidelines or requirements that apply.

Data Sources and Challenges
Properties with features that are new to the market or that are not easily identified in common data sources create challenges for appraisers in developing supportable opinions of value and clarity as to the market’s reaction to the feature.

MLS and Public Records Data. All MLSs do not have searchable fields to identify ADU properties. Public records also may not separate the ADU living area from the main structure. Using a variety of key search terms is typically the best way to find ADU properties that have sold or been actively listed for sale. It is also necessary to search listings that are expired, pending, and temporarily off the market as well as dated sales to complete the market analysis and uncover market reaction to ADU properties.

The Agency appraisal guidelines require the appraiser to address the market’s reaction to a feature. The key to identifying the market reaction or penetration is through extensive searches of multiple sources each with its limitations, which is a challenge for even the most experienced appraiser. In addition to the limitations mentioned previously, the following other factors compound the difficulty of the data search:
• A wide variety of names are used for ADUs.
• Data sources seldom have standard data for ADU improvements.
• Data sources, like public property records, often do not identify the ADU improvement or identify it inaccurately as a shed or outbuilding.

These challenges complicate the appraisal assignment and the ability to meet the appraisal guidelines or requirements as well as USPAP standards. Therefore, understanding how the specific market identifies ADUs is the first step to successfully completing the market analysis. The following is a partial list of names found for ADUs, and it reveals the added challenge in identifying the units through the internet websites or MLSs. Word searches of these data sources are the best step to finding homes with ADUs that are listed, sold, expired, or rented. Remember, market reaction is more than a search for comparable sales; it is a search to identify the existence of ADUs in this market. Research should include the following terms to identify ADUs in a market and to understand the market’s acceptance of this feature:
• accessory apartment
• accessory dwelling
• accessory dwelling unit
• accessory suite (an attached ADU)
• accessory unit
• ADU
• ancillary unit
• backyard cottage
• basement apartment
• carriage house
• casita (Arizona)
• coach house
• granny cottage
• granny flat
• in-law suite
• in-law unit
• junior accessory dwelling unit/JADU (a small, internal ADU)
• mother-in-law flat
• multigenerational homes
• “Next Gen” (a commercial name by Lennar)
• ohana unit (Hawaii)
• two-family house
### Exhibit 1  Mortgage Market ADU Guidelines

<table>
<thead>
<tr>
<th></th>
<th>Fannie Mae</th>
<th>Freddie Mac</th>
<th>VA</th>
<th>HUD/FHA</th>
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<td>ADU defined in the guidelines</td>
<td>Yes</td>
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<td>Yes</td>
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<td>Must ADU be legal to be eligible for financing?</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>ADU cannot be included in gross living area of primary structure</td>
<td>Correct</td>
<td>Correct</td>
<td>Correct</td>
<td>Correct</td>
</tr>
<tr>
<td>Must ADU be owner occupied?</td>
<td>No</td>
<td>No</td>
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<td>Yes</td>
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<tr>
<td>Is ADU required to have a kitchen, bathroom, bedroom, and living area?</td>
<td>Bedroom not required (can be an efficiency)</td>
<td>Bedroom not required (can be an efficiency)</td>
<td>Bedroom not required but sleeping area is</td>
<td>Bedroom not required but sleeping area is</td>
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<tr>
<td>Must ADU have a building permit to be eligible for financing?</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
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<tr>
<td>Is separate meter and address required for ADU?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Does attached or converted space ADU require separate access from the primary dwelling?</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>If required by zoning</td>
</tr>
<tr>
<td>Is ADU used as a short-term rental eligible for financing?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes as long as it remains residential</td>
<td>May if HBU classifies it residential</td>
</tr>
<tr>
<td>Is a two- to four-unit with an ADU eligible for financing?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Legal Use—No. of comparables with ADUs required in sales comparison grid</td>
<td>1 w/ADU*</td>
<td>1 w/ADU min</td>
<td>3 closed comparables (best available)</td>
<td>1 w/ADU minimum</td>
</tr>
<tr>
<td>Illegal Use—No. of comparables with ADUs required in sales comparison grid</td>
<td>2 w/illegal ADUs</td>
<td>2 w/illegal ADUs</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Dated sales accepted as comparables?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Are listings and pending sales accepted to show marketability and market reaction?</td>
<td>As additional exhibits</td>
<td>As additional exhibits</td>
<td>As additional exhibits</td>
<td>As additional exhibits</td>
</tr>
</tbody>
</table>

* All Agencies require 3 or more comparables in the sales grid with support for adjustments. While the Fannie Mae appraisal guidelines do not require “comparables with an ADU,” best practice suggests at least one should be in the sales grid when the ADU is legal. This is consistent with Freddie Mac’s requirement and a requirement that lenders might also expect.
Residential appraisers providing mortgage lending appraisals are required to have access to the necessary and appropriate public and private data sources to develop credible assignment results.\(^\text{14}\) Appraiser Certification 12 of Fannie Mae Form 1004 requires the appraiser to certify as follows:

12. I am aware of, and have access to, the necessary and appropriate public and private data sources, such as multiple listing services, tax assessment records, public land records and other such data sources for the area in which the property is located.

The MLS is a data service specifically for use in buying and selling properties. As a result, it is a valuable data source for appraisers, where it is available. As useful as an MLS is to an appraiser’s daily work, most appraisers have experienced searchable fields that are not populated or inaccurately populated. However, despite any local MLS data integrity issues, the MLS can provide leads to properties that are listed, sold, pending, expired, and withdrawn to further investigate, and the MLS usually gives more detailed information than the public assessor property records.

Because not all MLSs will have data entry or searchability for special improvements such as ADUs, some ingenuity is needed in the keyword searches to find ADU comparables sales, listings, pending sales, or other useful transaction data. A search for sales for a more extended period (such as the past five years) can be helpful in identifying how many properties in the market may have ADUs. Even if listed properties were not sold, at least the appraiser can confirm there are other properties with ADUs in the market and identify them by address to illustrate market reaction. Again, it is important to research a variety of terms to gather the most complete information. The following are suggestions for a possible “word search” in the local MLS to identify ADU transactions.

