Is Excess Rent Intangible?

PRESENTATION BY STEPHEN ROACH, MAI, SRA, AI-GRS
1. What is excess rent and what causes it?
2. What do we do with excess rent?
3. Why do I care if excess rent is intangible?
4. What does *The Appraisal of Real Estate* say?
5. So, is excess rent intangible?
6. What do the courts say?
7. Thought question to make your head explode
What is excess rent?

Consider two nearby stores in a regional mall
Both sell technology products to consumers
Both pay the same base rent and have the same lease terms
Both leases have percentage rent clauses
Let’s check in and see how they are doing...
What is excess rent?
What is excess rent?

- As a result of the percentage rent clause, one of the stores will pay a much higher amount of total rent.
- All of the rent paid is part of the contract rent.
- The landlord’s position is enhanced by the additional contract rent, and it’s more valuable as a result.
What is excess rent?

“The amount by which contract rent exceeds market rent at the time of the appraisal; . . .”

Dictionary of Real Estate Appraisal, Fifth Edition
What is excess rent?

- So, excess rent equals **contract rent** minus **market rent** (if the contract rent is higher)
- Let’s look at those two terms . . .
What is contract rent?

“The actual rental income specified in a lease.”

Dictionary of Real Estate Appraisal, Fifth Edition
What is market rent?

“The most probable rent that a property should bring in a competitive and open market reflecting all conditions and restrictions of the lease agreement, including permitted uses, use restrictions, zoning and use, expenses, term, concessions, renewal and purchase options, and tenant improvements (TIs).”

Dictionary of Real Estate Appraisal, Fifth Edition
What causes excess rent?

“... created by a lease favorable to the landlord (lessor) and may reflect unusual management, unknowledgeable parties, a lease execution in an earlier, stronger rental market, or an agreement of the parties. ...”

Dictionary of Real Estate Appraisal, Fifth Edition

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What do we do with excess rent?

“... Due to the higher risk inherent in the receipt of excess rent, it may be calculated separately and capitalized at a higher rate in the income capitalization approach.”

Dictionary of Real Estate Appraisal, Fifth Edition
What do we do with excess rent?

Excess rent generally gets capitalized (or discounted) and included in the value when appraising a leased fee interest.
Why do I care if excess rent is intangible?

USPAP SR 1-4(g):

When personal property, trade fixtures, or intangible items are included in the appraisal, the appraiser must analyze the effect on value of such non-real property items.

What are “intangible items”?

INTANGIBLE PROPERTY (INTANGIBLE ASSETS): nonphysical assets, including but not limited to franchises, trademarks, patents, copyrights, goodwill, equities, securities, and contracts as distinguished from physical assets such as facilities and equipment.
Why do I care if excess rent is intangible?

USPAP 2-1:

650 Each written or oral real property appraisal report must:

651 (a) clearly and accurately set forth the appraisal in a manner that will not be misleading;

652 (b) contain sufficient information to enable the intended users of the appraisal to understand the report properly; and

653 (c) clearly and accurately disclose all assumptions, extraordinary assumptions, hypothetical conditions, and limiting conditions used in the assignment.
Why do I care if excess rent is intangible?

**USPAP 2-2(a)(iii):**

summarize information sufficient to identify the real estate involved in the appraisal, including the physical, legal, and economic property characteristics relevant to the assignment,\(^{19}\)

Comment: The real estate involved in the appraisal can be specified, for example, by a legal description, address, map reference, copy of a survey or map, property sketch, and/or photographs or the like. The summarized information can include a property sketch and photographs in addition to written comments about the legal, physical, and economic attributes of the real estate relevant to the type and definition of value and intended use of the appraisal.
Why do I care if excess rent is intangible?

USPAP 2-1(a)(viii):

726 (viii) summarize the information analyzed, the appraisal methods and techniques employed, and the reasoning that supports the analyses, opinions, and conclusions; exclusion of the sales comparison approach, cost approach, or income approach must be explained;

Comment: An Appraisal Report must include sufficient information to indicate that the appraiser complied with the requirements of STANDARD 1. The amount of detail required will vary with the significance of the information to the appraisal.
“A lease never increases the market value of real property rights to the fee simple estate. Any potential value increment in excess of a fee simple estate is attributable to the particular lease contract.”

The Appraisal of Real Estate, 14th Edition, P. 441
“Value over and above market value that can be ascribed to a lease that guarantees contract rental income in excess of market rent at the time of the appraisal. Excess value is attributable to the terms of a contract that may run with the land but is separate from the bundle of rights in the land (or property) itself.”
So, is excess rent intangible?

- By definition, the real estate ("a property") can produce market rent, but no more
- By definition, excess rent exceeds market rent
- By definition, excess rent is created by the contract, not the real estate
- By definition, a contract is an intangible asset; it’s not real estate
- Therefore, excess rent is intangible
Hard to tell . . .

- USPAP FAQ 194. LEASED FEE INTEREST WHEN INTANGIBLE ASSETS EXIST
- Question: I am appraising a single tenant retail property that is being sold with financing by my client, which is a bank. The property was . . . just completed last month for a total development cost of $1,500,000. A large retail chain will occupy the building at an above-market lease rate. The property is being sold to an investor on a sale-leaseback basis for over $2,000,000. Both parties recognized the lease rate was above-market and that the price was well above replacement cost. **Should I allocate the portion of above-market rent to the real estate or treat it as an intangible?** My client insists that I attribute the entire rent to real property value. What does USPAP require in this situation?
Everyone agrees, right?

Hard to tell . . .

