TRANSFERRED VALUE

LAW OF CONSERVATION OF COST

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Attorney
THREE MAJOR CONCEPTS IN THIS TALK...

TRANSFERRED VALUE

CONVERSION OF ASSETS

NATURE OF THE TRANSACTION
Major Presentation Points

- The market for real estate will not pay for...

1. Branding elements
2. Design elements
3. Personal preference items
4. Excess land cost
The Market Value of What?

• Some argue that e.g. build-to-suits have a market value and therefore they are real estate transactions.

• Build-to-suits have a market value but you must look at the nature of any transaction to determine what is transferring...
  – Real Estate
  – Intangible Assets
  – Financial Assets
  – Personal property
  – Personal preference items
The total cost exceeds the value of the land and building. The slope of the change in land value is greater than the slope in the change of the building value. The total value of the building and land is 50% of total cost. As long as the transferred value goes up, the building can have no real estate value, but contribute to the entities asset value.
Major Presentation Points

• The reason these buildings exist is because they are worth the cost (investment not market value).

• Cost, however, does not provide the basis for the market value of the real estate!
A property (real, personal and intangible) can have an off the shelf market value & a value minutes later for resale that is a different value.

- People pay for new.
- Most materials in buildings are off the shelf. A stud is worth $5 because all are buying them for $5.
Feasibility

• Feasibility is taught as when cost of the real estate project = the value of the project.
• This is wrong in most cases!
• Escargot example...
Feasibility

- House remodel is feasible when my wife is happy
- The commercial building is feasible when the value of the enterprise is greater than the cost of all inputs
- A church is feasible when its ministry functions can be met
- The only class of real estate that feasibility is cost = market value is that real estate built for sale or lease. This represents a small fraction of buildings
TRANSFERRED VALUE

Law of Conservation of Cost
Definition of Transferred Value

- Transferred value is the difference between the total cost of a project and the value of the real estate.
  - The concept will help explain why many if not most retail and specialty properties are not worth cost the day they are built to the open market.
  - This concept is communicative & many appraisers owners and brokers know about transferred value, but to date there is no organized offering of the information.
Why build a building where the value is less than cost?

• The short answer is... because it is worth it!!!

• However, it is worth it to the owner, not the open market.
Why build a building where the value is less than cost?

• All designer/branding components or elements of a building are not worth cost to the open market.
  – McDonald’s
  – Wendy’s
  – Specialty house items such as window coverings, countertop, etc.
Appraiser’s Misunderstanding

• As appraisers, we often believe & are taught that spending money on a building that is worth less than market value is a poor decision.

• There are numerous examples, including those that are economic, that cost is not equal to market value, yet the construction of the building is a feasible and good decision.
### Why remodel?