<table>
<thead>
<tr>
<th>Word Search Options</th>
<th>Common Word Search Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basement</td>
<td>Living quarters</td>
</tr>
<tr>
<td></td>
<td>Apartment</td>
</tr>
<tr>
<td></td>
<td>Accessory dwelling unit</td>
</tr>
<tr>
<td>Interior Features</td>
<td>Accessory dwelling unit</td>
</tr>
<tr>
<td></td>
<td>(common if the ADU is part of the primary dwelling)</td>
</tr>
<tr>
<td>Exterior Features</td>
<td>Accessory dwelling unit</td>
</tr>
<tr>
<td></td>
<td>(common if the ADU is a separate structure from the primary dwelling)</td>
</tr>
</tbody>
</table>

The fields and details vary considerably from MLS to MLS, but if a search using one of the previously mentioned terms (or others) results in finding properties with ADUs, property details may also be available in the MLS data. Otherwise, additional investigation will be required in order to properly analyze the subject’s ADU improvement against the MLS’s ADU improvement search results. For example, it may be necessary to contact the real estate agent or agent’s selling office, the seller, or the buyer. Further, the appraiser may need to expand the search to beyond one-unit (e.g., single-family) properties—however, this will depend on how the MLS might qualify or code a property with an ADU. Consider applying the word search options to the multifamily, rental, and even commercial property categories.

Public property records can be more challenging to search than the MLS, depending on the quality of your local assessment data. Following are a few examples of the ways properties can appear in the assessor records. Reviewing these examples gives a better understanding of ways to identify ADUs in public property records.

Illustration 1 Property

**MLS Data:** The MLS search identified a listing of a property in Charlotte County with a “guest house.” No other information provided.

**Public Records Property Data:** The public records search found the MLS listing’s property type as single unit; and current use: multi-single-units (2) single-family residences; single-family residence and mobile home; or (2) mobile homes.

Illustration 2 Property

**MLS Data:** The MLS search for comparable data identified a sale of a property in Sarasota County with a “multi-generational home,” i.e., an ADU with 1 bedroom, 1 bath, separate entrance, and a kitchenette.

**Public Records Property Data:** The public records search found property from the MLS by address in the public property record data with the following information:

- Property Type: Single-family
- Additional Features: None
- Building Area: 1,784 sq. ft.
- Other Building(s): 700 sq. ft.

The public property record incorporated the ADU living area in the main house square footage. Therefore, appraisers should beware of how the living area is identified to avoid major errors. Always verify the data with other sources. The listing of the comparable that sold used the assessor’s square footage of 1,784 sq. ft.; however, the ADU square footage was 700 sq. ft. and included in the main house. This creates a potential for a material error if the appraiser does not verify this information with other sources. Keep in mind the secondary mortgage market has a large database of sales supplied by appraisers and this same sale may be correctly identified in the database. If this is the case, the error might be caught by the secondary market review.

Illustration 3 Property

**MLS Data:** The MLS search identified a historical bungalow with an upstairs “in-law suite” that has a full kitchen, bath, bedroom, and private entrance from the back.

**Public Records Property Data:** The public records search found property from the MLS by address in the public record data, and it identified the following:

- Property Type: Single-family (No mention of an additional kitchen or living space.)
- Building Area: Second Floor Finished Attic
- Additions: “In-law Unit”
- Permits: 650 Sq. ft. Finished Attic
- Permit Date: xx/xx/xxxx

These examples illustrate just how difficult it can be to identify properties with ADUs and why competency in valuing properties with ADUs is necessary. Geographical experience and knowledge in a market are important, because an appraiser must use multiple data sources to verify information about ADU comparable(s). The illustrations clearly show that one data source is not adequate to obtain property information, since not all data sources provide accurate or complete information about improvements. A best practice is to research multiple data sources and verify data with primary sources. Properly verified data with good market analysis will ensure the work completed results in credible opinions and conclusions and does not mislead the client/intended user.

In addition to public records and the MLS, online technology provides sources for identifying properties with various features such as ADUs. Consider researching the following real estate platforms available in most, if not all markets; they can be valuable search tools for properties with ADUs.

**Zillow.** Zillow is a free, well-known internet-based real estate search platform that is often used by buyers and sellers in the market to obtain a “Zestimate” (www.zillow.com/z/zestimate/) of a property’s “value.” While Zillow’s algorithms have come under question through the media, the platform does provide another potential source for identifying ADU properties. Zillow collects both MLS listing and sales data as well as public record data as an aggregate, meaning it collects any public information about the subject property and places it in one location.

The Zillow search example in Exhibit 2 is telling. It provides a wider understanding of trends and data that could be overlooked if the search parameters are too narrow, if only a single source

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is used for real estate transactions, if the improvement data information is not verified with multiple sources, or if the Zillow data source is not used. Note, the results of the Zillow search may change as the search parameters are modified. For example, in Exhibit 2

- If in Keywords the term “Guest House” is changed to “Accessory Dwelling Unit,” only 1,625 properties in California meet this criterion and are shown in the search results.16
- If in Keywords the term “Accessory Dwelling Unit” is changed to “ADU,” 11,602 properties in California meet this criterion and are shown in the search results.17
- If in Keywords the term “junior accessory dwelling unit” (JADU) is used, the results show 36 properties in California meet this criterion.18

Realtor.com. Realtor.com is another free and well-known internet-based real estate search platform. It often is used by buyers and sellers in the market to find homes to buy, lease, and sell. Unlike Zillow, it does not provide a “Zestimate” of value of a specific property. However, like Zillow, this website aggregates data based on multiple data sources into one location. The data aggregation includes information from the MLS, public property records, local data consortiums regarding schools for example, and more. As with the previous Zillow search example, the following Realtor.com search was telling. It provided a wider understanding of trends and data that could be overlooked if an appraiser is too narrow in their search parameters, uses a single source for real estate transactions,19 does not verify the improvement data information with multiple sources, or does not use this data source.

