Shining Light on Dark Big Box Theory

Nashville, TN
July 30, 2018
Why this Matters

• Identification of the problem
  ➢ What is the market value of an asset that doesn’t transact in the relevant market?
  ➢ Valuation methods, techniques and compliance with Standards the same
    ➢ Big box retail
    ➢ Residential rental properties with tax credits (LITC)
    ➢ Any asset that is valued by market participants on the basis of a financial instrument
  ➢ Are there legal risks for the valuer? How can they be handled?

These concepts apply in a wide range of engagements
Shining Light on Applicable Best Practices

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July 30, 2018
Lender request a leased fee value plus additional value “as if the lease does not exist”

• **Reason**
  • Most common for risk assessment on a loan for lender

• **Appraisal Request**
  • Value of leased fee
  • Value “as if dark” – Thus, the Dark Store
Specialty Market Segment

Motivations for purchase (Leased fee)

- The lease (and what the lease brings with it)
  - Credit tenant (Bonded Income)
  - No management responsibilities (NNN Lease)
  - Increased liquidity (Special Market Segment)
- Existing Body of Knowledge Gives Guidance
  - But first we need to understand when, why and how
Big Picture Pre-1990’s Asset Classes

Stocks → Bonds → Currencies → Commodities → Other Financial Instrument → CRE
Big Picture Today Asset Classes

- Stocks
- Bonds
- Currencies
- Commodities
- Other Financial Instruments
- CRE
Institutional-grade tenant defined as:

“any tenant that has an S&P rating of BBB- or better or a Moody’s rating of Baa3 or better.”

### Standard & Poor's Long-Term Credit Ratings

<table>
<thead>
<tr>
<th>Rating</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>Extremely strong capacity to meet financial commitments. Highest Rating.</td>
</tr>
<tr>
<td>AA</td>
<td>Very strong capacity to meet financial commitments.</td>
</tr>
<tr>
<td>A</td>
<td>Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances</td>
</tr>
<tr>
<td>BBB</td>
<td>Adequate capacity to meet financial commitments, but more subject to adverse economic conditions.</td>
</tr>
<tr>
<td>BBB-</td>
<td>Considered lowest investment grade by market participants.</td>
</tr>
<tr>
<td>BB+</td>
<td>Considered highest speculative grade by market participants.</td>
</tr>
<tr>
<td>BB</td>
<td>Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions.</td>
</tr>
<tr>
<td>B</td>
<td>More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments.</td>
</tr>
<tr>
<td>CCC</td>
<td>Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments.</td>
</tr>
<tr>
<td>CC</td>
<td>Currently highly vulnerable.</td>
</tr>
<tr>
<td>C</td>
<td>Currently highly vulnerable obligations and other defined circumstances.</td>
</tr>
<tr>
<td>D</td>
<td>Payment default on financial commitments.</td>
</tr>
<tr>
<td>----------</td>
<td>-----------------</td>
</tr>
</tbody>
</table>

Click [here](http://www.nnnpropertiesgroup.com/client-resources/market-research/tenant-credit-ratings/) for notes on how to use this chart.
## How Credit Transforms Motivations

### Growth Investment Group

http://www.nnnpropertiesgroup.com/client-resources/market-research/tenant-credit-ratings/