- USPAP FAQ 194. LEASED FEE INTEREST WHEN INTANGIBLE ASSETS EXIST

- Response: The subject of this appraisal is real property, not intangibles, specifically the leased fee estate . . .

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Everyone agrees, right?

- Hard to tell . . .
  - USPAP FAQ 194. LEASED FEE INTEREST WHEN INTANGIBLE ASSETS EXIST
  - Response: The subject of this appraisal is real property, not intangibles, specifically the leased fee estate . . .
- So, according to the ASB, when intangible assets exist, there are no intangibles?
Walgreens appealed the assessment of two of its stores in Madison, Wisconsin.

Walgreens worked with developers who found sites for its stores, bought out existing businesses, bought the sites, and developed the sites to suit Walgreen’s needs.

Thus, Walgreen’s lease payments included compensation for the developer’s financing, land acquisition, construction, and development costs.
The assessor valued the properties based on contract rents; Walgreens argued that a lower market rent must be used. The trial court agreed with the assessor.

The appellate court upheld the use of contract rents. The appellate court concluded that because the monthly payments are appended to the properties by the lease agreement, they are "rights and privileges appertaining thereto" within the Wis. Stat. § 70.03 definition of "real property" ("'Real property', 'real estate', and 'land'... include not only the land itself but all buildings and improvements thereon, and all fixtures and rights and privileges appertaining thereto").
The Wisconsin Supreme Court overturned the appellate court, ruling that market rent must be used if the contract rent is above market.

"...we reaffirm... that Wis. Stat. § 70.32(1) "proscribes assessing real property in excess of market value." This holding is consistent with the nationally recognized principle that "[a] lease never increases the market value of real property rights to the fee simple estate." Appraisal Institute, The Appraisal of Real Estate 473 (12th ed. 2001)."
“Given the uncontroverted testimony that sale-leaseback transactions often reflect the sale of more than just real property, the Indiana Board explained that one should approach the rental data from such transactions with caution, taking care to ascertain whether the sales prices/contract rents reflect real property value alone or whether they include the value of certain other economic interests.”

“A lease never increases the market value of real property rights to the fee simple estate. Any potential value increment in excess of a fee simple estate is attributable to the particular lease contract, and even though the rights may legally “run with the land” they constitute contract rather than real property rights.” (Quoted TARE, 12th Edition. The highlighted language was also present in the 13th Edition, but removed from the 14th.)
The subject property is a build to suit property with a lease in place that represents the cost to construct the project rather than the market.

The Complainant’s appraiser grouped rentals in three categories. The first category was referred to as first generation leases. The circumstances regarding the lease and the terms of the lease reflect a sale leaseback for build to suit properties. The terms of these leases may not reflect actual market and instead reflect the cost to construct and the financing of the purchase of the property. The second category of leases is referred to as second generation leases. These properties involve a new tenant coming into the structure after renovations were made by the owner. The third category involves rentals in which the tenant takes the space “as-is.” The appraiser also reviewed former CVS spaces around the country.
Properties like the subject are custom built property for the occupant and the lease terms reflect the recoupment of the custom construction. The rents are usually above market. The cost of the construction and rental are part of an overall business operation of the tenant and works in their business plan. The occupant’s business plan may not reflect the actual market.

The Complainant’s premise was correct in that the appraiser recognized that the appraisal was for market value and not value in use but his lack of support within the report left the hearing officer without substantial and persuasive evidence to support the conclusion reached by his analysis.
Respondent’s (City) sales comparison and income approaches indicate very similar values for the subject property, both of which are substantially higher than that indicated by its cost approach. [The appraiser] concluded that the higher values associated with these approaches reflect entrepreneurial profit or some other business-related value, and relied on the cost approach.

The income approach reflects lease rates for pharmacies, which are typically based on construction costs plus the cost to acquire the land.
Petitioner’s appraiser successfully established that pharmacy retailers are not motivated by the resale value of the stores and that secondary uses of such properties, much like big-box stores, result in a lower market value than the original construction cost. This is because, like big-box stores, modern pharmacies and drugstores are specifically constructed to meet the design, location, and physical requirements of one major retailer’s business needs.
Petitioner’s selected comparables were vacant and available at the time of sale and the Tribunal finds that these sales best represent the fee simple interest in the subject property.

Although Petitioner’s sales comparison analysis is found to provide the most reliable indicator of value, [the appraiser] was able to prove that build-to-suit leases are above market rent, and through the use of lease and sublease listings, as well as actual leasings of former drugstore space throughout Michigan, was able to show the decline in value for the secondary user.
No, not all do. However, these are assessment cases, and state laws vary.

- Shelby County v. CVS (Indiana; 2013) - **Yes**
- Walgreens v. Fayette County Assessor (Kentucky; 2015) - **No** ("lease must be considered")
- Prieb Properties v. Shawnee County (Kansas; 2012) - **Yes**
Thought question . . .

Assume the following facts:

- A shopping center has a vacant pad available for ground lease
- The market value of the fee simple interest in the parcel is $1,000,000
Thought question . . .
Thought question . . .

Assume the following facts:

- The market rate of return for a ground lease is 8% of the land value
- A credit tenant (say, Starbucks) leases the land for $80,000 per year
- The lessee builds a store and begins operation
Thought question . . .
Thought question . . .

Assume the following facts:

- The new lessor puts the leased fee interest on the market
- The investment sells at a cap rate of 5%:

\[
\$80,000 \div 0.05 = \$1,600,000
\]
Thought question . . .

Here’s the situation now:

- There is no excess rent (Starbucks is paying market rent)
- The leased fee interest is worth way more than the fee simple
- OK, so what’s the $600,000? (Real estate? Intangible?)
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