Exhibit 3 shows ADU parameters chosen and placed in the Realtor.com search to illustrate search tiers in this platform. Although the Realtor.com data are listings and not sales, this information will support that ADUs exist in the subject market and can further help to support information on ADUs by investigating the listings with their real estate agent and public record data to assist also in finding sales of ADU properties. Like Zillow, if a property has sold and there was an MLS listing, Realtor.com will post that MLS data in its database.

16. However, changing the parameters to a specific city—for example, keeping the city location parameter “Concord, CA”—dropped down the search results to 5,172 properties. If the search is further fine-tuned to a specific area—“Cowell, Concord, CA”—the results further drop to 57 properties.
17. Keeping the location parameters as “Cowell, Concord, CA,” but changing the Keyword search to “ADU” results in the response “no matches.”
18. Keeping the location parameters as “Cowell, Concord, CA,” but changing the Keyword search to “JADU” results in the response “no matches.”
19. Realtor.com will allow additional parameters to be added in the “Buy” option; in other words, properties listed for sale. The option to write in a search parameter is not available under the “Sold Homes” option.

Exhibit 2 Zillow ADU Search Example

<table>
<thead>
<tr>
<th>Search Step Tiers</th>
<th>Tab</th>
<th>Selection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Search</td>
<td>“Address”</td>
<td>California</td>
</tr>
<tr>
<td>First-Tier Search Options</td>
<td>“Buy” (top left tab above map)</td>
<td>“Recent Home Sales”</td>
</tr>
<tr>
<td>Second-Tier Search Options</td>
<td>“Home Type”</td>
<td>All but “Apartments,” “lots/land”</td>
</tr>
<tr>
<td></td>
<td>“More”</td>
<td>Sold in Last—“36 Months”</td>
</tr>
<tr>
<td></td>
<td>“More”</td>
<td>Keywords—“Guest House”</td>
</tr>
<tr>
<td></td>
<td>“More”</td>
<td>Click “Done”</td>
</tr>
</tbody>
</table>

Exhibit 3  Realtor.com ADU Search Example

<table>
<thead>
<tr>
<th>Search Step Tiers</th>
<th>Tab</th>
<th>Selection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Page</td>
<td>“Buy” + location</td>
<td>Phoenix, AZ</td>
</tr>
<tr>
<td>First-Tier Search Options</td>
<td>Property type</td>
<td>All but “Any,” “Farm,” Mobile, “Land”</td>
</tr>
<tr>
<td></td>
<td>Listing status</td>
<td>Existing Homes (other options, “New Construction,” “55+Community,” “Foreclosure”)</td>
</tr>
<tr>
<td>Search Results</td>
<td></td>
<td>3,717 homes for sale</td>
</tr>
<tr>
<td>Second-Tier Search Options</td>
<td>“More Filters”</td>
<td>Keywords—“Guest House” (68 listed homes result)</td>
</tr>
<tr>
<td></td>
<td>“Alternate More Filters”</td>
<td>Keywords—“ADU,” “In-Law,” “Granny Unit,” “Casita” (0 homes)</td>
</tr>
<tr>
<td></td>
<td>“More Filters”</td>
<td>Location—“Expand Search” + “Search Radius in Miles,” or “Include Nearby Areas”</td>
</tr>
</tbody>
</table>


Scope of Work
Both the Realtor.com and Zillow research exercises make it clear that the many names in the market for ADUs will affect the results of the data research. It is the appraiser’s responsibility to be competent in knowing what those names/options are to ensure the collection, research, and analysis of data is complete and accurate. Using only one data source or only one term for ADUs in the research could result in opinions and conclusions that are not supported. Data should be verified from primary sources as part of the market research. These steps help avoid issues with clients and with the state appraiser enforcement agency. Being complacent with the data search, not being competent in the subject market or the ADU property type, and not completing a thorough highest and best use analysis can result in a scope of work that leads to assignment results without credibility due to insufficient support.

The data challenges identified should be described in the scope of work. A scope of work can be in one section of the appraisal report or provided throughout the report from section to section. Remember, the scope of work must provide credible assignment results based on the intended use, and the reporting of the scope of work must not mislead the client or intended user. A well-written scope of work discussion can lessen the appraiser’s liability and give the intended user a better understanding of the complexity of the assignment from the beginning.

A number of sources provide guidance on scope of work. The Uniform Standards of Professional Appraisal Practice (USPAP) includes the Scope of Work Rule with comments. Stephanie Coleman in the text Scope of Work, third edition, explains that the GSEs expect the appraiser to identify throughout the appraisal report form, from section to section and where necessary, the following:

- the extent to which the subject property requires identification, including the neighborhood, market conditions, the site and improvements;

20. The GSEs are currently updating the appraisal report forms, and the language in the new design may change from the current forms.


22. The GSE appraisal guidelines and scope of work do not limit the appraiser to only these statements.
The Scope of Work provision in the Fannie Mae 1004/Freddie Mac 70 Appraisal Report (March 2005, page 4), states as follows:

**Scope of Work:** The scope of work for this appraisal is defined by the complexity of this appraisal assignment and the reporting requirements of this appraisal report form, including the following definition of market value, statement of assumptions and limiting conditions, and certifications. The appraiser must, at a minimum: (1) perform a complete visual inspection of the interior and exterior areas of the subject property, (2) inspect the neighborhood, (3) inspect each of the comparable sales from at least the street, (4) research, verify, and analyze data from reliable public and/or private sources, and (5) report his or her analysis, opinions, and conclusions in this appraisal report.

