Market Value in Use
Is not an Oxymoron
Case Study:

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
Case Study:

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
Case Study:

Appraisal request from a mortgage lender...

Two value opinions:

(1) Market value in fee simple

(2) “Go-dark” value
Case Study:

Appraiser’s questions:

• What is the definition of dark value or go-dark value?

• Doesn’t a fee simple value opinion already assume the property is vacant (dark)?
Mortgage Underwriting Dilemma:

Suppose the dealer decides to open a second location:

Original location:
- Owner occupied, but…
- At advice of accountant, dealer leases to herself at $300,000/year (7.5%)

New location:
- Bid out to developers as a build-to-suit
- Winning bidder figures the cost at $4,000,000 and accepts a lease at $300,000/year (7.5%)
Mortgage Underwriting Dilemma:

Suppose the dealer decides to open a second location:

Original location:

- Owner occupied, but...
- At advice of accountant, dealer leases to herself at $300,000/year (7.5%)

What is the H&B use of the original location?

- Generic auto dealership (second-generation)
- Porsche dealership (first-generation)
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Suppose the dealer decides to open a second location:

Original location:
• Owner occupied, but…
• At advice of accountant, dealer leases to herself at $300,000/year (7.5%)

What is market rent for the original location?
• $300,000 (what the owner pays herself, based on cost)
• $240,000 (7.5% of $3,200,000)
Mortgage Underwriting Dilemma:

Suppose the dealer decides to open a second location:

New location:

• Bid out to developers as a build-to-suit

• Winning bidder figures the cost at $4,000,000 and accepts a lease at $300,000/year (7.5%)

What is market rent for the new location?

• $300,000 (actual, arms-length, build-to-suit lease)

• $240,000
Mortgage Underwriting Dilemma:

Consider this scenario…

Original location:

- Because the lease is not arms-length, the property is valued at $3,200,000, and the maximum loan is $2,240,000 (70%).

New location:

- Because the lease is arms-length, the property is valued as a leased fee @ $4,000,000 and the loan is $2,800,000 (70%).

If the dealer fails and both properties are foreclosed, is the bank any better off with the second property than with the first?
Ad Valorem Tax Dilemma:

Assessor’s Appraiser:
- Highest and best use is a Porsche dealership
- Because the building is perfectly suited to the tenant and justified by sales (demand); no obsolescence
- Market value is $4,000,000

Property Owner’s Appraiser:
- Highest and best use is a dealership (or some alternative use); potential buyers are second-generation tenants
- Based on sales of second-generation dealerships, market value is $3,200,000
Ad Valorem Tax Dilemma:

Assessor’s Argument:

• Second-generation value violates the principle of highest and best use
“When a big-box chain abandons a store, its actions indicate there may no longer be market support for that use at that location. Dark stores are typically closed because they were poorly located, had functional issues, or were part of a company bankruptcy or downsizing. Abandoned big-box stores are often occupied by furniture stores, churches, indoor flea markets, or similar second-tier uses. Dark store sales usually involve what is commonly called second-generation space. This describes a building whose original tenant has departed and has been replaced with a new user, and often there is a new use for the property. This situation is not exclusive to bigbox stores. When unsuccessful grocery stores, drugstores, even corporate headquarters go dark, they are often sold at a fraction of their original cost and converted to a different use. Usually the use of the property changes because the property is no longer suitable for its original purpose.”

Tim Wilmath and Pat Alesandrini, CAE. “Thinking Outside the Big Box.” Fair & Equitable, November 2015.
Property Owner’s Counter-Argument:

• Highest and best use must consider the most likely buyer. There are no first-generation buyers for a property with unique features, and *market value* is based on a hypothetical sale.

Assessor’s Counter-Counter-Argument:

• The hypothetical sale is hypothetical, so why should the existing tenant be counted out? If the property was available for purchase, the existing tenant would be first in line to buy.
Ad Valorem Tax Dilemma:

Assessor’s Argument:
• A sale requires a meeting of the minds. If the buyer just spent $4,000,000 and it perfectly suits their needs, they would never sell it for less.

Property Owner’s Counter-Argument:
• Market value assumes the seller is typically motivated to sell. To find a buyer, they would have to drop the price to what buyers are willing to pay.
Ad Valorem Tax Dilemma:

Assessor’s Argument:

• Second-generation sales and leases reflect functional obsolescence that does not exist in first-generation properties.

