Special Purpose Properties
Special Valuation Considerations
2017 Case Study in Ottawa:

New Automobile Dealership

• Many brand-specific specialties

• Cost: $4,000,000 (including land and a developer fee)

• Sales are well in excess of the amount necessary to justify $4,000,000

• Value to a dealer of any other brand: $3,200,000
2017 Case Study in Ottawa:

1. What is the appropriate fee simple market value for mortgage loan underwriting?

2. What is the appropriate fee simple market value to establish assessed value for ad valorem taxes?

3. What is the appropriate fee simple market value to establish just compensation for a taking in eminent domain?

4. If the dealership is sold as a going concern, what is the appropriate purchase price allocation to the real property (IRS)?

$3,200,000
-or-
$4,000,000
Informal poll results:

<table>
<thead>
<tr>
<th></th>
<th>$4.0M</th>
<th>$3.2M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Underwriting</td>
<td>±40%</td>
<td>±60%</td>
</tr>
<tr>
<td>Property Tax</td>
<td>±40%</td>
<td>±60%</td>
</tr>
<tr>
<td>Eminent Domain</td>
<td>±60%</td>
<td>±40%</td>
</tr>
<tr>
<td>IRS Allocation</td>
<td>±50%</td>
<td>±50%</td>
</tr>
</tbody>
</table>
The Solution – Value in Use

In Economics...

Value in Use:
Value derived from utilization of an asset.

Value in Exchange:
What the asset could be exchanged for.
The Solution – Value in Use

Value in Exchange:
• What a thing would sell for
• Synonymous with *market value*
• Objective
• Very useful

Value in Use:
• What a thing is worth to one particular party, based on their own needs, tastes or opinions
• Subjective
• Not very useful
The Solution – Value in Use

Another confusing distinction…

Use Value vs. Value in Use
Use Value:
A type of value, distinct from market value, investment value or disposition value.

Value in Use:
A valuation premise.
Defining Value in Use

Two good definitions…

Value in Use:

(1) The value the real estate contributes to the enterprise of which it is a part.¹

¹The Appraisal of Real Estate, 14th edition, page 62
Value in Use Example

Specialty Manufacturing Enterprise

• Value of the enterprise with the building included = $9,000,000

• Value of the enterprise with the building excluded = $4,000,000

• Value in use = $5,000,000

* This is a special purpose property; value in use may not equal value in exchange.
Defining Value in Use

Two good definitions…

Value in Use:

(1) The value the real estate contributes to the enterprise of which it is a part.¹

(2) The present value of future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.²

¹The Appraisal of Real Estate, 14th edition, page 62
²International Financial Reporting Standards, Appendix A
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Note: if the discount rate selected is appropriate, this definition is equivalent to the first.
Defining Value in Use

Value in Use:

(2) The present value of future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.²

For special-purpose real estate – the cash flows are the net amount of rent the enterprise saves by owning the asset; the amount the enterprise would expect to pay for a replacement (first-generation market rent).
So, what is **Use Value**?

The value of a property assuming a specific use, which may or may not be the property’s highest and best use.³

³The Dictionary of Real Estate Appraisal, 6th edition, page 245
So, what is **Use Value**?

The value of a property assuming a specific use, which may or may not be the property’s highest and best use.  

**Example:** farm ground in the path of urban growth that must be valued strictly on the agricultural use for property tax purposes.
Defining Value in Use

So, what is **Use Value**?

The value of a property assuming a specific use, which may or may not be the property’s highest and best use.³

**Note:** If highest and best use is the use that maximizes value, use value can only be equal or less than market value.
Defining Value in Use

How does the 6th Edition Dictionary define **Value in Use**?

The value of a property assuming a specific use, which may or may not be the property’s highest and best use.
Perspective of other valuation professionals:

• Business appraisers
• Accountants
• Personal property appraisers
Two Valuation Premises

Going concern premise:
The business is valued as a unified operating enterprise, generally based largely on the amount of income the business generates.

Liquidation premise:
The valuation assumes the business is closed and the assets are sold off in an orderly disposition.