From 2017 NAR Cost v. Value Report

<table>
<thead>
<tr>
<th>Remodeling Project</th>
<th>NARI Cost Median</th>
<th>NAR Value Median</th>
<th>NAR Percent of Cost Median (C/B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Roofing</td>
<td>$7,500</td>
<td>$8,150</td>
<td>109%</td>
</tr>
<tr>
<td>Hardwood Flooring Refinish</td>
<td>$3,000</td>
<td>$3,000</td>
<td>100%</td>
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<tr>
<td>Insulation Upgrade</td>
<td>$2,100</td>
<td>$1,600</td>
<td>76%</td>
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<tr>
<td>New Wood Flooring</td>
<td>$5,500</td>
<td>$5,000</td>
<td>91%</td>
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<tr>
<td>New Garage Door</td>
<td>$2,300</td>
<td>$2,000</td>
<td>87%</td>
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<td>New Vinyl Siding</td>
<td>$13,350</td>
<td>$10,000</td>
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<td>New Vinyl Windows</td>
<td>$18,975</td>
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<td>New Fiber Cement Siding</td>
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<td>$15,000</td>
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<tr>
<td>New Steel Front Door</td>
<td>$2,000</td>
<td>$1,500</td>
<td>75%</td>
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<tr>
<td>HVAC Replacement</td>
<td>$7,475</td>
<td>$5,000</td>
<td>67%</td>
</tr>
<tr>
<td>Basement Conversion</td>
<td>$40,000</td>
<td>$25,000</td>
<td>63%</td>
</tr>
<tr>
<td>Kitchen Upgrade</td>
<td>$35,000</td>
<td>$20,000</td>
<td>57%</td>
</tr>
<tr>
<td>Complete Kitchen Renovation</td>
<td>$65,000</td>
<td>$40,000</td>
<td>62%</td>
</tr>
<tr>
<td>Attic Conversion to Living Area</td>
<td>$75,000</td>
<td>$40,000</td>
<td>53%</td>
</tr>
<tr>
<td>New Fiberglass Front Door</td>
<td>$2,700</td>
<td>$1,800</td>
<td>67%</td>
</tr>
<tr>
<td>Bathroom Renovation</td>
<td>$30,000</td>
<td>$15,000</td>
<td>50%</td>
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<tr>
<td>New Wood Windows</td>
<td>$35,000</td>
<td>$20,000</td>
<td>57%</td>
</tr>
<tr>
<td>Closet Renovation</td>
<td>$3,750</td>
<td>$2,000</td>
<td>53%</td>
</tr>
<tr>
<td>New Master Suite</td>
<td>$125,000</td>
<td>$65,000</td>
<td>52%</td>
</tr>
</tbody>
</table>
Why remodel?

• Because you like the new house feature
• Because your significant other does
• It is like a car, clothes, a bicycle, etc. – You don’t think about the market value, but it is a consumer item
Transferred Value

- When a building is built for the design of a specific user, it is unlikely that the components, design, layout, etc. will result in cost being equal to value in the open market.
Categories of Transferred Value

- To a person or people
- Within a property
- To another property
- As an intangible asset
- To the community
- To an organization
- Within a system
Examples of improvements where cost is not equal to market value

- McDonald’s
- Wendy’s
- Burger King
- Lowe’ Home Improvement
- Home Depot
- Custom Homes
- Industrial properties designed for a specific user
- Dollar stores
- Arenas
- Bus terminals
- Parking garages
- Amenities in a subdivision
- Golf courses
• Understanding why cost does not equal to the market value of real estate is important to understand (1) motivations of those who own and build buildings that are worth less than cost to the open market, and (2) to avoid over-valuing property.
Some Ramifications of the Transferred Value Concept

- In general, residential real estate is worth a greater percentage of cost than commercial properties.
- Therefore, taxation often looks unfair in that residential properties are taxed more as a percentage of cost than non-residential properties.
Some Ramifications of the Transferred Value Concept

• The greater the adaptability of the building to a different use or user, the less the transferred value & the greater the % of value to cost.
Some Ramifications of the Transferred Value Concept

• Rightly understanding transferred value decreases risk in lending.

• A lender should understand that an appraisal of a property with transferred value means the loan-to-value ratio will be higher than the loan-to-cost ratio.

• However, the transaction to a lender often includes real property and intangible property components! These are often booked as 100% real estate loans.
Some Ramifications of the Transferred Value Concept

• Understanding transferred value assists in knowing who to get money from if the transferred value is to the community.
Confusion..

There are at least two Highest & Best Use Scenarios on Branded Buildings!

Feasibility is based upon Investment Value, Not Market Value!

• Highest & Best Use to McDonalds...
  – Is the construction physically possible?
  – Is it legally permissible?
  – Is it financially feasible, that is, does it contribute what it should to the enterprise?
  – If the answer is yes to all 3, then McDonald’s will build and this is based upon INVESTMENT VALUE, not the MARKET VALUE OF THE REAL ESTATE!!!

• Highest & Best Use of the McDonalds building, to the market...
  – What is physical possible? [Note: the market will not pay for design and branding elements of the building]
  – Is the proposed use legally permissible?
  – Is the proposed use financially feasible? [This will be answered after deducting from cost branding & design elements specific to McDonalds.]
  – The HBU is based upon market demands! This value is based upon either adapting the McDonalds building or razing the structure.
There are at least two Highest & Best Use Scenarios on Residences!