<table>
<thead>
<tr>
<th>Company</th>
<th>Industry</th>
<th>Symbol</th>
<th>Credit Rating</th>
<th>Interest Rate</th>
<th>Moody's Rating</th>
<th>S&amp;P Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costco Wholesale Corp.</td>
<td>Discount</td>
<td>COST</td>
<td>A+</td>
<td>2.91%</td>
<td>A2</td>
<td>1.29%</td>
</tr>
<tr>
<td>CVS Caremark Corp.</td>
<td>Drug</td>
<td>CVS</td>
<td>BBB+</td>
<td>10.29%</td>
<td>Baa2</td>
<td>4.64%</td>
</tr>
<tr>
<td>Dollar General Corp.</td>
<td>Discount</td>
<td>DG</td>
<td>BB</td>
<td>29.93%</td>
<td>B1</td>
<td>43.34%</td>
</tr>
<tr>
<td>Kohl's Corp.</td>
<td>Home &amp; Garden</td>
<td>KSS</td>
<td>BBB+</td>
<td>10.29%</td>
<td>Baa1</td>
<td>4.64%</td>
</tr>
<tr>
<td>The Kroger Co.</td>
<td>Grocery</td>
<td>KR</td>
<td>BBB</td>
<td>10.29%</td>
<td>Baa2</td>
<td>4.64%</td>
</tr>
</tbody>
</table>
### How Credit Transforms Motivations

**Growth Investment Group**


<table>
<thead>
<tr>
<th>Company</th>
<th>Industry</th>
<th>Symbol</th>
<th>Rating</th>
<th>Credit Rating</th>
<th>Rate</th>
<th>Bond Rating</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowe's Companies, Inc.</td>
<td>Home &amp; Garden</td>
<td>LOW</td>
<td>A+</td>
<td>2.91%</td>
<td>A</td>
<td>1.29%</td>
<td></td>
</tr>
<tr>
<td>The Sherwin-Williams Co.</td>
<td>Home &amp; Garden</td>
<td>SHW</td>
<td>A-</td>
<td>2.91%</td>
<td>A3</td>
<td>1.29%</td>
<td></td>
</tr>
<tr>
<td>Starbucks Corp.</td>
<td>Restaurants</td>
<td>SBUX</td>
<td>BBB+</td>
<td>10.29%</td>
<td>Baa3</td>
<td>4.64%</td>
<td></td>
</tr>
<tr>
<td>The TJX Companies, Inc.</td>
<td>Discount</td>
<td>TJX</td>
<td>A</td>
<td>2.91%</td>
<td>A3</td>
<td>1.29%</td>
<td></td>
</tr>
<tr>
<td>Verizon Communications Inc.</td>
<td>Technology</td>
<td>VZ</td>
<td>A</td>
<td>2.91%</td>
<td>A3</td>
<td>1.29%</td>
<td></td>
</tr>
<tr>
<td>Walgreen Co.</td>
<td>Drug</td>
<td>WAG</td>
<td>A</td>
<td>2.91%</td>
<td>A2</td>
<td>1.29%</td>
<td></td>
</tr>
<tr>
<td>Wal-Mart Stores, Inc.</td>
<td>Discount</td>
<td>WMT</td>
<td>AA</td>
<td>1.50%</td>
<td>Aa2</td>
<td>0.52%</td>
<td></td>
</tr>
</tbody>
</table>
How Credit Transforms Motivations

Institutional Investor
Meet “Uncle Hank”
Sale Verification Is Critical

- **Does the fee simple sale have the same highest and best use?**
  - Big Boxes close stores for various reasons
    - Supply and demand
    - Market share mix
    - Need for revised store design
    - Location demographics changes
    - Corporate balance sheet adjustments
  - With **use of fee simple sales** as comparables, must:
    - Understand reasons the comparable is vacant (verification)
    - Not assume “vacant and available" (definition of fee simple) is not **only** criteria for a comparable
    - Verify sales to ascertain motivations for purchase/sale
Sale Verification Is Critical

- **Does the fee simple sale have the same highest and best use?**
  - Deed restrictions exist against same tenancy?
    - If so, **NOT** the same highest and best use
    - Such restrictions change the highest and best use of the property (no longer be used for certain retail)
  - Are the **demographics suitable** and similar to subject
    - Population, income, employment drive retail demand
    - Look at retail leakage
    - Retail sales for subject type retail in trade area
“Appraisers have a special responsibility to scrutinize the comparability of all data used in a valuation assignment. They must fully understand the concept of comparability and should avoid comparing properties with different highest and best uses, limiting their search for comparables, or selecting inappropriate factors for comparison.”