Whichever valuation premise results in the highest value indication determines the market value of the business.
Example:

Business is the owner/operator of a single **Sonic franchised restaurant**

- Opened just long enough to demonstrate its stabilized income
- Real property cost = $3,000,000 (turn-key including developer fee); however, 2nd generation user would pay only $2,000,000
- Personal property cost = $500,000; however, 2nd generation user would pay only $300,000
Example:

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- Personal property cost = $500,000; however, 2\textsuperscript{nd} generation user would pay only $300,000

Value under the liquidation premise = $2,300,000
Suppose the appraiser finds the income is adequate to support a value of $4,000,000 under the going concern premise…

**Going Concern P > Liquidation P**

Therefore, market value = **$4,000,000**

Real Property   $3,000,000  
Personal Property  $500,000  
Intangible Property  $500,000  
Total Market Value  $4,000,000
Now suppose the appraiser finds the income is adequate to support a value of only $2,000,000 under the going concern premise…

**Going Concern P < Liquidation P**

Therefore, market value = $2,300,000

<table>
<thead>
<tr>
<th>Item</th>
<th>Value</th>
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<tbody>
<tr>
<td>Real Property</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Personal Property</td>
<td>$300,000</td>
</tr>
<tr>
<td>Intangible Property</td>
<td>$0</td>
</tr>
<tr>
<td>Total Market Value</td>
<td>$2,300,000</td>
</tr>
</tbody>
</table>
A fair value measurement assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. The highest and best use of the asset establishes the valuation premise used to measure the fair value of the asset, specifically:

1. In use. The highest and best use of the asset in use [if the asset] would provide maximum value to market participants principally through its use in combination with other assets as a group.

2. In exchange. The highest and best use of the asset in exchange if the asset would provide maximum value to market participants principally on a stand-alone basis.

14th Edition says FASB fair value is equivalent concept to market value
Machinery & Technical Specialties Committee of the American Society of Appraisers has definitions for twelve different value concepts and valuation premises.

**Fair Market Value in Continued Use**: An opinion, expressed in terms of money, at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts, as of a specific date and supported by the earnings of the business [emphasis added].

**Fair Market Value – Removed**: An opinion, expressed in terms of money, at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts, considering removal of the property to another location, as of a specific date [emphasis added].
Use Value – The value of a property assuming a specific use, which may or may not be its highest and best use.

Value in Use – (1) The value a property contributes to the enterprise of which it is a part. (2) The present value of future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

Value in Exchange – The value of a property on a stand-alone basis, separate and apart from other assets or the enterprise of which it is a part.
Market Value in Use – *market value under the value-in-use premise; assumes the property is sold in combination with other assets as a group.*

Market Value in Exchange – *market value under the value-in-exchange premise; assumes the property is sold separate and apart from any other asset.*
• For any property with special design or construction for the current tenant, market value conclusions should distinguish between market value in use and market value in exchange. For general purpose properties, no distinction is applicable.

• Market value in use implies a hypothetical sale of the subject as part of an enterprise or a group of assets on the valuation date, with all the conditions of market value (no atypical motivation, knowledgeable buyer and seller, reasonable exposure, etc.) It is not a subjective measure of value from the current owner’s perspective.
Market value in use cannot exceed replacement cost minus physical depreciation because the value contribution of a property cannot be more than a buyer of the enterprise would expect to spend on a replacement.

If property is vacant or not used by the tenant or purpose it was originally designed for, it is likely that market value in use does not exceed market value in exchange.
The Cost Approach:

• In many cases, the cost approach is a primary valuation method for market value in use.

• Market value in use can reflect functional and external obsolescence, but those calculations are from the perspective of the current tenant.

• Cost approach is only meaningful in determining market value in exchange if the estimate of obsolescence can be supported.
The Income Approach:

• A market value in use indication by the income approach is calculated as the present value of future cash flows (including reversion). For an owner-occupied property, the periodic cash flows are the net amount of rent saved from ownership of the property, figured from the perspective of the current tenant (first-generation market rent).

• A market value in use indication by the income approach likely requires some analysis of the business income potential.
The Income Approach:

- For market value in exchange, potential gross income is figured from the perspective of the market in general (second-generation market rent).

- The appropriate discount rate or capitalization rate for market value in use may be different from the appropriate rate for market value in exchange.
The Sales Comparison Approach:

• For market value in exchange, the sales comparison approach may be a primary valuation method.

• A market value in use indication by the sales comparison approach presents special challenges, but may be possible based on purchase price allocations from sales of going concerns, or on sales of leased fee interests if it can be shown that the leases were negotiated on an arms-length basis and involve only real property. Each of those data sets must be used with caution.
The Sales Comparison Approach:

• Sale-leaseback transactions often involve non-market rent or atypical motivation, and may not be a reliable basis of comparison, even for market value in use.
2017 Case Study in Ottawa:

Back to our questions...

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Thank You