The Appraisal Institute text *The Scope of Work*, third edition, is a good resource for developing the scope of work wording for a variety of assignments. The Appraisal Institute seminar *Valuation Overview of Accessory Dwelling Units* is also helpful; it reviews several scope of work examples that would apply to ADU property appraisals. In residential lending work, appraisers often rely on the preprinted scope of work language; however this may not be adequate in an ADU assignment. A well-developed scope of work is important to lessen liability and provide an understanding of the extent to which the appraiser analyzed the market data. When developing the scope of work, keep in focus the intended use, intended user, and type of value, which are important to the credibility of the appraisal. As Coleman cautions in *Scope of Work*, third edition,

*Don’t forget:* The scope of work is a critical step in the appraisal process. The manner in which you address scope in your report should underscore its importance. In the briefest of appraisal reports, the scope of work discussion might well comprise the bulk of the report.

**ADU Valuation Dilemmas**

**Sales Comparison Approach**

The sales comparison approach is the most-often used approach to value driven by the fact that certification in the appraisal report forms specifically requires it. The secondary mortgage market and government entity appraisal guidelines address the sales comparison selection as follows:

- Dated settled sales may be used to demonstrate market acceptability, and
- Active listings or pending sales may be used as supplemental exhibits to show marketability.
- Include a traditional comparable with an ADU in the sales comparison grid. At least one ADU comparable is required.

Depending on how scarce current sales, listings, or pending sales are to support a market for a subject with an ADU, the appraiser may con-

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26. Fannie Mae Form 1004, Appraiser Certification 4, states “I developed my opinion of the market value of the real property that is the subject of this report based on the sales comparison approach to value. I have adequate comparable market data to develop a reliable sales comparison approach for this appraisal assignment. I further certify that I considered the cost and income approaches to value but did not develop them, unless otherwise indicated in this report.”
sider the use of expired listings and withdrawn listings or may go further back in time but stay within the defined subject neighborhood or market area. An important detail to consider is that the dated settled sales, listings, or pending sales do not have to be comparable properties to the subject in order to support the presence of a market for ADU properties in the subject neighborhood/market area.

Suppose, for instance, the property being appraised is 2,100 square feet with a 750-square-foot ADU. The dated settled sales, listings, and/or pending sales are 1,200 square feet to 2,500 square feet, with ADUs that vary from 500 square feet to 800 square feet. These properties would not be placed in the sales comparison grid because they do not represent “comparable” sales to the subject. Instead, such data would be identified in the text addendum and summarized in sufficient detail to support the appraiser’s highest and best use opinion regarding the market’s reaction to single-unit properties with ADUs. This data further answers the underwriter’s question, Is the ADU a feature that is accepted in the subject’s defined neighborhood/market area?

In 2020, Fannie Mae issued its ADU update.27 Some clients/lenders, reviewers, and underwriters may be unfamiliar with the latest document. Therefore, it would be most helpful, and likely a time saver to the appraiser and those involved, if this documentation is cited or referenced in the appraisal report.

Paired-Data Analysis, ADU Value Contribution. The following paired-data analysis example involves a hypothetical ADU. It provides a good illustration of a pairing to extract the value of a feature from the market. The two sales in Exhibit 4 are similar in all respects except Sale 2 does not have an ADU. A market conditions adjustment is not warranted based on a history of sales in the last two months. The minor difference in the gross living area (GLA) of the primary structure is not recognized by the market. A real estate agent interviewed for both sales indicated the condition and quality of construction is similar. While properties are not in the same subdivision, they are in adjacent subdivisions that compete for the same buyers. This pair is a strong indicator of the contributory value of the ADU at $75,000 or $130.44 per square foot of the ADU living area. Sale 1’s owner reported the attached ADU was constructed four years ago for $125,000.

Remember, one paired-data set does not make a market. Appraisers must use evidence and logic in reconciling the pair(s) to see if they make sense for use in supporting conclusions in the appraisal report. For instance, if the paired analysis suggested the ADU had a contributory value of $150,000 after construction costs of $125,000 four years ago, that conclusion might not make sense. The market is not perfect, and sometimes results are not logical. Always use a test of reasonableness before placing weight on a single method or result, then reconcile the conclusion to allow the reader to follow the analysis logic.

### Exhibit 4 Paired-Data Analysis, ADU Value Contribution

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Sale 1</th>
<th>Sale 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale Date</td>
<td>6 months ago</td>
<td>8 months ago</td>
</tr>
<tr>
<td>Sale Price</td>
<td>$890,000</td>
<td>$815,000</td>
</tr>
<tr>
<td>$/SF</td>
<td>$404.55</td>
<td>$383.53</td>
</tr>
<tr>
<td>Lot Size</td>
<td>18,000 SF</td>
<td>22,000 SF</td>
</tr>
<tr>
<td>Single-Family Dwelling GLA</td>
<td>2,200 SF</td>
<td>2,125 SF</td>
</tr>
<tr>
<td>Room Count</td>
<td>6/3/2.5</td>
<td>6/3/2.5</td>
</tr>
<tr>
<td>Basement</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>ADU Size/Age</td>
<td>575 SF/4 yrs.</td>
<td>None</td>
</tr>
<tr>
<td>Adjusted Sale Price</td>
<td>$890,000</td>
<td>$815,000</td>
</tr>
<tr>
<td>Difference</td>
<td>$75,000 ($890,000 – $815,000)</td>
<td></td>
</tr>
</tbody>
</table>

27. Fannie Mae, Selling Guide, B4-1.3-05, Improvements Section of the Appraisal Report.
Sensitivity Analysis. A test of reasonableness might include a sensitivity analysis. Apply the adjustment from the paired-data analysis to a series of “comparables,” and see if the adjusted sale prices reflect a reasonable range based on the data collected and verified for sales in the subject market and the market trend analysis conducted.