Feasibility is based upon what the owner(s) want & Not Market Value!

• Highest & Best Use to family...
  – Want a swimming pool
  – Want expensive counter tops
  – Want alternative power – solar, wind
  – Want expensive flooring
  – Want expensive window coverings
  – Want 8,000 SF with one bedroom

• Highest & Best Use of a house, to the market...
  – No swimming pool
  – Standard countertops
  – No alternative power system
  – Typical flooring
  – Typical window coverings
  – 2,400 SF with 4 bedrooms, 2 baths
“Good” & “Bad” Functional Obsolescence

• **Good Functional Obsolescence** is when the portion of cost that exceeds the value of the building transfers to e.g. the intangible value or assets of a firm
  – McDonald’s, Wendy’s, Lifetime Fitness, etc.

• **Bad Functional Obsolescence** is when the portion of cost that exceeds the value of the building does not transfer
  – A building built for rental purposes that is over or under-improved
You cannot use...

• **Build-to-suit leases** as evidence of market rent for real estate
  – Total cost is included, even branding elements
  – ROR is specific to the transaction
  – Terms of the lease are specific to the transaction
  – The arrangement includes real property & intangible values

• **Lease renegotiations** as evidence of market rent
Revenue & Nonrevenue Nodes

• **Revenue** nodes are real estate properties that generate rents or revenues

• **Nonrevenue** nodes are properties that do not in and of themselves generate rents or revenues
Good & Bad

Functional Obsolescence

- Functional obsolescence that does not transfer is lost and is “bad.”
- Functional obsolescence that transfers is not lost and is “good.”
Examples of Transferred Value...

- **Person**
  - Clothes & cars
  - Swimming Pools
  - Upgrades in Houses & Commercial Property
  - Exact Design of special purpose properties for Company Image
Swimming Pool Example...

• Example 1: Build a pool for $60,000, believe it will enhance a home by $60,000, but the Pool is worth $20,000 [“Bad” Functional obsolescence]

• Example 2: Build a pool for $60,000, Don’t know what it is worth, but the wife & kids are really happy, & You don’t care the pool is worth $20,000 [TV to a person & “good” Functional Obsolescence]

• Example 3: Build a Pool worth $60,000, that is worth $20,000 because Cardiologist says to “swim or die.” Live 20 extra years billing $400/hour for 20 hours/week for the 20 years, or $8,000,000 more. [“Good Functional Obsolescence with TV to a person.”]
Transferred Value
Law of Conservation of Cost

• Examples of Transferred Value...

– To another property

• A golf course that is worth $3M that costs $10M. Lots around the course sell for a PV of $8M more.

• Amenities in a subdivision

• A special purpose property e.g. an arena that cost $25M, and is worth $5M from ticket sales but the immediate area restaurants and land prices go up by $20M in value. (This will come up later in the Community)
• Examples of Transferred Value...

- **Within a property**
  
  • A parking lot is needed to service a retail building. The parking lot does not generate rent, the cost or value is in the building.
  
  • Tenant finish that is worth zero to the next tenant in the market, but the land & main part of the building have no value without tenant finish.
  
  • Within a special purpose property, any component that does not directly generate revenue or rent transfers the cost to the overall value of the property.
  
  • Loss leaders such as restaurants, etc.
• Examples of Transferred Value...