Source: The Appraisal of Real Estate 14th edition, page 125
Sale Verification Is Critical

- **Highest and best use is fundamental in choosing comparables.**
- A big box that sells for an alternate use does not compete for same market investors as institutional grade retail properties.
- Sale-leasebacks and Build-to-suit transactions
- 1031 Property exchanges (prevalent in this market segment)
- Is the sale a **depressed sale**?
  - REO, Foreclosure, etc. (Conditions of sale)
Highest and Best Use Conclusions

- Highest and Best Use – 3-Part Conclusion Required
  - Use
  - Timing
  - User
Valuation of Interest in Real Property

- **Fee simple**
  - “When the fee simple interest is valued, the presumption is that the property is available to be leased at market rates.”

- **Leased fee**
  - Right of use and occupancy given up by contract (lease)
  - USPAP – “must analyze the effect on value of existing leases”
  - May include “credit” tenant considered
  - May include “bonded lease”
  - May include no management responsibilities (NNN)
“A lease never increases the market value of the 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.”

Why the difference?

Property #1 - $1,126,900
Cap rate 7.00% $125/SF
NN Lease 15-yrs remaining

Property #2 - $675,000
Cap rate 7.70% $75.00/SF
NN Lease 9-yrs remaining

Difference is remaining term on the lease
Why the difference?

Property #1 - $1,769,000  
Cap rate 6.5%  
$177.00/SF  
NN Lease  
10- yrs remaining

Property #2 - $557,000  
Cap rate 8.0%  
$69.00/SF  
NN Lease  
4.5- yrs remaining

Difference is remaining term on the lease
Why the difference?

### CASUAL DINING VS RETAIL NET LEASE MARKET CAP RATES

<table>
<thead>
<tr>
<th>Sector</th>
<th>Q1 2017 (Previous)</th>
<th>Q1 2018 (Current)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Casual Dining Sector</td>
<td>6.00%</td>
<td>6.05%</td>
</tr>
<tr>
<td>Retail Net Lease Market</td>
<td>6.19%</td>
<td>6.10%</td>
</tr>
<tr>
<td>Casual Dining Premium (bps)</td>
<td>19</td>
<td>5</td>
</tr>
</tbody>
</table>

### MEDIAN ASKING CAP RATE BY LEASE TERM REMAINING

<table>
<thead>
<tr>
<th>Lease Term Remaining</th>
<th>Cap Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>20+</td>
<td>5.65%</td>
</tr>
<tr>
<td>15-19</td>
<td>5.93%</td>
</tr>
<tr>
<td>10-14</td>
<td>6.30%</td>
</tr>
<tr>
<td>5-9</td>
<td>6.44%</td>
</tr>
<tr>
<td>Under 5</td>
<td>6.85%</td>
</tr>
</tbody>
</table>

### MEDIAN NATIONAL CLOSED CAP RATE SPREAD

<table>
<thead>
<tr>
<th>Tenant</th>
<th>Closed</th>
<th>Asking</th>
<th>Spread (bps)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Casual Dining</td>
<td>6.02%</td>
<td>5.85%</td>
<td>17</td>
</tr>
</tbody>
</table>

### CASUAL DINING ASKING CAP RATE BY GUARANTOR

<table>
<thead>
<tr>
<th>Tenant</th>
<th>Corporate Cap Rate</th>
<th>Franchise Cap Rate</th>
<th>Spread (bps)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Casual Dining</td>
<td>5.90%</td>
<td>6.50%</td>
<td>60</td>
</tr>
</tbody>
</table>
What happens without the corrections?

• Correction of 3 CRE shortfalls:
  • Liquidity
  • Shares in securities
  • Investment grade
  • BBB or better S&P Tenant company backed guarantee
  • No management responsibilities
  • NNN or Institutional grade management company

What’s left is dirt, sticks, and bricks . . .
“Income-producing real estate is often subject to an existing lease or leases encumbering the title. By definition, the owner of real property that is subject to a lease no longer controls the complete bundle of rights, i.e., the fee simple estate. If the sale of a leased property is to be used as a comparable sale in the valuation of the fee simple estate of another property, the comparable sale can only be used if reasonable and supportable market adjustments for the differences in rights can be made.”

