

The Future of Retail Properties in Valuation for Property Tax Purposes

Benjamin R. Sellers, MAI



SELLERS
& ASSOCIATES

VALUATION AND ADVISORY SERVICES

*Historic CRE = Cottage Industry
"Location, Location, Location"*



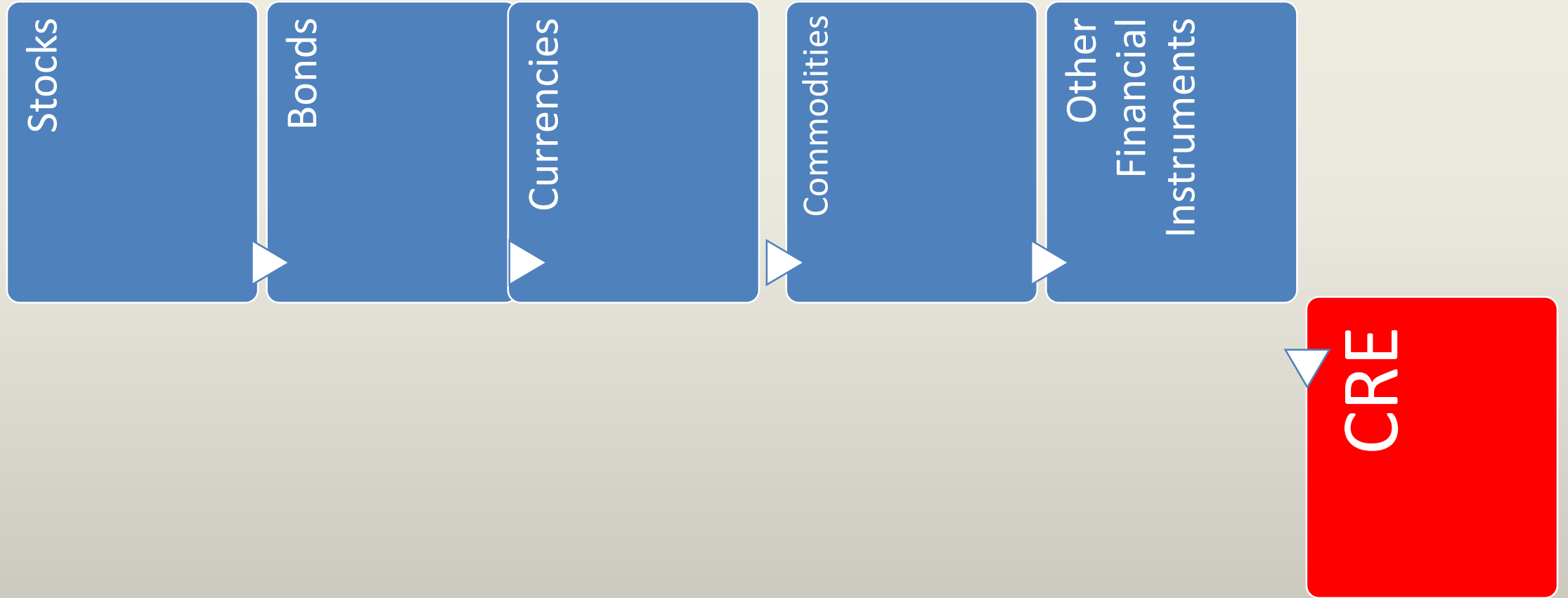
Does Location, Location, Location apply in ALL situations?



CRE Adaptation & Evolution

*Is Location, location, location dead?
“The LIN Correction changes everything”*

Institutional Investment Grade Asset Classes – Pre-1990's



The Making of an Asset Class

Wharton Real Estate Review, Roy Hilton March, Spring 2012

- *Prior to the 1990s, any significant equity investment in real estate was limited to pension funds*
- *Lending was limited to life companies, banks and thrifts*
- *Despite being nearly 30 years old, the U.S. REIT market had a capitalization of less than \$10 billion*
- *Non-traditional investors such as private equity, hedge funds and Wall Street looked to real estate for office space rather than for investment*



The Making of an Asset Class

Wharton Real Estate Review, Roy Hilton March, Spring 2012

- *From 1992 to 1997, the equity REIT market grew by a factor of 13*
- *Market capitalization increased from less than \$10 billion to nearly \$128 billion*
- *Commonly referred to as the dawn of the "modern REIT era"*
- *Today more than a quarter of the equity invested in U.S. real estate is owned by publicly traded REITs*



The Making of an Asset Class

Wharton Real Estate Review, Roy Hilton March, Spring 2012

“Today, real estate competes directly with stocks, bonds, currencies, commodities and other financial assets.”