Sensitivity analysis is the process of isolating how change in one or more variables may affect an outcome variable like property value. Sensitivity analysis is often used to support investment risk analysis. In Exhibit 5, Comparable 1 is the base comparable and adjustments are applied to the primary five comparable sales. Adjustments for other differences are developed using paired-data analysis and market surveys of real estate agents. The market has not shown significant differences over the four months difference in market time; therefore, no adjustment for date of sale is required. The data supports a finding that minor differences in GLA are not recognized by buyers; therefore, no adjustment is applied for differences of less than 100 square feet in GLA. The ADU adjustment identified in the previous paired-data analysis (Exhibit 4) is applied to Comparables 2 and 4. After applying the $75,000 adjustment for the ADU to those two sales, the range tightens for the base sale. The overall average variance of –1.26% is insignificant, which lends good secondary support to the ADU adjustment of $75,000.

Income Capitalization Approach

Single-unit properties can be appraised using the income capitalization approach by

- Analyzing market rents to establish the potential market rent for the subject.
- Developing a gross rent multiplier (GRM) by finding similar sales that were rented at the time of the sale and dividing the sale price by the monthly rent to arrive at a GRM.

Obtaining monthly rentals of single-unit homes is less challenging than the second step of obtaining GRMs. In the absence of GRMs developed from market sales of rental properties, GRMs can be extrapolated. The method combines the sale of a property similar to the subject with the rental data collected from another property also similar to the subject. The concept is that if the property that sold had been rented at the time of sale, the rental rate would have been similar to the property rented (but not sold).

Extreme caution is necessary, however, in making the choice to use a market-extracted GRM.

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**Exhibit 5** Sensitivity Analysis to Isolate Value of ADU

<table>
<thead>
<tr>
<th>Features</th>
<th>Base Comparable 1</th>
<th>Comparable 2</th>
<th>Comparable 3</th>
<th>Comparable 4</th>
<th>Comparable 5</th>
<th>Comparable 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>$785,000</td>
<td>$855,000</td>
<td>$775,000</td>
<td>$900,000</td>
<td>$750,000</td>
<td>$765,000</td>
</tr>
<tr>
<td>Contract Date</td>
<td>Current</td>
<td>3 months ago</td>
<td>2 months ago</td>
<td>1 month ago</td>
<td>4 months ago</td>
<td>2 months ago</td>
</tr>
<tr>
<td>Condition</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
</tr>
<tr>
<td>Site Size/Sq.Ft.</td>
<td>8,000</td>
<td>9,500</td>
<td>8,700</td>
<td>10,500</td>
<td>7,500</td>
<td>8,000</td>
</tr>
<tr>
<td>Gross Living Area</td>
<td>1,750</td>
<td>1,625</td>
<td>1,695</td>
<td>2,100</td>
<td>–26,250</td>
<td>1,525</td>
</tr>
<tr>
<td>Parking</td>
<td>2-car garage</td>
<td>2-car garage</td>
<td>2-car garage</td>
<td>3-car garage</td>
<td>–10,000</td>
<td>2-car garage</td>
</tr>
<tr>
<td>ADU</td>
<td>No</td>
<td>Yes-600 SF</td>
<td>–75,000</td>
<td>No</td>
<td>Yes-575 SF</td>
<td>No</td>
</tr>
<tr>
<td>Basement</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Other</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Adjusted Sale Price</td>
<td>$780,000</td>
<td>$775,000</td>
<td>$788,750</td>
<td>$766,875</td>
<td>$765,000</td>
<td></td>
</tr>
<tr>
<td>Variance as a percentage</td>
<td>–0.64</td>
<td>–1.27</td>
<td>0.48</td>
<td>–2.31</td>
<td>–2.54</td>
<td></td>
</tr>
<tr>
<td>Average Percentage Variance versus Base Sale</td>
<td>–1.26</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
multiplied by a market-extracted rental rate and applying it to the ADU of the subject or a comparable to develop an opinion of value for the ADU. The reasons for caution include the following:

- A GRM includes rent attributed to the land and the improvements.
- Applying a single-unit or multifamily GRM to the rent of an ADU would overvalue the ADU, because it would include the value for the land that already was accounted for with the primary dwelling.
- The ADU does not have land as part of the value contribution; it is the value attributed to a secondary unit on a primary dwelling site that is being established.
- It is possible to extract the land value from the GRMs; however, that complicates the appraisal assignment, requires extensive support and explanation for the client/lender to understand, and is not a typical method buyers seeking one-unit dwellings with ADUs will use to determine the ADUs’ worth to them.
- Finding similar single-unit sales with ADUs where both primary dwelling and ADU are rented would be ideal, but rarely do those exist in sufficient supply to provide a credible value opinion.

The rent potential or existing rent/lease of the ADU should be analyzed. A discussion of why the income capitalization approach is not applicable is also an important step in the final reconciliation.

**Income Capitalization Approach Example—GRM Applied to the Accessory Dwelling Unit Rental.**

The following example illustrates how an income capitalization approach would apply when the primary dwelling and ADU are both rented, and the market analysis indicates houses with ADUs in this market are rented. Just because the subject is rented does not indicate an income capitalization approach is applicable if it is the only house in the neighborhood that is rented.

In this example, suppose the primary dwelling unit is rented at $3,500 per month and the ADU at $1,500 per month. Both units have annual leases with the tenants paying utilities. The ADU has separate utility meters for billing. The only expenses paid by the landlord are real estate taxes and insurance as is customary in the market area. A comparable search for properties rented supports the current market rents for both the primary dwelling and the ADU. The details of the rentals must be summarized in the appraisal report to support the rental opinion conclusions.