• A leased fee at market rent is equal to fee simple value, so the best indication of fee simple market value is sales of first-generation leased fees.

Property Owner’s Counter-Argument:

• Leased fee interests are different property rights and cannot be compared. The only valid comparable is a vacant building.
Ad Valorem Tax Dilemma:

Review of articles and cases...

- Both sides believe the courts are generally on their side, but both acknowledge substantial inconsistency.
Eminent Domain Dilemma:

In the a condemnation, the property owner switches sides, and now argues fee simple market value is $4,000,000

- An appraisal for a property tax appeal could haunt them
“Fair market value, as the standard measure of just compensation, is often simply not just. Value in use, rather than value in exchange, may offer a more defensible standard to determine just compensation for special-use properties.”

Murphy, John C., JD, and Emily L. Madueno, JD. "Square Pegs, Round Holes, Easy Targets: Valuing Special-Use Property in Eminent Domain." The Appraisal Journal, Summer 2010
Both statutes and case law sometimes allow alternate valuation for special-use property, including income capitalization or replacement cost techniques, but…

…what is a special-use property???
Eminent Domain Dilemma

Special-purpose property – “A property with a unique physical design, special construction materials, or a layout that particularly adapts its utility to the use for which it was built.”

Special purpose property… must have:

1) Physical features peculiar to its specific use
2) No apparent market other than the current owner-user
3) No feasible economic alternative use


“…a uniform method of measuring compensation in the taking of special-use properties has never been developed, thus the potential for widely divergent value testimony is great.”

Intent of this presentation:

• Recommend a refinement to our understanding of value in use
• Suggest that a proper understanding of value in use is key to clearing up the disagreements
• Start a discussion about the term *market value in use*
Value in Use

Then:

Value in Use -vs- Value in Exchange

Now:

Use Value -vs- Market Value
Value in Use

Common Perception:
“What a thing is worth to a particular person or entity”

Use value of my pool:
$40,000 (what I paid for it)

Market value of my pool:
$4,000 (what it adds to the value of my home)
Common Usage:

Convenient way to explain an atypically high comparable sale price
Review of texts, articles and an internet search reveal four generally accepted concepts of *value in use*:

1. The value the real estate [or any other asset] 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.

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

4. The value a specific property has to a specific person or specific firm as opposed to the value to persons or the market in general.
Four Definitions of Value in Use

1. The value the real estate [or any other asset] contributes to the enterprise of which it is a part.

Example:

<table>
<thead>
<tr>
<th>Description</th>
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</tr>
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<tbody>
<tr>
<td>Value of a widget manufacturer (going concern) including the plant</td>
<td>$12,000,000</td>
</tr>
<tr>
<td>Value of the business with the plant excluded</td>
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</tr>
<tr>
<td>Value in use (contribution) of the plant</td>
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</tr>
</tbody>
</table>

The Appraisal of Real Estate. 14th ed. Chicago, IL: The Appraisal Institute, 2013. (pg 62)
Four Definitions of Value in Use

1. *The value the property contributes to the enterprise of which it is a part.*

Note: *Value in use* by this definition…

- Is not subjective
- Is not from the perspective of the current owner
- It is the amount the asset would actually bring in a sale of the going concern

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Four Definitions of Value in Use

1. *The value the property contributes to the enterprise of which it is a part.*

Note: *Value in use* by this definition…

- Is no more than replacement cost minus depreciation (because an informed buyer would not pay more than they would expect to pay for a substitute)

- Is at least equal to value in exchange, because the buyer of the enterprise could elect to sell it

**Example:**

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**Four Definitions of Value in Use**

1. *The value the property contributes to the enterprise of which it is a part.*

   Note: By this definition…

   • If the hypothetical sale of the going concern meets all the tests of market value (typically-motivated and knowledgeable buyer and seller, reasonable exposure, etc.) it would be reasonable to label the $5,000,000 contribution as *market value in use.*

**Example:**

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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.