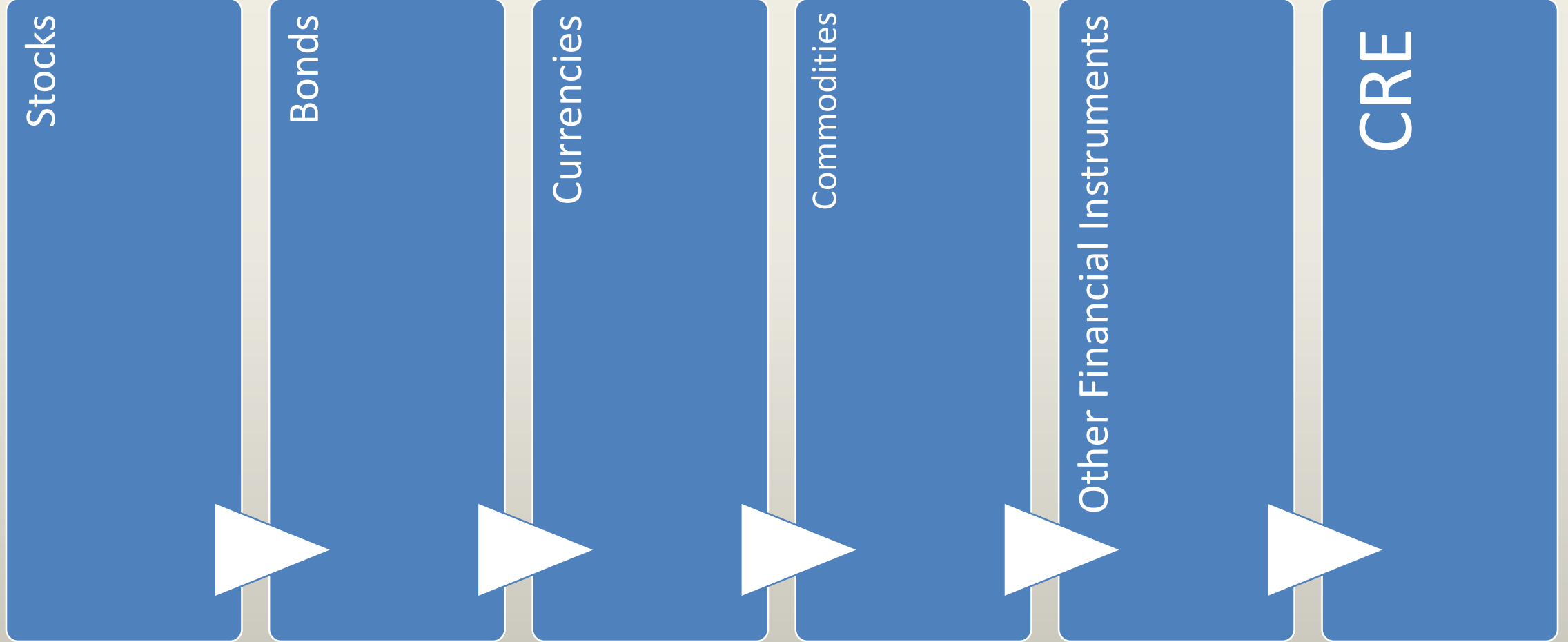
The Making of an Asset Class

Wharton Real Estate Review, Roy Hilton March, Spring 2012

“With the advent of Modern Portfolio Theory in the 1950s and its subsequent adoption by institutional investors in the 1960s to 1980s, commercial real estate went from cottage industry to bona fide asset class.”



Institutional Investment Grade Asset Classes – Today



*Meet Uncle Hank...
Institutional Investor*





- *According to JLL / RCA, the US NNN market was:*
- *In 2006: 6.6% foreign share*
- *In 2016: 20.0% foreign share*



- *According to JLL / RCA, the US NNN market was:*
- *2009: \$9.0 billion*
- *2015: \$8.8 billion . . .*
- ***IN THE FIRST QUARTER***

Property types will adapt to the market....

Restaurants



Hotels



General Retail



Drug Stores



NOT SUBJECT PROPERTY

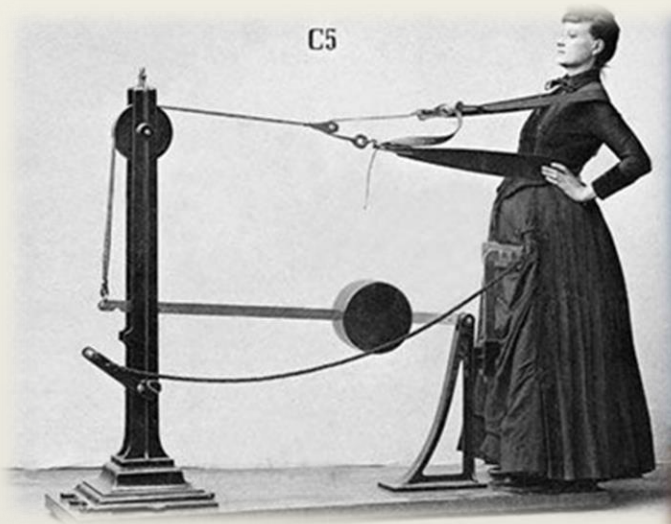
Automotive Tire Sales and Auto Repair



Banks



Fitness



*“CRE Property Types
Adapt to the
Demands of
Investment-Grade
Investors”*

In other words - Follow the money...



3-1-2016

Chapter 2 in the History of CMBS: Coming to Terms with the New Rules

Alan Kronovet

Chris van Heerden

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“By providing liquidity to otherwise illiquid debt markets, securitization links providers of capital with those in need of capital by aligning the risk appetite of investors with the appropriate risk premium paid by borrowers.”

Transform CRE to Investment Class by..

Correction of 3-CRE shortfalls for Investment Class Status: (the “LIN” correction):

- *(L) Liquidity*
- *(I) Investment grade*
- *(N) No management responsibilities*

- *Liquidity, Investment Grade, No management = (LIN)*
- *The lease provides the correction*
- *Leased fee versus fee simple*

LIN

LIN

Verb

1. To desist (from something), stop.
2. To cease; leave off.

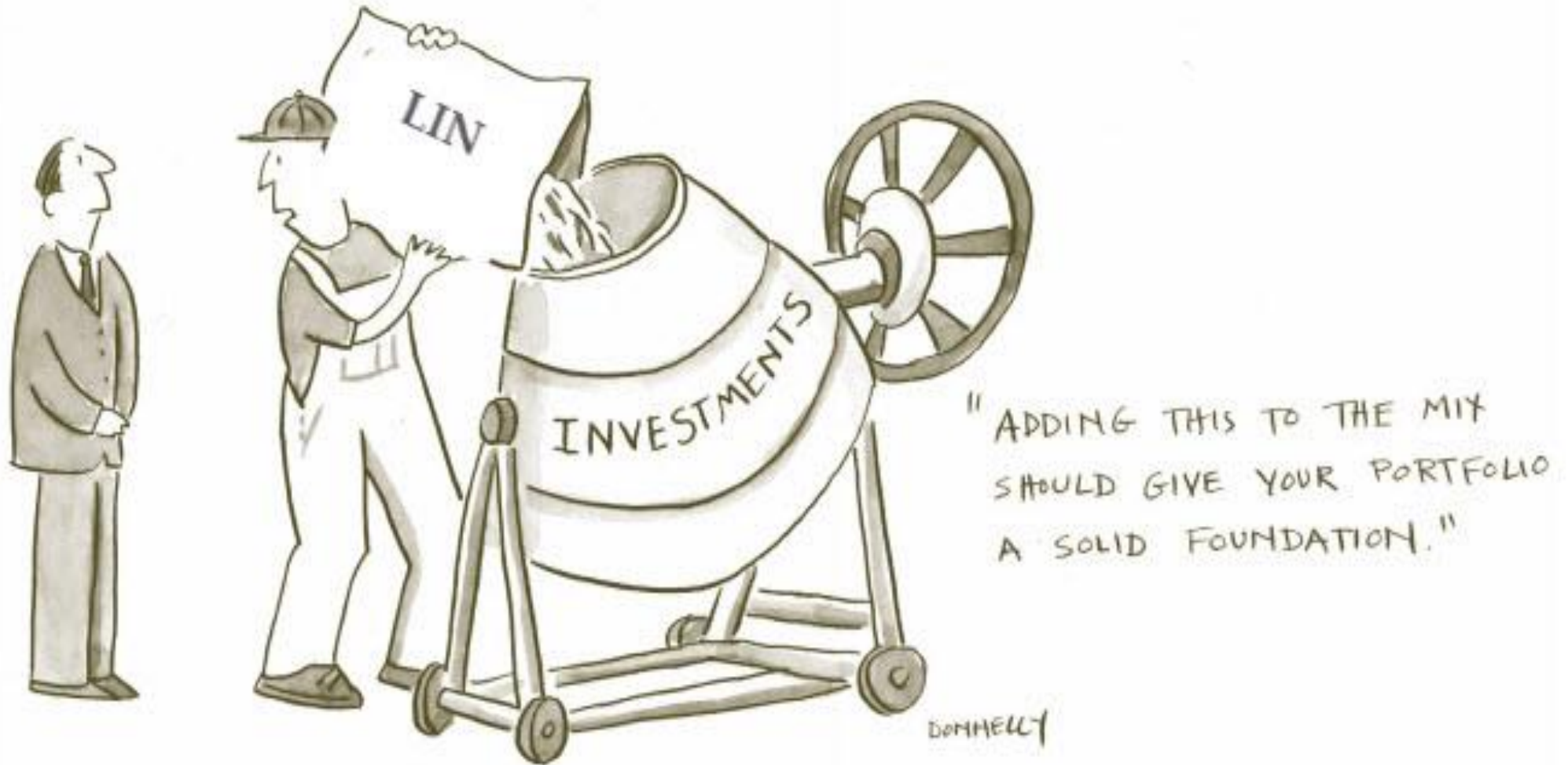
<http://www.yourdictionary.com/lin#c3H0DWIJyE00om5X.99>

Transform CRE to Investment Class by..