–To Intangible Value

• Most retail buildings have cost that exceed value the day they are built.
  – McDonald’s
  – Lowe’s & Home Depot & Walmart ($45 PSF sales even with good locations) Generally it is land value + parking lot
  – Special purpose buildings such as breweries, silos, factories, Car dealerships, funeral homes, cemeteries & related structures, etc. have cost = Value of Real Property + Value to Intangible Property

• When value (Cost) is transferred to intangible value it can be realized through stock purchases.
Transferred Value
Law of Conservation of Cost

• Example: Home Depot
• Take total Equity + Debt and divide by the number of units, the value is $85.6M per Store.
• Home Depot costs $12-18M per store & generate $39M per store. This revenue must cover the non-revenue Nodes, the warehouses, distribution centers, headquarters, etc.
• When Big Box sells, the sales tend to be around $45PSF. With a land-to-building ratio of 5-7:1, this is $6.43 to $9.00 PSF of land.
• There is not a lot of difference between deed restrictions or no deed restrictions, or age, or successful locations or not
Look at These Two “Out of Business Locations”

- Gander Mountain and Academy closed these two locations around relatively the same time period...
Look at These Two “Out of Business Locations”

• Gander Mountain has a failed concept, Academy does not. The Gander closing was not because it was a bad location. This location is on HWY 6 across from a regional mall in College Station, TX. The following is the new and improved Academy located just .5 miles south of the closed location.
Transferred Value
Law of Conservation of Cost

• Examples of Transferred Value...

– To a community

• Arenas, Mass transit, roads, parks, utilities, city facilities are examples of cost >
  market value. However, there is a transfer of value to other properties, people
  & businesses because of the cost of these improvements.

• Most cost of mass transit, arenas, etc. will never be justified by ticket sales.
  (Including Dallas to Houston train)

• Example: Brick Town in Oklahoma City
Example

Growth of NHL hockey nationwide boosts apartment markets

By Daniel Goldstein

Published: Oct 16, 2016 9:45 p.m. ET

Why a hockey stadium in your neighborhood means higher rent

Getty Images

Fans line up outside of Nationwide Arena before the opening night game between the Columbus Blue Jackets and the New York Rangers on October 9, 2015 in Columbus, Ohio.
If you live near these major-league ballparks, your home is worth more

By Daniel Goldstein
Published: Mar 30, 2016 4:43 p.m. ET

Live close enough to smell the peanuts and Cracker Jack, and your home valuation might improve.
Transferred Value
Law of Conservation of Cost

Examples of Transferred Value...

To an Organization

- A corporate headquarters may be worth 50 cents on the dollar the day it is built but economically be fully justified...

- Image
- Occupancy savings (J.C. Penney)
- Employee savings

- The particular design of a McDonald’s, Harley Davidson Motorcycle building, car dealership, Wendy’s, Burger King, Popeye’s chicken, Etc. may bring branding and a certain image to an organization and the cost can be translated to a higher stock value

- Churches, American legion lodges, etc. are examples of special purpose properties that have transferred value to organizations
• Examples of Transferred Value...

–To a system

– Assume the following system...

• Gas processing wells produce natural gas.
• At the well head, CO2 & water is knocked out by treatment
• The gas is sent down a pipeline to a processing plant that takes out sulfur and other impurities & separates natural Gas to Liquids.
• The Liquids are sent down another pipeline to another processing plant that separates the liquid product into the "anes" such as butane & propane, etc.

– What is the value of the first processing plant to the system? What is the market value of that plant to any other mid-stream company?
• It depends on closest pipelines and capacity of the other market participants.
What is the market value of one of the pieces standing alone?
Feasibility & TV

We need to rethink feasibility. Transferred value must be brought into the equation. Especially for special purpose properties...

Assume all 3 building costs give exactly the same functional utility as far as the real estate is concerned. An entity would choose 3 even though the cost is greater. Our current models would show choice 1. There is functional obsolescence in choice 3 by the difference in cost.