“The interest to be valued depends on the intended use and intended user of the appraisal. Federal or state law often requires appraisers to value leased properties as fee simple estates, not leased fee estates, for eminent domain and ad valorem taxation. **When the fee simple interest is valued, the presumption is that the property is available to be leased at market rates.**”

Source: The Appraisal of Real Estate 14th edition, page 441
“The performance of the property is likely to be the most reliable indicator of current demand for existing properties in the market.”

Source: The Appraisal of Real Estate 14th edition, page 310
Bondable Net Lease - “A Lease in which the tenant assumes nearly all of the obligations of ownership of the property, therefore making the lease payments net of any offsets or deductions and net to the lessor or owner. In other words, the tenant pays rent for the entire term of the lease regardless of what happens to the building, e.g., condemnation.”

A credit tenant is “A tenant in a retail, office, or commercial property with a long history in business, strong financial statements, or a large market presence that could be rated as investment grade by a rating agency. Because of the likelihood of honoring their leases, credit tenants are considered less risky to lease to, and developments with credit tenants as anchors are considered less risky investments for lenders.”

“When a market rent estimate for the subject property is required, the appraiser gathers, compares, and adjusts comparable rental data. The parties to each lease should be identified to ensure that the party held responsible for rent payments is actually a party to the lease or, by endorsement, the guarantor. It is also important to ascertain that the lease represents a freely negotiated, arm’s-length transaction. A lease that does not meet these criteria, such as a lease to an owner-tenant or a sale-leaseback, often does not provide a reliable indication of market rent. Since sale-leasebacks are actually financing vehicles, they should not be used in estimating market rent.”

Source: The Appraisal of Real Estate 14th Edition, Page 466
“The sale of a property encumbered by a lease involves rights other than the complete fee simple estate, and valuation of those rights requires knowledge of the terms of all leases and an understanding of the tenant or tenants occupying the premises”

“Market analysis and highest and best use analysis set the stage for the selection of appropriate comparable sales.”

“In a balanced market, feasibility rent will be the same as market rent.”

Shining Light on Standards

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July 30, 2018
So What’s the Problem?

• Opposing value conclusions are often very far apart ($2M v $20M)

• Harmful to public trust in appraisal process

• Two knowledgeable, experienced valuation professionals arrive at such different opinions

• Consistent high value for taxing authority, for example

• Calls appraiser ethics into question
1. Ethics Rule requirements of independence

2. “...correctly employ those recognized methods and techniques that are necessary to produce credible assignment results”

3. Scope of Work Rule requirement to not let assignment conditions limit the professional to the point that he or she cannot produce credible assignment results
Assignment Conditions to Consider Carefully

✓ No need to adjust build-to-suit rents

✓ Always adjust build-to-suit rents

✓ Since “fee simple” means without leases, assume subject is available for rent at date of value

✓ Assume subject is leased at market rates

✓ Base your methods and techniques on a particular judicial opinion
Courts are not the best source for which methods and techniques to use

- Judicial opinions are based on the specific facts of the case
- Judges take the persuasiveness of the arguments presented by counsel for each party into account
- Many court opinions used by valuation professionals to support appraisal methods really opine to whether the lower body (taxing authority) abused its discretion in coming to its opinion

But still, many of us use these opinions to support the “rightness” of methods and techniques we use
“We have held that a recent arm's-length sale price should not be adjusted to remove the economic effect of such encumbrances when they exist. And we have also determined that a sale price does not have to be adjusted to remove the effect of above-market rent paid by a creditworthy tenant.”

WHY?

“by drawing the distinction between "fee simple" and "leased fee," Meijer predicates its argument on a legal premise that our cases have rejected.”