Correction of 3-CRE shortfalls (the “LIN” correction):

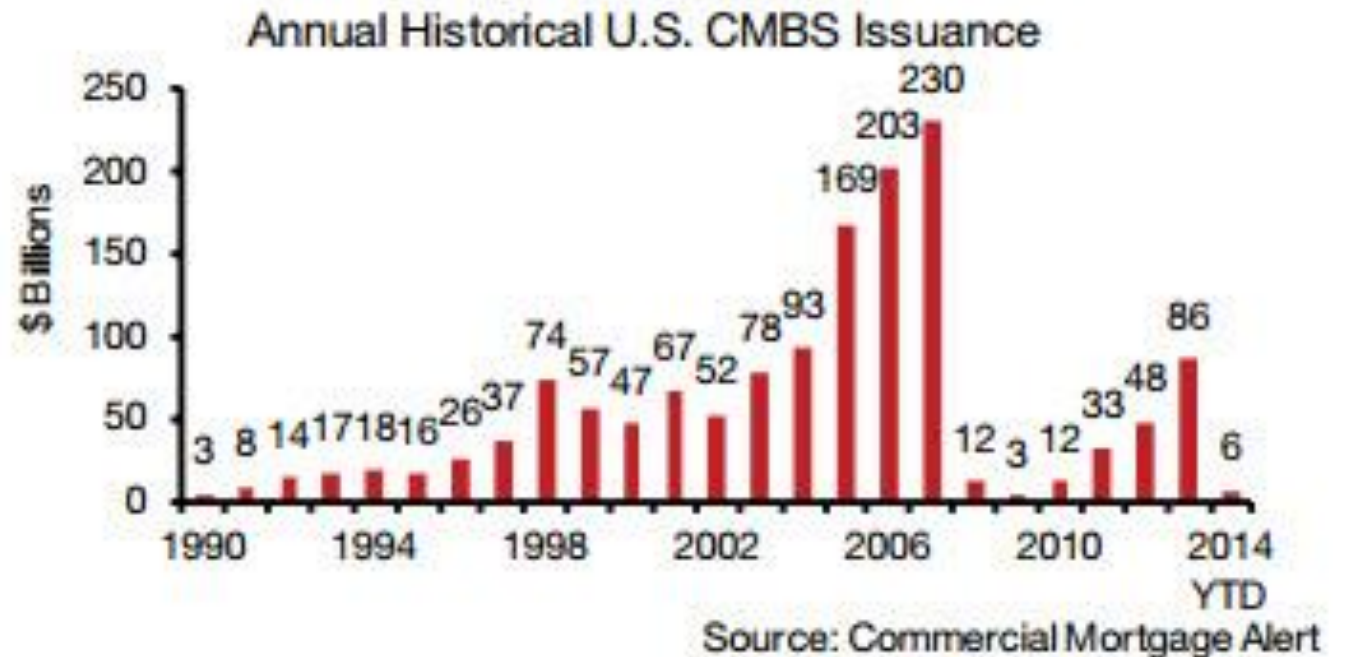
- *(L) Liquidity*
 - *Shares in securities or company (REIT or vehicle)*
- *(I) Investment grade*
 - *BBB- or better S&P rating company for tenant*
Tenant company backed guarantee
- *(N) No management responsibilities*
 - *NNN or Institutional grade management company*
- *Liquidity, Investment Grade, No management = (LIN)*

Transform CRE to Investment-Grade Asset by..



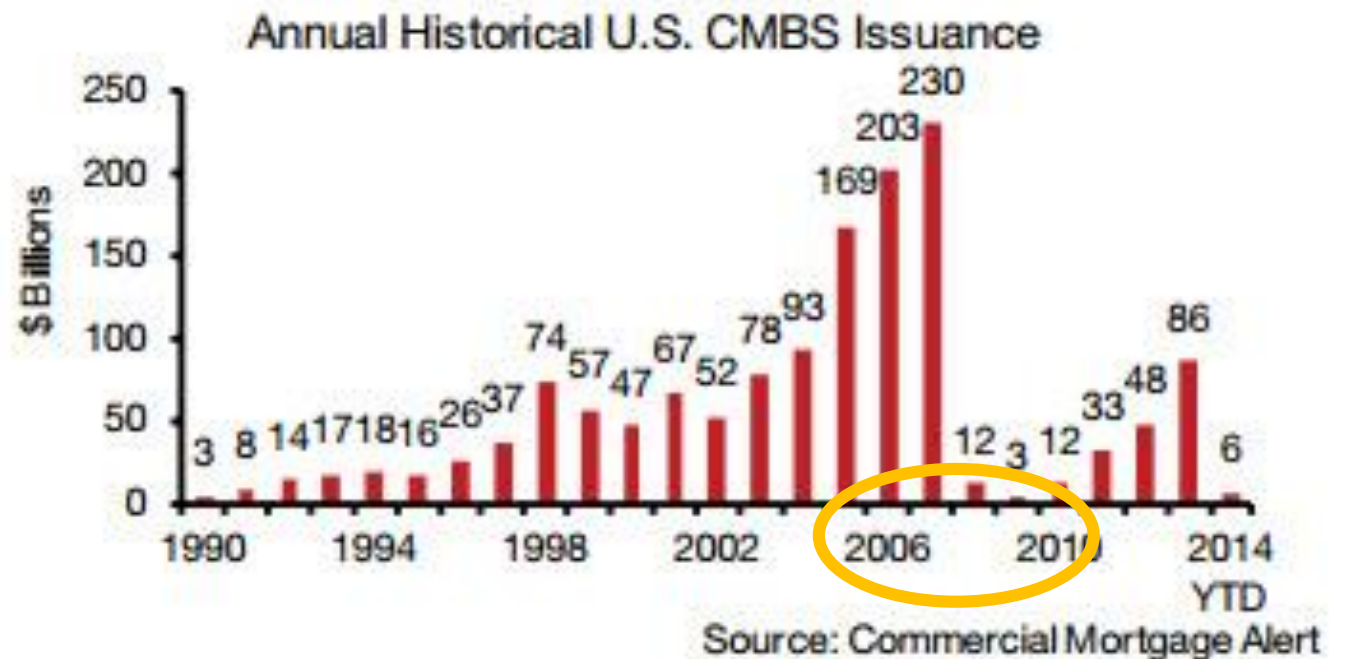
Annual Historical Commercial Mortgage Backed Securities (CMBS) Issuance

“In its opening chapter spanning roughly 25 years, commercial mortgage backed securitization (“CMBS”) has played a significant role in financing commercial real estate.”