Example:

<table>
<thead>
<tr>
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<tr>
<td>Cash Flow 1</td>
<td>$xxx,xxx</td>
</tr>
<tr>
<td>Cash Flow 2</td>
<td>$xxx,xxx</td>
</tr>
<tr>
<td>Cash Flow 3</td>
<td>$xxx,xxx</td>
</tr>
<tr>
<td>...Cash Flow n</td>
<td>$xxx,xxx</td>
</tr>
<tr>
<td>Disposal (Reversion) period n</td>
<td>$x,xxx,xxx</td>
</tr>
<tr>
<td>Present Value (Value in Use)</td>
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</tr>
</tbody>
</table>

IFRS 5, Appendix A
Four Definitions of 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.

Note: This definition...

• Is the one used in accounting and finance

• Does not conflict with the first definition (if the proper discount rate is selected)

Example:

<table>
<thead>
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<tbody>
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*For real property, the periodic cash flows are rent the enterprise saves by owning the asset
3. 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.

The Dictionary of Real Estate Appraisal. 6th ed. Chicago, IL: The Appraisal Institute, 2015. (pg 245)
3. 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.

**Notes:**

- This definition contradicts the first two
- If highest and best use is the use that maximizes value, value in use by this definition can only be equal or less than value in exchange
Four Definitions of Value in Use

4. The value a specific property has to a specific person or specific firm as opposed to the value to persons or the market in general.

Four Definitions of Value in Use

4. The value a specific property has to a specific person or specific firm as opposed to the value to persons or the market in general.

Note: This definition…

• Is outdated

• Is the one best remembered by appraisers, but

• Is the least meaningful
Four Definitions of Value in Use

4. The value a specific property has to a specific person or specific firm as opposed to the value to persons or the market in general.

Value to a specific firm overlaps the definition of investment value:

**Investment value** - *The value of a property to a particular investor or class of investors based on the investor’s specific requirements.*
Four Definitions of Value in Use

4. The value a specific property has to a specific person or specific firm as opposed to the value to persons or the market in general.

Value to a specific person is entirely subjective… like my pool.
## Four Definitions of Value in Use

<table>
<thead>
<tr>
<th>Dictionary of RE Appraisal, 6th Ed:</th>
<th>The Appraisal of RE, 14th Ed:</th>
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<tbody>
<tr>
<td><strong>Value in Use</strong> – The value of a property assuming a specific use, which may or may not be the property’s highest and best use on the effective date of the appraisal.</td>
<td><strong>Use Value</strong> – In real estate appraisal, the value a specific property has for a specific use; may be the highest and best use of the property or some other use specified as a condition of the appraisal.</td>
</tr>
<tr>
<td><strong>Use Value</strong> – The value of a property assuming a specific use, which may or may not be the property’s highest and best use on the effective date of the appraisal.</td>
<td>Mixes in the concept of value contribution to an enterprise, but never directly addresses the contradiction.</td>
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Four Definitions of Value in Use

Dictionary of RE Appraisal, 6th Ed:

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 on the effective date of the appraisal.

Use Value – The value of a property assuming a specific use, which may or may not be the property’s highest and best use on the effective date of the appraisal.

The Appraisal of RE, 14th Ed:

…makes the point that confusion can arise because appraisers often use the terms value in use and use value synonymously, whereas the International Financial Reporting Standards define value in use as “the discounted present value of estimated future cash flows…” (the second value concept above)
Recommendations:

**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.

**Use Value** – The value of a property assuming a specific use, which may or may not be its highest and best use. Aka Specific Use Value.

The value a specific property has to a specific person or specific firm as opposed to the value to persons or the market in general.
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:
Business is the owner/operator of a single Sonic franchised restaurant

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- 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

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

<table>
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<tr>
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<tr>
<td>Real Property</td>
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<tr>
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<td>$500,000</td>
</tr>
<tr>
<td>Intangible Property</td>
<td>$500,000</td>
</tr>
<tr>
<td>Total Market Value</td>
<td>$4,000,000</td>
</tr>
</tbody>
</table>
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>Real Property</th>
<th>$2,000,000</th>
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<tbody>
<tr>
<td>Personal Property</td>
<td>$300,000</td>
</tr>
<tr>
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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 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.
Personal Property Appraisers

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. Aka Specific Use Value.

**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.
Recommended Definitions

**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.*
Conclusions and Recommendations

• 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.
Conclusions and Recommendations

- 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.

- Market value in use cannot be less than market value in exchange because the owner of an enterprise has the option to sell it.

- 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.
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.

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.
Conclusions and Recommendations

- 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. Each of those data sets must be used with caution. 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.
Thank You