A comparable search for properties that sold and were rented at the time they sold resulted in three comparables. Two are dated sales and one is a recent sale. The details of the GRM properties are summarized in the appraisal report to address their comparability to the subject property. The two dated sales support GRMs of 120 and 125 while the most recent sale supports a GRM of 130. The sales form a reasonable range of GRMs. In the GRM reconciliation, the more dated sales deserve less consideration, because they have fewer updates than the subject property. The more recent sale deserves the most consideration because it is in the subject’s neighborhood and most similar in condition and updates, supporting a GRM of 130. Using the income capitalization approach and applying the formula GRM × Monthly Rent = Value yields the following value indication:

\[ \text{Value} = \left(3,500 + 1,500\right) \times 130 = 650,000 \]

**Payback Period.** Another way market rent can be valued is by establishing a period in which it would be reasonable to recoup the investment of the adjusted value of the ADU. Assume the ADU has a contributory value of $75,000 (developed using three paired-data sets), and the actual market rent for the ADU is $1,500 per month. How long will it take the owner to receive $75,000 back in rent collected assuming there are no annual rent increases or decreases? The payback period formula below suggests a period of 4.17 years.

\[ \text{Payback Period} = \frac{75,000}{1,500} = 50 \text{ months/12 months} = 4.17 \text{ years} \]

However, the example does not account for primary tenancy, real estate taxes, and insurance and does not consider rent increases or decreases. These additional expense and potential rent changes may not extend the payback period significantly unless market changes are dramatic. For example, a natural disaster could instantly change the rental market. Similarly, a major employer entering or exiting the market area could cause significant change. A discussion of the payback period is a reasonable supplemental discussion to support the indicated value by the paired-data analysis method.
In this example, the investor who pays $75,000 for the subject’s ADU is anticipated to receive the payback of their investment (gross rent) in a little over four years. A quick payback period such as that is extremely attractive for real estate investors. Even an owner-occupant would find this to be an attractive real estate investment. While the Agencies do not allow this additional income from the ADU to be considered in qualifying the borrower for a mortgage loan, it can be significant in assisting the primary dwelling’s owner-occupant with monthly mortgage or utility expenses, or obtaining a private loan or seller carry back loan.

Cost Approach
The cost approach is another method that can provide secondary support to the sales comparison approach. The replacement cost new should be supported with local data because of the jurisdictional requirements that can materially affect cost. Some factors that can significantly impact the cost new include the following:

- Detached units cost more to construct than attached units
- Building permit cost
- ADU impact fees, if any
- Review and approval process involving a development review committee that may be required for additions to an ADU
- Economies of scale where ADUs cost more per square foot to build than the primary dwelling
- Cost to comply with specific building ordinances that must be met, like parking requirements, setbacks, and height restrictions

Once the cost new is established, the next most difficult step is supporting the depreciation, including potential obsolescence from all forms of loss. In appraisal, depreciation is “a loss in property value from any cause; the difference between the cost of an improvement on the effective date of the appraisal and the market value of the improvement on the same date.” This step is challenging but must be based on market data to avoid being subjective. Remember that even proposed or new construction improvements should be analyzed for obsolescence. Developers will and can use outdated floor plans for fast and cheaper construction and greater profit, yet those outdated floor plans may be the reason the sales are slow in that subdivision. Therefore, recognize the terms “proposed” or “new” do not eliminate the concept of functional obsolescence. Proving this step with good market evidence requires sales data of similar units to understand how the cost new relates to the contributory value of the ADU. Contributory value is “a type of value that reflects the amount a property or component of a property contributes to the value of another asset or to the property as a whole.” The definition of depreciation places emphasis on the sales comparison challenge of finding comparable ADU property sales to establish the contributory value of the ADU to compare to the cost new of the ADU.

The Fannie Mae guidelines do not allow the cost approach as the primary (or only) basis for an opinion of value. While the cost of repairs, updating, remodeling, etc. are commonly considered by buyers and sellers when negotiating a home sale price, the cost approach does have weaknesses. Experienced appraisers will discuss the strengths and weaknesses of each valuation approach as it applies to the appraisal problem they are solving. When the final reconciliation is well-written, it provides the client/intended user with a clear understanding of the methods used and/or omitted and a summary of the reasons why one method deserves more consideration in the value opinion.

29. A review of various municipal departments governing development and planning indicates that a development review committee generally is charged with reviewing land use plans, preliminary subdivision plans, development plans, and additions. In locations where such reviews are required prior to approval, the process may require longer for approval and add costs to the project that may not be considered in the cost new sources.

30. Usually the smaller the space, the more expensive the cost per square foot. Economies of scale refer to the “reduction in cost of production per unit due to a large number of items produced.” Appraisal Institute, The Dictionary of Real Estate Appraisal, 6th ed., s.v. “economies of scale.”


Conclusion

ADUs are not new but are gaining in popularity as a way to meet today’s growing housing needs that include multigenerational family units and a supply of affordable housing. ADUs are a part of the sustainability movement. Municipalities are realizing ADUs take advantage of the current infrastructure instead of exacerbating urban sprawl that increases demand for extending services and results in higher taxes and delays in meeting housing demands. As the market’s demands change, so must zoning, financing, marketing, and valuing properties with features such as ADUs. Appraisers prepared to address the ADU appraisal problem will be in demand as these trends continue to grow.

About the Author

Sandra K. Adomatis, SRA, LEED Green Associate, NAR Green, is the 2022 incoming vice president of the Appraisal Institute. Her one-year term as vice president will be followed by one year each as president-elect, president, and immediate past president. Adomatis is the principal of Adomatis Appraisal Service in Punta Gorda, Florida. She specializes in residential valuation, green construction, solar photovoltaic systems, and expert witness testimony for assignments that include eminent domain, construction defects, bankruptcy, and fraud litigation cases. She is a published author in The Appraisal Journal, and author of the book Residential Green Valuation Tools. Adomatis has received Appraisal Institute awards for her work including the Lifetime Achievement Award, and the Armstrong/Kahn Award and Swango Awards for her outstanding Appraisal Journal articles; the Henry C. Entreken Lifetime Achievement Award from the Florida Gulf Coast Chapter of the Appraisal Institute; Outstanding Service Award in 2016; AI President’s Award in 2013; Dr. William N. Kinnard Junior Award in 2012; and Region X Volunteer of Distinction in 2010. Contact: adomatis@hotmail.com