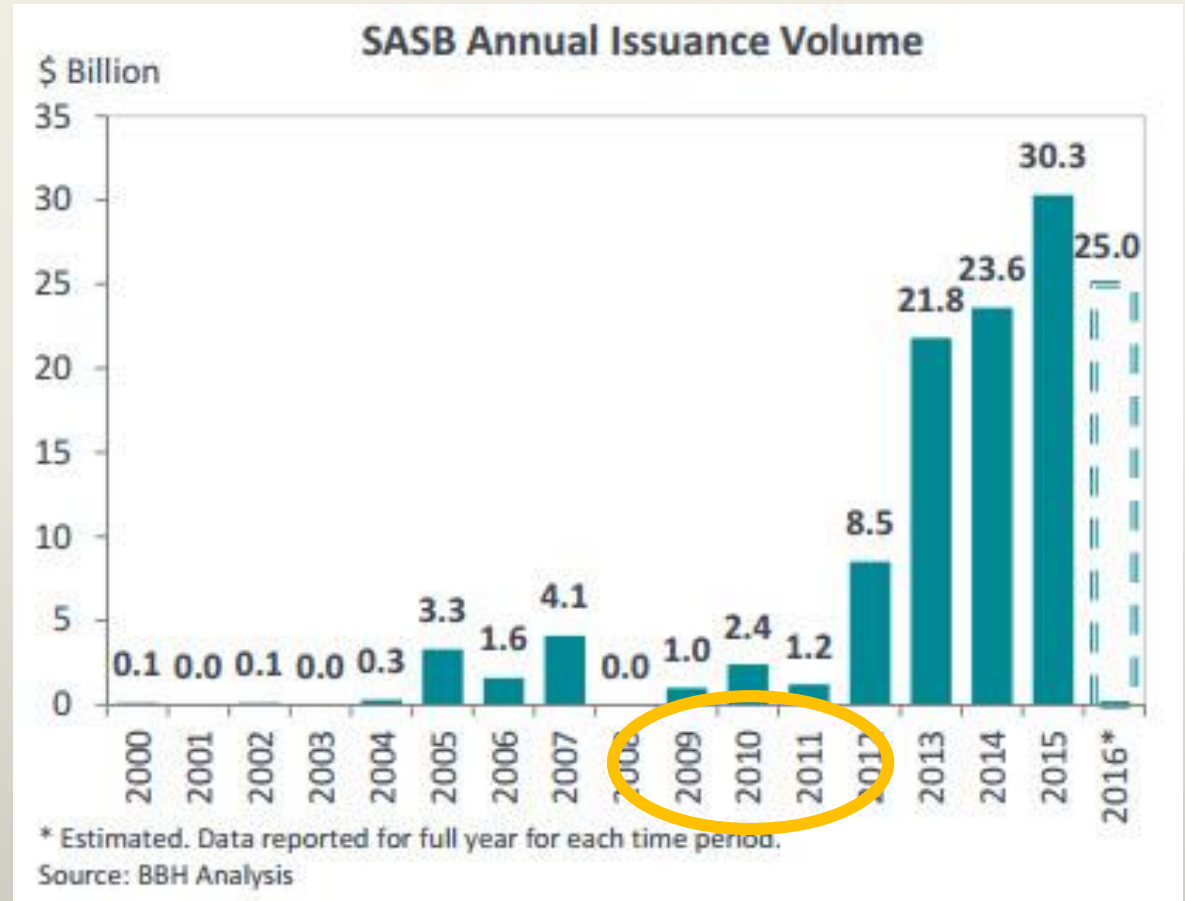
“CMBS grew from relative obscurity in the early 1990s to become the largest capital source to commercial real estate by 2007”

Annual Historical Commercial Mortgage Backed Securities (CMBS) Issuance



Annual Single-Asset Single-Borrower Issuance

“CRE Property Types Develop Over Time to Adapt to Both Use of Space and Demands of Investment-Grade Investors”



Question?

So, what does all of this history have to do with the future of retail property?

Answer:

Because what they are buying is changing...

What happens when the corrections are Uncorrected?

~~Correction of 3 CRE shortfalls:~~

- ~~• Liquidity~~
- ~~• Shares in securities~~
- ~~• Investment grade~~
- ~~• BBB or better~~
- ~~• Tenant~~
- ~~• No~~
- ~~• or Institutional grade management company~~

What's left is dirt, sticks, and bricks . . .

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**

Dollar General Garrison, KY



[View Large Photo](#)

Square Footage: 9,026
Property Type: Retail
Lease Term: 15 yrs
Lease Structure: NN
NOI: \$78,884
Cap Rate: 7.00%
Price: \$1,126,900

Additional Property Information:

- Investment Grade Credit
- 15-Year Corporate Net Lease
- Structured Rent Increases
- This is a busy Dollar General store, serving as one of the only local grocery store in the trade area.