Choice 1: Least cost for same size. Least transferred value
Choice 2: More cost for same size. More transferred value
Choice 3: Highest cost for same size & utility but greatest TV
Feasibility Analysis Including Considering Transferred Value

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of Land</td>
<td>$700,000</td>
</tr>
<tr>
<td>Direct Costs</td>
<td>$1,280,000</td>
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<tr>
<td>Indirect Costs</td>
<td>$120,000</td>
</tr>
<tr>
<td>Entrepreneurial Incentive</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total Cost</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>Total Cost With Land</td>
<td>$2,200,000</td>
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<td>Physical Depreciation</td>
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<tr>
<td>Functional Obsolescence</td>
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<td>External Obsolescence</td>
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<td>Total Depreciation &amp; Obsolescence</td>
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<tr>
<td>Value of Building</td>
<td>$600,000</td>
</tr>
<tr>
<td>Total Value of Real Estate</td>
<td>$1,300,000</td>
</tr>
</tbody>
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**Transferred Value:**

- To a Person
- Within the property
- To another property
- To intangibles
- To the community
- To a system
- To an organization

**Total Transferred Value:**

- $900,000

**Total Value With TV:**

- $2,200,000

The $50,000 is from tax credits and subsidies to attract the business. The $850,000 is transferred to the intangible value/assets. This property is worth $1,300,000 if sold in the open market but is feasible because of the amount of transferred value.
The total cost exceeds the value of the land and building. The slope of the change in land value is greater than the slope in the change of the building value. The total value of the building and land is 50% of total cost. As long as the transferred value goes up, the building can have no real estate value, but contribute to the entities asset value.
Special Purpose, Transferred Value & Economic life

• The two biggest determinants of economic life are..
  – 1. Slope of the change in land value
  – 2. Value of the building in time zero
The total cost exceeds the value of the land and Building. The slope of the change in land value is greater than the slope in the change of the building value. The value of the building to the market is $0 in time zero. However, there is enough transferred value to make it feasible. Furthermore, as long as the transferred value exceeds land value, the use will continue. The building can be a negative value (demolition cost).
Example of a Big Box when transferred value goes away... It is time to refit or demolish the building.

What happened to the transferred value of Toys-R-Us?
Transferred Value & Land Value

• The highest & best use of land is the use that will provide the greatest price!
• The highest & best use is one that a purchaser will have the most transferred value!
• Some land purchases have intangible value in the Price
  – Walgreens, CVS sales
  – A church was purchased for $10M Hoping for a zoning & Deed Restriction change
CONVERSION OF ASSETS
Except for land, all inputs in the cost approach are either personal property or intangible assets. When built, those assets convert to real property.
Cost Approach Revisited

• RCN
• Less: Depreciation
• Plus: Site Value
• Equals: Indicated Value by the Cost Approach
Cost Approach

Inputs – All Physical Components Were Personal Property

• The entirety of any of the physical parts of a building were once personal property

• What makes up the components of a building were on a yard, in a store, in a warehouse, etc. and were brought in to the site and became a part of the land (or real property)

  – Foundation: Sand, limestone, rebar, etc.
  – Walls: Studs, Nails, Sheetrock, Texture, Paint
  – Floors: Tile, carpet, etc.
  – Ceilings
  – Roofs
Cost Approach Inputs

• All contracts are intangible property
  – Contract of sale
  – Listing agreement
  – General contractor’s contract(s)
  – Sub-contractor’s contracts
  – Architect
  – Structural Engineer
  – Mechanical & Electrical Engineer
  – Contract to agree to pay developer
  – ETC

• The intangible property becomes real property, that is, it is converted to be real property!
Conversion of Non-Realty Assets to Real Property

- Purchase land for cash (Intangible asset) & receive the land (real property asset).
- Put in direct costs (this is personal property and intangible assets)
- Put in indirect costs (intangible assets)
- Profit (intangible asset)
Conversion of Assets to Real Property & Value of the Assets

- All assets in the cost are 100% converted to real property.
- This does not say what the value of the asset is --- only that what was once personal property and intangible is now real property!!!
Real Property (Summary) – Conversion of intangible & personal property to real property

• Intangible property (money) is exchanged for land
• Intangible property and personal property are converted to real property

➢ All components of a building were once...

✓ Intangible assets – contracts, design, entrepreneurial incentive etc. (this is included in direct costs)

✓ Personal property – all physical components of all buildings were once personal property. They were on a truck, yard, warehouse, etc. and brought to the site.
Real Property – Conversion of intangible & personal property to real property

• Feasibility is based more on investment value and less on market value on many building types, even houses.