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Additional Resources

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

AARP—Accessory Dwelling Units: A Step by Step Guide to Design and Development

AccessoryDwellings.com—News, Research, and Trends

American Planning Association—ADU
https://www.planning.org/search/?keyword=ADU

Appraisal Institute
Lum Library, External Resources, Resource Links [Login required]
Knowledge Base Bibliographies—Residential Properties, Accessory Dwelling Units

Association of Bay Area Governments—Accessory Dwelling Unit Handbook
https://abag.ca.gov/technical-assistance/accessory-dwelling-unit-adu-handbook

Remodeling magazine—ADU
https://www.remodeling.hw.net/search?q=ADU
Building the Body of Knowledge: An Introduction to The Dictionary of Real Estate Appraisal, Seventh Edition

Abstract

The Appraisal Institute releases its seventh edition of The Dictionary of Real Estate Appraisal in early 2022. In this article, the dictionary’s technical editor provides a behind-the-scenes look at what’s inside the latest edition.

In 2021, cartographers at the National Geographic Society concluded that the earth has five oceans, not the four oceans whose names many of us learned in childhood and held onto for decades without question. To be precise, future maps created by the society will label a portion of what was once considered the Pacific Ocean around Antarctica as the Southern Ocean.

The rationale set forth by the society’s experts was that the Southern Ocean is now understood to be a distinct body of water with unique characteristics, a categorization accepted by the scientific community long ago but only recently recognized more broadly by political bodies.

Adding a new name to a familiar and seemingly definitive list of oceans, like subtracting the name of Pluto from the traditional list of planets in the Earth’s solar system, can require some conscious reprogramming of a person’s memory. Eventually the existence of that fifth ocean—which was always there but only recently recognized officially by experts—will not seem like a piece of geographical trivia foisted upon us by an ostensible authority. Rather, it will be considered common knowledge.

This process of reenvisioning what is currently known and working toward a new

1. For more information on the National Geographic Society’s recognition of the Southern Ocean as a distinct body of water, see Sarah Gibbens, “There’s a New Ocean Now—Can You Name All 5?” (June 8, 2021), https://bit.ly/2021ocean.
understanding of the world and the things in it is how a body of knowledge evolves.\(^2\)

Every five to seven years, the body of knowledge of the appraisal profession is scrutinized and refreshed—sometimes uncomfortably—with the publication of a new edition of *The Appraisal of Real Estate*. That textbook is customarily followed in relatively quick succession (in book development terms) by a new edition of *The Dictionary of Real Estate Appraisal*. So, in early 2022, a new edition of the dictionary will arrive to complement the 2020 publication of the fifteenth edition of *The Appraisal of Real Estate*. Many longtime users of these reference works may suffer through a period of adjustment, questioning what has changed and why. But remapping the content of the textbook and dictionary serves to move the body of appraisal knowledge forward for the benefit of the profession as a whole and to provide a new, clearer understanding of familiar concepts.

**Dictionary Development Process**

*The Dictionary of Real Estate Appraisal* is a core component of the Appraisal Institute’s body of knowledge, as defined by the organization’s board of directors. In the past, an ad hoc project team of reviewers was assembled to serve as subject matter experts to assist in developing the dictionary, but this time around the standing Body of Knowledge Committee was recruited to handle the review and revision of existing definitions and to suggest new entries. One of the Body of Knowledge’s primary duties is ensuring consistency among the components of the body of appraisal knowledge, making this committee the logical group to compare *The Appraisal of Real Estate*, the Appraisal Institute’s educational materials, and the dictionary terms and definitions for consistency.

The task of developing the new dictionary was not a straightforward manuscript review because a dictionary has a unique quality. Reviewing and revising content for a textbook like *The Appraisal of Real Estate* is like writing prose, whereas working on *The Dictionary of Real Estate Appraisal* is like wrestling with poetry. That is, the ordeal of combining words to create a concise definition of a dictionary term requires intense scrutiny of syntax and semantics. Every word in a definition carries an inordinate amount of weight in explaining what a particular term or combination of words is understood to mean within the specific context of professional practice. This type of close reading is not for the faint of heart, but it can be a welcome challenge for those who like to scrutinize the details and argue fine distinctions in potential interpretation and misinterpretation.

Over the course of 2021, competing suggestions for dictionary revisions were debated by members of the Body of Knowledge Committee in numerous online meetings conducted over Zoom as well as on their own time. In fact, all the formal interaction among the core dictionary contributors occurred virtually, both by necessity given the travel restrictions imposed by the pandemic and in the interest of efficiency of working through pages and pages of potential changes. The professional experience and personal commitment of the committee members and the disciplined leadership of the committee chair allowed the review and revision processes to proceed smoothly and, for the most part, pleasurably for all involved despite the physical challenges.

**Between the Book Covers**

Differences in the content of the sixth and seventh editions of the dictionary can be categorized in three ways:

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2. For an interesting examination of how knowledge evolves over time, see Chuck Klosterman, *But What If We’re Wrong? Thinking about the Present as if It Were the Past* (New York: Penguin, 2017).
1. New dictionary entries
2. Deleted entries
3. Revisions to existing definitions

This last category includes dictionary entries in which the existing definition did not change substantively, but the term itself was changed for clarity's sake. For example, the weighted rate entry in the sixth edition was relabeled weighted capitalization rate in the seventh edition.

Unsurprisingly, many changes in definitions relate to consistency between The Appraisal of Real Estate and The Dictionary of Real Estate Appraisal. For example, during the development of the fifteenth edition of The Appraisal of Real Estate, the Body of Knowledge Committee proposed a significantly revised definition of market rent. That wording was adopted by the Appraisal Institute Board of Directors and then integrated into the fifteenth edition of The Appraisal of Real Estate and now into the new edition of the dictionary. Other content changes made in the latest edition of the textbook were similarly integrated into the appropriate entries of the dictionary.