States that Ohio does not recognize the AI definition of “fee simple”

Some Facts

✓ Subject was recently built
✓ Subject contained 196,000± SF
In a later case, Justice O’Connor held:

When valuing property for tax purposes, as a general rule, the sale prices of leased-fee properties should be adjusted when used to determine the value of an unleased subject, because a long-term lease affects sale price and value. (*Rite-Aid of Ohio, Inc. v. Washington County Board of Revision*)

The county argued that Meijer controlled, but Court distinguished 10-year old, 11,052 SF building.
Be Credible

- Use methods and techniques determined **BY YOU** to be the right ones
- Use methods and techniques that are **CONSISTENT WITH THE VALUATION BODY OF KNOWLEDGE**
- One test of reasonableness: Are you retained by both owners and authorities?
- One test of reasonableness: Do you sometimes use one type of data for support and other types in other engagements?

![Trust Caring Expertise](image)
Unboxing the Liability Issues

Peter T. Christensen, JD
LIA Administrators & Insurance Services

July 30, 2018
Liability Issues from Dark Boxes

- Liability risk? Focusing on the appraiser’s risk of a professional negligence claim by a party involved in the transaction or tax matter.

- Not an out of control risk, but almost no appraiser enjoys being a defendant or gains anything from it other than a learning experience.

- Risk is very different depending on the use for which the appraisal is being provided.

- Let’s look at the differences and what can be done to decrease the risk.
Who Sues over Lending Work?

Claims relating to appraisals for loan origination:

- Borrowers/purchasers (60-65%)
- Lenders (30%), small v. big, bank v. alternative lenders
- Others (5-10%)
“Typical” Buyer’s Remorse Case

SUPERIOR COURT OF CALIFORNIA - COUNTY OF BUTTE

CASE NO. 150077
FIRST AMENDED COMPLAINT FOR:

1. DECLARATORY AND INJUNCTIVE RELIEF;
2. FRAUD AND DECEIT;
3. FRAUD AND NEGLIGENT MISREPRESENTATION;
4. CONSTRUCTIVE FRAUD;
5. BREACH OF FIDUCIARY DUTY;
6. BREACH OF COVENANT OF GOOD FAITH AND FAIR DEALING;
7. UNJUST ENRICHMENT;
8. NEGLIGENCE:

DOES 1 through 10, inclusive,

Defendants.

JOEL K. LIBERSON (SBN: 164857)
JASON N. WOLFORD (SBN: 194177)
LIBERSON & WOLFORD LLP
660 Market Street, 5th Floor
San Francisco, CA 94104
Tel.: (415) 677-4110
Fax: (415) 358-8154

Attorney for Plaintiffs
TYP, LLC, CHESLEY B. SULLENBERGER III, and
LORRAINE SULLENBERGER

TYP, LLC, CHESLEY B. SULLENBERGER
III and LORRAINE SULLENBERGER,
Plaintiffs,

v.

GRUBB & ELLIS COMPANY, CHERIE
HUILLADE, STERLING SAVINGS BANK as
successor in interest by merger to SONOMA
NATIONAL BANK, BECKI ROBERTS, and
DOES 1 through 10, inclusive,

Defendants.
22. On or around October 2009, Plaintiffs obtained a forensic appraisal of the Subject Property. The appraisal verified that Defendants’ representations regarding the fair market value of the Subject Property when it was purchased in 2002 had been significantly overstated. The forensic appraisal indicated in pertinent part as follows:

It is our opinion that the market value of the Leased Fee Interest in the subject property, as of October 20, 2002, should fall within a value range of $680,000 to $720,000. This range of value has been based on a review and analysis of numerous sales and rent comparables of auto-service related facilities in the Northern California marketing area which had closing dates between 2000 and early 2003 (and also included an analysis of the four sales and four rent comparables utilized in the original appraisal report – which were represented by the same four properties). It appears that the original appraised value of $920,000 and contract sales price of $935,000 were substantially above market value. This may have occurred for a number of reasons from both an appraisal perspective, but also from a lack of fiduciary responsibility on the part of the other real estate professionals involved in the transaction.
The key legal elements of a negligence claim:

- Duty owed by the defendant to the plaintiff to conform his or her conduct to a standard of care.