• Tax depreciation is based upon cost and not value.
Real Property – Conversion of intangible & personal property to real property

• Lease-up costs also convert to real property...

  – Entrepreneurial incentive – Marketing phase

<table>
<thead>
<tr>
<th>Entitlements</th>
<th>Construction</th>
<th>Marketing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketing costs</td>
<td>Legal to draw up contract</td>
<td>Leasing commissions</td>
</tr>
</tbody>
</table>
Real Property – Conversion of intangible & personal property to real property

• Big Box, Owner-occupied buildings and houses do not have a conversion of lease-up costs to real estate... (& occupancy is not a highest & best use!)

– Entrepreneurial incentive – No Marketing phase

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</thead>
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Real Property – Conversion of intangible & personal property to real property

• Although costs to lease-up convert to real property, the lease IS NOT REAL PROPERTY, it is a contract!

• All of the lease payment $$$ is a financial asset, not just excess rent.
An intangible asset is a non-physical asset having a useful life greater than one year. These assets are generally recognized as part of an acquisition, where the acquirer is allowed to assign some portion of the purchase price to acquired intangible assets. Few internally-generated intangible assets can be recognized on an entity's balance sheet. Examples of intangible assets are:

- Marketing-related intangible assets
  - Trademarks
  - Newspaper mastheads
  - Internet domain names
  - Noncompetition agreements
- Customer-related intangible assets
  - Customer lists
  - Order backlog
  - Customer relationships
- Artistic-related intangible assets
  - Performance events
  - Literary works
- Musical works
- Pictures
- Motion pictures and television programs
- Contract-based intangible assets
- Licensing agreements
- Service contracts
- Lease agreements
- Franchise agreements
- Broadcast rights
- Employment contracts
- Use rights (such as drilling rights or water rights)
- Technology-based intangible assets
- Patented technology
- Computer software
- Trade secrets (such as secret formulas and recipes)
What can be leased in addition to real estate?

- **Personal property** - It is common to lease automobiles. The automobile is the subject of the right to use and is also security for the lease. *The lease does not become an automobile anymore than a lease on real property becomes the real property!*

- **Intangible property** – Software is often leased with a license agreement. *The lease does not become the software anymore than a lease on real property becomes the real property!*

- If the contract is breached, the lessor can take back the automobile, and if that does not cover the loss, then sue on the lease. If the lessor prevails, there is a judgment for the difference. The rights on the judgment can be sold to another as an intangible right.
NATURE OF THE TRANSACTION

Although there is a complete conversion of personal property & intangibles to real property, a transaction is often a mix of types of property.
Anatomy of a Build-to-Suit

- Sometimes an investor buys real estate that comes with leases.
  - Apartments
  - Strip Centers
  - General office

- Sometimes the investor buys a lease that comes with real estate.
  - Corporate headquarters
  - Dollar store
  - Specialized retail such as Starbucks, McDonald’s etc.
• When an investor buys a build-to-suit transaction, the purchase price is based upon…

– The value of the real estate

– The branding or design elements that have value to the tenant, but not in the open market (transferred value)

– The right to sue on the lease if the tenant defaults
Highest & Best Use

The steps are the same for investment and market value and a custom house

To a retailer...
- Physical possibility
- Legal permissibility
- Financially feasible
- Maximally productive – A certain prototype building

To a family...
- Physical possibility
- Legal permissibility
- Financially feasible
- Maximally productive – A certain prototype building

To the market (or current courses solely teach this…)
- Physical possibility
- Legal permissibility
- Financially feasible
- Maximally productive – What produces the highest value
Conclusions...

• Don’t mix the nature of the asset(s) with value of the asset(s)
• All cost converts to real property
• Some of the cost has value to real property and sometimes part of the cost transfers to an intangible value
• Don’t confuse “market value” with the property interest
• Regardless of the definition of “fee simple” one should not include intangible assets if the assignment is to appraise only real property
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