Dollar General Conway, SC



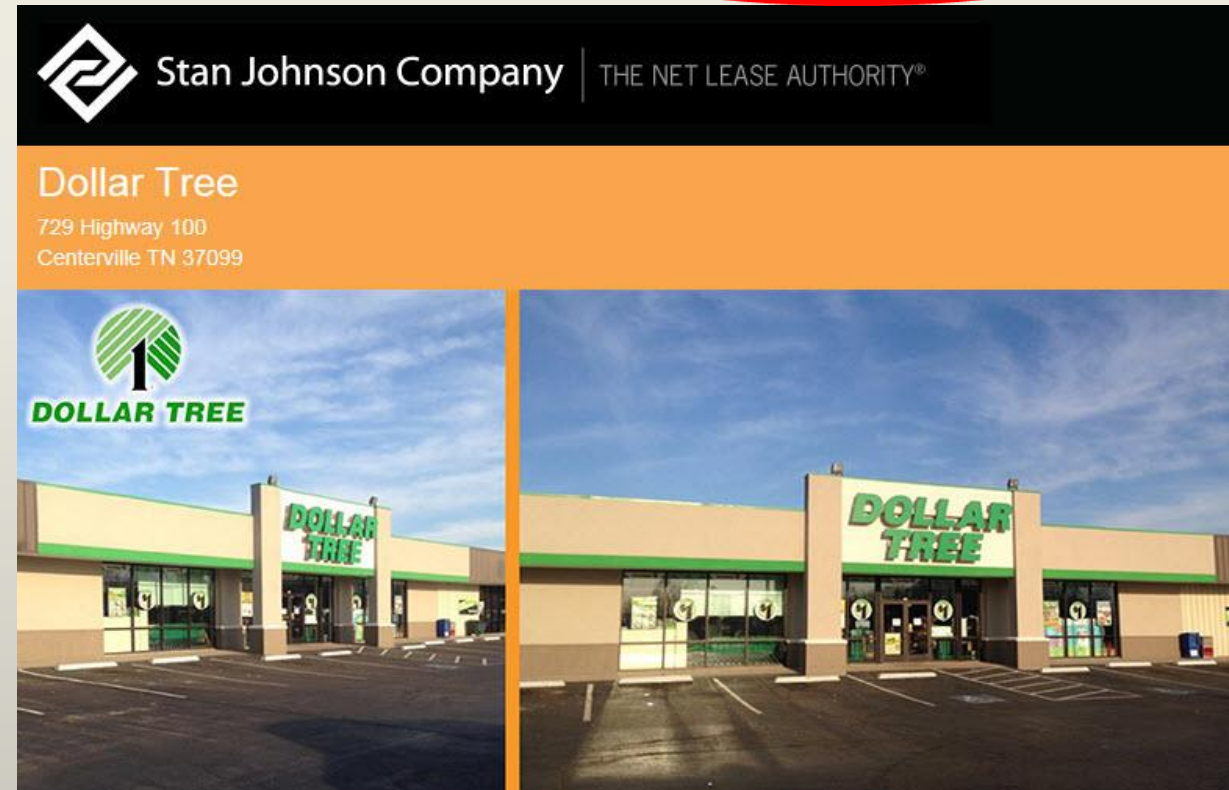
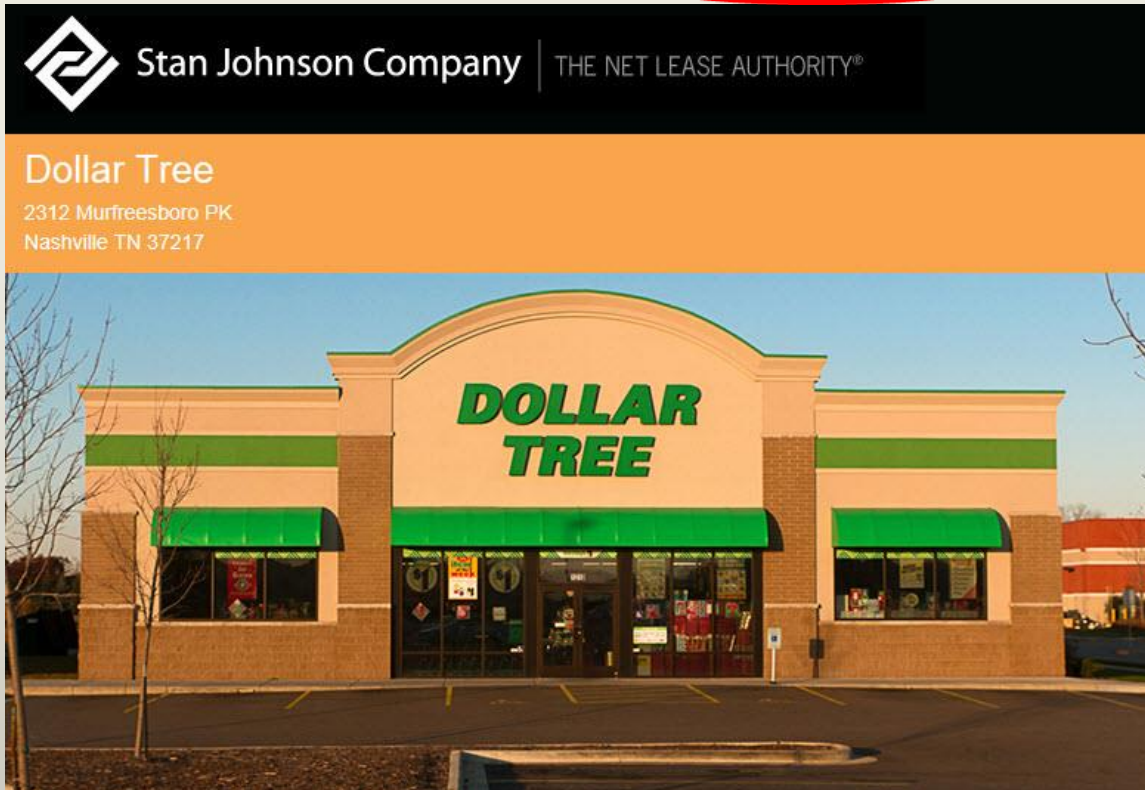
Square Footage: 9,014
Property Type: Retail
Lease Term: 9 yrs
Lease Structure: NN
NOI: \$51,914
Cap Rate: 7.70%
Price: \$675,000

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

What do Institutional Investors Purchase?

- Leases with Credit Performing Tenants
- Leases provide the corrections “LIN” needed to make it an institutional-grade asset class



CRE Market Total

Institutional CRE Market
(\$360 Billion sales – 2014
Top 100 hold \$6 Trillion)
(Source: Real Capital
Analytics)

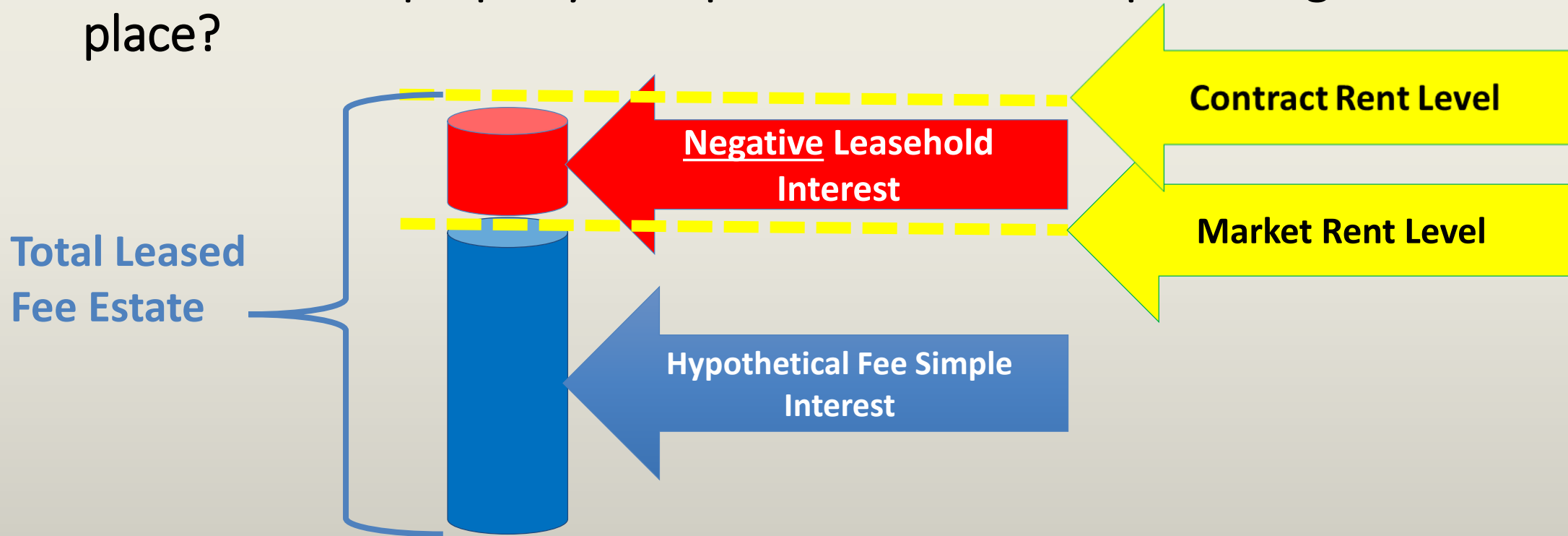
Fee Simple Value

- What can the property produce in rent as fee simple?
- What does “Available for lease” mean?
- Does Fee Simple allow for excess or deficit rents?
- If so, how does it change the value(s)?