- Breach of that duty – e.g., providing an inflated valuation or failing to produce a USPAP-compliant appraisal.

- Reliance by the plaintiff.

- Actual damages to the plaintiff.
**What Should I Do?**

**Always** be careful with your intended use and user language. Be precise and as narrow as possible.

**Include** a specific advisory in reports directed to purchasers/borrowers and sellers. Example:

“The appraiser has not identified any purchaser, borrower or seller as an intended user of this appraisal and no such party should use or rely on this appraisal for any purpose. Such parties are advised to obtain an appraisal from an appraiser of their own choosing if they require an appraisal for their own use. This appraisal report should not serve as the basis for any property purchase decision or any appraisal contingency in a purchase agreement relating to the property.”
➢ Much different risk.
➢ Your tax client is where the risk lies almost entirely.
➢ Working for the taxpayer, your risk is that the client has a bad outcome and blames you.
➢ Working for the taxing authority (as a contractor), your risk is the same.
➢ There is virtually no risk to the other side.
➢ You have no duty to the other side in tax appeal or tax litigation – and it’s a clear enough legal point that almost no attorney is going to take a case like that.
➢ In tax litigation, a witness privilege also applies.
When do tax clients typically sue?
• Mistakes in appropriate, supportable methodology.
• Overly aggressive valuation position that leads to a bad outcome.
• When a fee shifting statute has come into play.

➢ Taxpayer sued appraiser over an aggressively low valuations in series of tax appeals. Taxpayer lost each appeal. The basis of the claim was that the aggressive valuation positions led the taxpayer into pursuing the unsuccessful appeals and caused the taxpayer to waste money on fees.

➢ Taxing authority sued contracted appraisal firm for mistakes in methodology that caused loss of tax appeal case (following appeals to court). The mistake was that appraisers had essentially ignored market value definition under applicable state law (valued the property based on the revenue of big box tenant). Taxing authority was ordered to pay taxpayer’s fees and costs for the unjustified position.
Property Tax Fee Shifting

Be aware of fee shifting provisions in your state’s tax procedures. For example, Oregon law (ORS 305.490(4)(a)) provides:

"(4)(a) If, in any proceeding before the tax court judge involving ad valorem property taxation. . ., the court finds in favor of the taxpayer, the court may allow the taxpayer, in addition to costs and disbursements, the following:

"(A) Reasonable attorney fees for the proceeding under this subsection and for the prior proceeding in the matter, if any, before the magistrate; and

"(B) Reasonable expenses as determined by the court. Expenses include fees of experts incurred by the individual taxpayer . . ."
What Can you Do?

➢ Use a good engagement agreement with clients for tax work.
➢ Always get engagement agreements signed.
➢ Include specific wording relating to tax results.
Client intends to utilize Appraiser’s appraisal(s) and/or report(s) prepared under this Agreement in connection with tax matters and acknowledges that Appraiser has not made any assurances or predictions as to the outcome of such tax matters. Client understands and acknowledges that the taxing authority (whether it is the Internal Revenue Service or any other federal, state or local taxing authority) may disagree with or reject Client’s tax position(s) and/or Appraiser’s appraisal(s), and further understands and acknowledges that the taxing authority may seek to collect from Client additional taxes, interest, penalties or fees. Client agrees that Appraiser shall have no responsibility or liability to Client or any other party for any such taxes, interest, penalties or fees or for any alleged damages, attorneys fees or costs incurred or awarded in connection with or as a result of the tax matters and that Client will not seek damages or other compensation from Appraiser relating to any taxes, interest, penalties or fees imposed on Client or for any attorneys’ fees, costs or other expenses relating to the tax matters.
Questions and Comments