Many of the entries new to the seventh edition of the dictionary can be found in the specialized glossaries in the book’s addenda (Exhibit 1). These glossaries cover areas of practice where subject matter experts have been seeing growth and an accompanying need for more explanatory material. For example, new terms related to energy efficiency and the health of building occupants, which continue to grow in importance to property owners and investors, were added to the Green Building Glossary, including the following:

- air changes per hour (ACH)
- benchmarking regulations
- bifacial solar panels
- cool roof
- engineered wood
- life-cycle analysis (LCA)
- living wall
- net metering
- resilient construction

Similarly, with statistical analysis gaining traction among real property investors and other appraisal clients, many new terms related to statistical modeling were added to the Mathematics and Statistics Glossary, including the following:

- average percentage error (APE)
- calibrated model
- cross-sectional data
- decision rule
- explanatory variable
- forecast standard deviation (FSD)
- holdout sample
- model specification
- omitted variable problem
- panel data
- prediction interval
- quadratic relationship
- random effects model
- spline regression
- type I statistical error
- type II statistical error

Another significant addition to the dictionary is the Appraisal Institute’s Property Use Classification System (PUCS), which is included as a freestanding resource in the addenda. The PUCS content replaces the taxonomy of property types included in previous editions, which originated in a database project almost twenty years ago. That listing of property types was reimagined recently and published as a comprehensive and complete system of classifying real property based on its use.

3. To download the Property Use Classification System document, go to https://www.appraisalinstitute.org/professional-practice/pucs/.
Exhibit 1 The Dictionary of Real Estate Appraisal, Examples of New Glossary Definitions

Green Building Glossary Examples

**air changes per hour (ACH).** A measure of how many times an HVAC device can fill up the full volume of a room with air; especially useful when comparing different air purifiers or air conditioners.

**engineered wood.** A range of derivative wood products that are manufactured by binding or fixing the strands, particles, fibers, or veneers or boards of wood together with adhesives or by other methods of fixation to form composite material; also called *mass timber, composite wood, man-made wood,* or *manufactured board.*

**net metering.** A solar incentive program that allows property owners to store energy in the electric grid; also known as *net energy metering* (NEM). When solar panels produce more electricity than needed, that energy is sent to the grid in exchange for credits. Then, at night or other times when solar panels are underproducing, the system pulls energy from the grid and uses these credits to offset the costs of that energy.

Mathematics and Statistics Glossary Examples

**average percentage error (APE).** The computed arithmetic average of percentage errors found by computing the percentage differences between forecasts from a model and the corresponding actual values of the variable analyzed.

**decision rule.** A formal statement that indicates the circumstances under which a null hypothesis would be rejected.

**holdout sample.** That portion of a dataset not used in fitting a model but later is used to assess the performance of a model. The holdout sample does not influence the process of fitting a model and is therefore used to independently test the fitted model. See also *testing sample.*

**model specification.** A process to determine which independent variables should be included in or excluded from a regression equation. Regression model specification should be based on a theoretical rationale rather than empirical or methodological ones to prevent illogical results.

**spline regression.** A type of nonlinear regression. A typical regression model results in forcing a global functional relationship for a variable over the entire range of the dataset. To overcome this restriction, a spline model segments the data into unique and separate partitions and different functional relationships for the variable are estimated within each portion of the dataset. The boundary between each unique and separate partition is called a knot, and these knots can be joint (the global spline function is continuous) or these knots can be disjoint (the global spline function is not continuous).
Using the New Edition of the Dictionary

A longtime debate in the dictionary world has been the tension between descriptivism, i.e., defining words as they are used out in the world, and prescriptivism, i.e., defining words as the primary authority in a top-down manner. By its nature, The Dictionary of Real Estate Appraisal falls more into the prescriptivist camp, because it serves as an authoritative reference on what a technical term means to the valuation profession first and foremost.

Indeed, many dictionary users seem to prefer a single, authoritative definition than a list of multiple definitions from various sources. However, a certain level of descriptivism is sometimes necessary when the context of the usage of the term in question dictates what definition is most appropriate. The most obvious example of unavoidable descriptivism is the presentation of the various definitions of market value that may be appropriate in different appraisal situations. Despite the efforts of the dictionary reviewers to eliminate excess verbiage (and sometimes extraneous definitions such as in the existing fair value and standard depth entries) in the interest of clarity and conciseness, sometimes multiple definitions are necessary, and users of the dictionary have to make informed decisions for themselves of which definition to use.

Optimizing the experience of users of the dictionary was a significant goal of the development process. The digital version of the dictionary, which has been extremely popular with users, has not changed radically with the new edition. The dictionary was the first Appraisal Institute text to be made available digitally back in 2002, and the digital version has evolved with the available technology, from CD-ROMs to Web-based applications to a searchable PDF version. Dictionary users familiar with its PDF version will have a smooth transition to the digital version of the seventh edition because the PDF functionality is largely the same.

As always, The Dictionary of Real Estate Appraisal will likely remain the most cited reference work in an appraiser’s library. Users of the book should expect to see some familiar definitions and some exciting new content, and to experience an occasional mental stumbling block along the way because the body of knowledge does continue to shift the tectonic plates underneath the feet of appraisers, sometimes at a glacial pace and in rare instances volcanically. Please be reassured that the learning curve for adapting to the latest edition of The Dictionary of Real Estate Appraisal should be manageable for serious practitioners, and soon enough the evolving language of valuation will be as familiar as the names of the nine—no, eight—planets of the solar system.

About the Author

Michael McKinley has been a book editor at the Appraisal Institute since 1998. He served as technical writer for the development of the four most-recent editions of The Appraisal of Real Estate, the third and fourth editions of Appraising Residential Properties, the four most-recent editions of The Dictionary of Real Estate Appraisal, as well as Review Theory and Procedures: A Systematic Approach to Review in Real Property Valuation, Real Property Valuation in Condemnation, and Rural Property Valuation. He has also edited numerous Appraisal Institute monographs and handbooks. Contact: mmckinley@appraisalinstitute.org

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