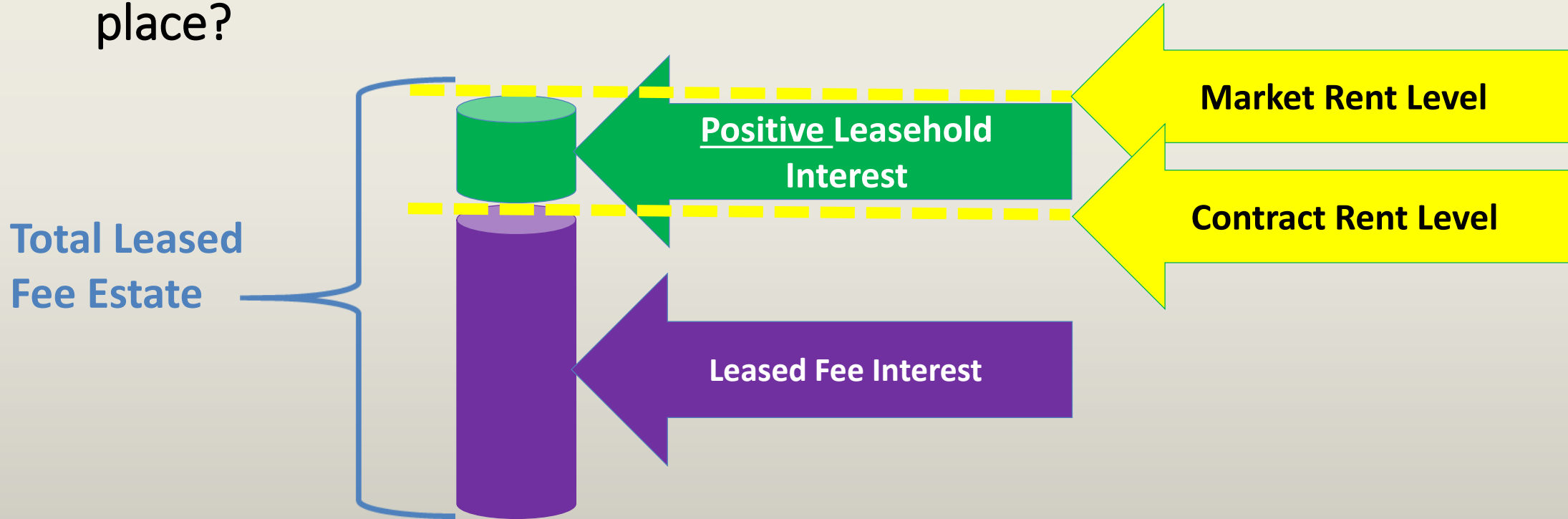
Leasehold Value with Excess Rent

- What can the property produce in rent as fee simple?
- What happens to the Leasehold Interest with Excess rent?
- Does what the property “can produce” as fee simple change with excess rent in place?



Leasehold Value with Deficit Rent

- What can the property produce in rent as fee simple?
- What happens to the Leasehold Interest with Excess rent?
- Does what the property “can produce” as fee simple change with excess rent in place?



The Credit (Institutional-grade) Real Estate Market

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.”

Source: The Dictionary of Real Estate Appraisal, 6th ed. (Chicago: Appraisal Institute, 2015), page 121.”

Standard & Poor's Long-Term Credit Ratings

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

Growth Investment Group

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



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Tenant Credit Ratings




Click [here](#) for notes on how to use this chart.

Tenant	Holding Company	Sector	Stock Ticker	Standard & Poor's	Cum. Historic Default Rates	Moody's	Cum. Historic Default Rates
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Growth Investment Group

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

	Costco Wholesale Corp.	Discount	COST	A+	2.91%	A2	1.29%
	CVS Caremark Corp.	Drug	CVS	BBB+	10.29%	Baa2	4.64%
	Dollar General Corp.	Discount	DG	BB	29.93%	B1	43.34%
	Kohl's Corp.	Home & Garden	KSS	BBB+	10.29%	Baa1	4.64%
	The Kroger Co.	Grocery	KR	BBB	10.29%	Baa2	4.64%

Growth Investment Group

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

	Lowe's Companies, Inc.	Home & Garden	LOW	A+	2.91%	A	1.29%
	The Sherwin-Williams Co.	Home & Garden	SHW	A-	2.91%	A3	1.29%
	Starbucks Corp.	Restaurants	SBUX	BBB+	10.29%	Baa3	4.64%
	The TJX Companies, Inc.	Discount	TJX	A	2.91%	A3	1.29%
	Verizon Communications Inc.	Technology	VZ	A	2.91%	A3	1.29%
	Walgreen Co.	Drug	WAG	A	2.91%	A2	1.29%
	Wal-Mart Stores, Inc.	Discount	WMT	AA	1.50%	Aa2	0.52%

*Once a
national credit
tenant,
ALWAYS a
credit tenant?*

Why should it matter?



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Why should it matter?



Why all the change??

One word....



*“Amazon wants to be
between you and
EVERYTHING you buy.”*

-Jeff Bezos




Value Proposition Article - William J. Barrett, Esq.

Smart tips for growing the business | Retail bankruptcy puts a spin on commercial leases | How vulnerable are AMCs to liability?

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INSIGHTS AND PERSPECTIVES FOR REAL ESTATE APPRAISERS Q2 2016



PUBLIC INTEREST

Valuation services for the federal government run the gamut, from national parks to office buildings



Retail Leaseholds

Value proposition

When a business goes bankrupt, its commercial leases often hold the key to value. Here's what appraisers need to know

by William J. Barrett

Generating an opinion of value for an interest in real property is familiar territory for many valuation professionals. Assignments become trickier when the interest to be valued is a lease or a property that's subject to a long-term lease, because leases grant the right to use real property and establish a set of personal obligations. Unlike interests in real property, which are durable rights that normally survive the bankruptcy of the owner, leases are delicate things, and their existence may depend on the continuation and solvency of a tenant.

The valuation of commercial leaseholds, particularly for retail, can be challenging. The RadioShack bankruptcy left nearly 2,000 vacant stores, including this space owned by Friedland Properties on Johnson Avenue, a prime retail strip in the Bronx, New York.

VALUATION • Q2 2016 19

Value Proposition Article - William J. Barrett, Esq.

by William J. Barrett

Generating an opinion of value for an interest in real property is familiar territory for many valuation professionals. Assignments become trickier when the interest to be valued is a lease or a property that's subject to a long-term lease, because leases grant the right to use real property and establish a set of personal obligations. Unlike interests in real property, which are durable rights that normally survive the bankruptcy of the owner, leases are delicate things, and their existence may depend on the continuation and solvency of a tenant.



Why should it matter?

“Business (intangible) value is the least secure and can change rapidly because of innovation and competition.”

Property Rights

For Property Tax Valuation (Generally) – Fee Simple

The Definition...

TCA 67-5-601 defines value for Tennessee property tax valuation as:

“The value of all property shall be ascertained from the evidence of its sound, intrinsic and immediate value, for purposes of sale between a willing seller and a willing buyer without consideration of speculative values”

The Stated Intent...

*“It is the legislative intent that no appraisal under this part shall be influenced by inflated values resulting from speculative purchases in particular areas in anticipation of uncertain future real estate markets; but all property of every kind shall be appraised according to its sound, intrinsic and immediate economic value”*¹

¹ TCA 67-5-601

The Challenge...

Value fee simple on a property that is generally transferred leased fee as an institutional grade investment.

(the conversion to institutional grade adds value by application of a lease - LIN effect).

Two choices:

- 1. Appraise using fee simple sales with same HBU*
- 2. Appraise using leased fee sales with adjustments for property right differences*

The Bundle of Rights



Fee Simple versus Leased Fee

Interest in Real Property

- *Fee simple*
 - *“Available for lease”*
 - *Assume rent 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”*

Fee Simple versus Leased Fee

- Question:
 - Is leased fee value at market rates a “proxy” for fee simple?
- Fee simple:
 - “When the fee simple interest is valued, the presumption is that the property is available to be leased at market rates.”*
 - What does “available for lease” mean?
 - How does the comparable being leased “at market rates” change things – or does it?

* The Appraisal of Real Estate 14th edition. Page 441



Fee Simple versus Leased Fee

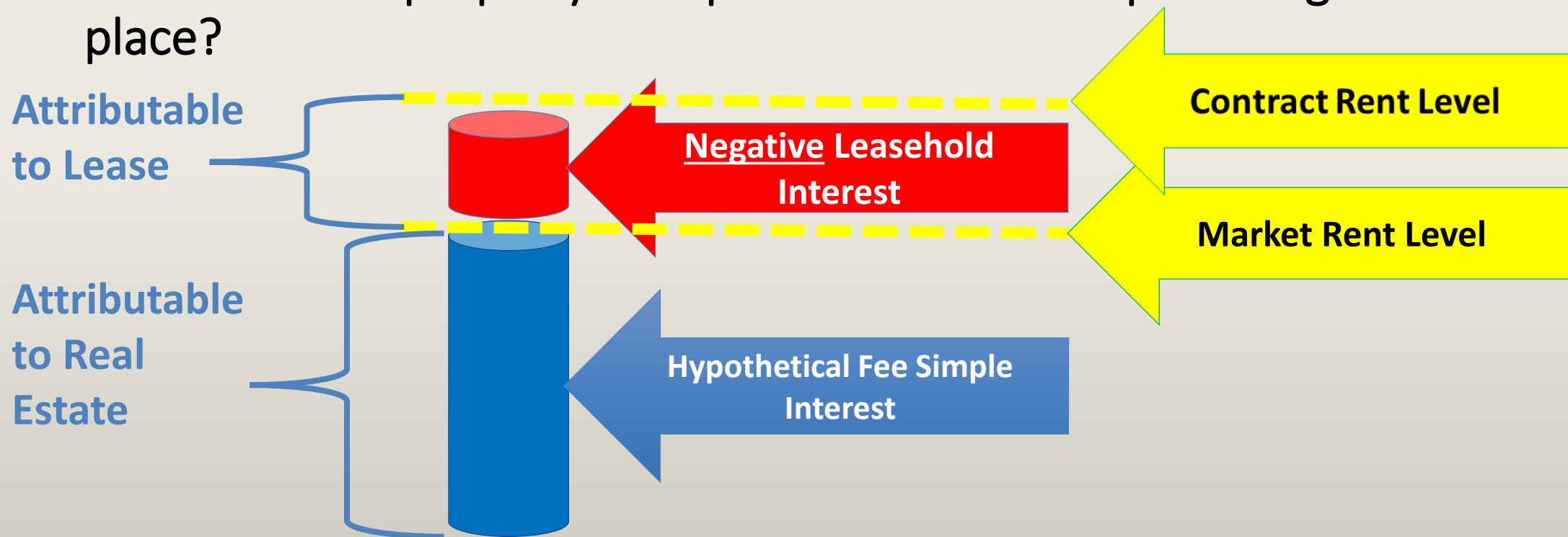


“A lease never increases the market value of the real property rights to the fee simple estate. Any potential value increment in excess of a fee simple estate is attributable to the particular lease contract.”

Source: Appraisal Institute, The Appraisal of Real Estate, 14th ed. (Chicago: Appraisal Institute), 2013, p. 441.

Leasehold Value with Excess Rent

- What can the property produce in rent as fee simple?
- What happens to the Leasehold Interest with Excess rent?
- Does what the property “can produce” as fee simple change with excess rent in place?



Let's talk about...

Go Dark



“Go Dark” comparisons mean different things...

Closed “Dark” store (vacant)



=???

Open store under lease



Different Highest and Best Uses

Choice of Comparable Sales

- “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

Viabile Retail Location?

	Subject	1	2	3	4	5
Demographics 5 Mile Radius						
Population	243,843	293,919	373,228	180,496	269,107	219,596
Households	75,372	121,383	152,473	65,878	102,157	66,710
Median Disposable Income	\$27,526	\$40,517	\$50,489	\$32,999	\$51,449	\$53,533
5 Year Population Growth	1.01%	1.03%	1.75%	0.97%	1.01%	0.46%
Demographic Comparison		Similar	Superior	Similar	Similar	Inferior
Retail Draw 5 Mile Radius						
Retail Sales (Supply)	\$2,278,165,256	\$7,154,992,259	\$8,332,770,573	\$3,172,683,794	\$4,354,627,381	\$1,458,308,274
No. of Stores	1,083	2,543	3,559	1,137	1,683	701
Retail Sales Per HH	\$30,226	\$58,946	\$54,651	\$48,160	\$42,627	\$21,860
Retail Sales Per Store	\$2,103,569	\$2,813,603	\$2,341,324	\$2,790,399	\$2,587,420	\$2,080,326
<i>Difference from Subject</i>		\$710,034	\$237,755	\$686,830	\$483,851	-\$23,243
Major Shopping Centers	3	13	16	3	11	4
Total Gross Leasable Area (SF)	1,232,203	5,862,107	8,832,697	2,019,025	4,429,383	1,674,540
Total Stores in Major Centers	155	631	1,129	237	477	122
Retail Draw Comparison		Superior	Superior	Superior	Superior	Inferior

Viabile Retail Location?

RETAIL MARKET METRICS	Subject	1	2	3	4	5
Vacancy Rate						
Q4 2014	6.40%	10.50%	8.40%	5.70%	12.70%	13.00%
Q4 2015	6.90%	10.50%	8.60%	3.80%	12.10%	12.40%
2015 Vacancy Rate Change	0.50%	0.00%	0.20%	-1.90%	-0.60%	-0.60%
<i>Vacancy Difference from Subject</i>		3.60%	1.70%	-3.10%	5.20%	5.50%
<i>Vacancy Change Difference from Subject</i>		-0.50%	-0.30%	-2.40%	-1.10%	-1.10%
Overall Vacancy Comparison		Similar	Similar	Similar	Similar	Inferior
Asking Rent						
Q4 2014	\$13.70	\$16.76	\$18.78	\$14.90	\$17.61	\$17.11
Q4 2015	\$14.29	\$17.00	\$19.04	\$16.20	\$17.88	\$17.58
2015 Asking Rent Change	4.30%	1.43%	1.38%	8.72%	1.53%	2.75%
Effective Rent						
Q4 2014	\$12.33	\$14.57	\$16.24	NA	\$14.84	\$14.67
Q4 2015	\$12.88	\$14.79	\$16.47	NA	\$15.08	\$15.12
2015 Effective Rent Change	4.46%	1.51%	1.42%	NA	1.62%	3.07%
<i>Effective Rent Difference from Subject</i>		\$1.91	\$3.59	-	\$2.20	\$2.24
<i>Effective Rent Growth Difference from Subject</i>		-2.95%	-3.04%	-	-2.84%	-1.39%
Overall Effective Rent Comparison		Superior	Superior	-	Superior	Similar
2015 Inventory Growth	0.00%	0.20%	0.00%	NA	0.00%	0.00%
Overall Inventory Growth Comparison		Similar	Similar	-	Similar	Similar
Final Comparison		Similar	Superior	Similar	Superior	Inferior
Sources: Site To Do Business, REIS						

“Go Dark” comparisons mean different things...

Sale1 - Leased - Sale Price \$4,000,000



Sale2 - Fee simple – Sale Price \$3,000,000



$=\sqrt{\sqrt{}}$

Same HBU as fee simple
The lease may provide the “LIN Correction” for Sale 1

“Go Dark” comparisons mean different things...

Fee simple sale – Former Walmart Marketplace



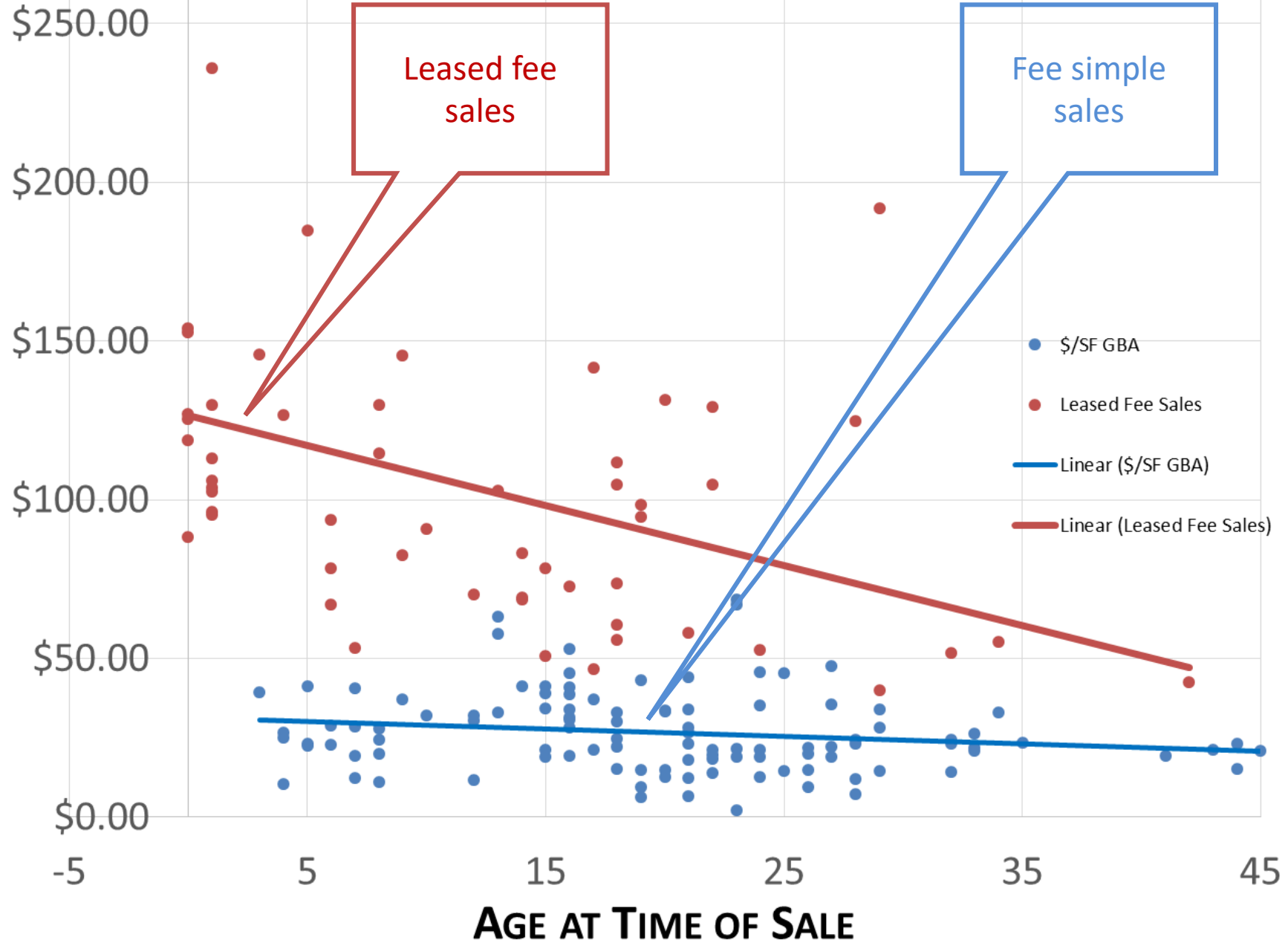
Across Street - New Super Walmart



Same HBU

Walmart stayed at location and moved across street

FREESTANDING BIG BOX SALES PRICES



Valuation of Fee simple on Leased Properties

“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.”

Source: The Appraisal of Real Estate 14th edition, page 406

What is “LIN”??

LIN

Verb

1. To desist (from something), stop.
2. To cease; leave off.

Institutional investors “leave out” location, location, location and replace it with the lease and 3-things the lease provides!

Retail Changing?

For institutional-grade properties, the difference between fee simple and leased fee is more pronounced because of the “LIN Correction” to the rights purchased.

Leased fee \neq Fee simple

Leased fee \neq Proxy for Fee simple

The Future of Retail Properties in Valuation for Property Tax Purposes

The Future is Only Going To get Worse

Benjamin R. Sellers, MAI



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