



**IAAO**

# **COMMERCIAL BIG-BOX RETAIL:**

*A Guide to Market-Based Valuation*



**By the Special Committee on  
Big-Box Valuation**

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## **I. PURPOSE**

This IAAO position paper provides guidance for the valuation of big-box retail properties. Over the last several years, issues involving these properties and theories about how to value them, such as the dark store theory, have resulted in great debate within both the appraisal and legal communities. Even though this paper concentrates on arriving at the market value of the fee simple interest of these properties, it provides guidance regardless of the specific law of a jurisdiction.

This analysis focuses on big-box retail stores from 50,000 to 200,000-plus square feet; however, the market trend for big-box retail is shifting to both smaller and larger stores. For example, one major retailer has six different prototype stores varying from 15,000 to 260,000 square feet, depending on the characteristics of the trade area. The concepts discussed in this paper apply to single-tenant retail stores of any size and also to other property types.

This paper does not explain how to mass appraise; rather, it describes the process that will help an appraiser support a market value estimate for big-box retail properties. The theories and methodologies discussed in this paper reflect market behavior. The paper identifies recurring issues in this controversy, clarifies the fundamental concepts used in appraisal practice, and explains the methodologies developed in arriving at the appropriate value required by the jurisdiction for assessment purposes.

## **II. BIG BOX RETAIL ISSUES AND THE DARK STORE THEORY**

The dark store theory originates from claims that big-box retail stores have been unfairly over-assessed by taxing jurisdictions. This viewpoint maintains that real property assessments should not be based on what the property is worth to the current user, purported to be value-in-use or use value, but on what the property would be worth to another prospective (hypothetical) user in the open market. The argument alleges that the latter is a true reflection of value-in-exchange and market value. Advocates of this position assert that any costs associated with the property's construction must be ignored as an indication of value, and that a significant portion of those costs must be considered functional obsolescence. By this argument, a property is already functionally obsolete as soon as it is constructed. Leases-in-place must also be ignored, because they too are a reflection of use value or value-in-use, in that the rents are typically based on costs to cover construction.

The term *dark store* generally describes vacant stores (as in dark because they are without electricity). The term is used to identify the types of sales that dark store theorists claim are appropriate comparables for the subject property, regardless of whether the subject is a vacant property or an occupied property. Vacant subject properties are rarely identified in this contentious debate, because there is generally less disagreement that vacant stores have less value. However, the debate escalates when vacant, blighted, abandoned, deed-restricted sales are used as comparisons to functioning, occupied stores. While it is often true that big-box stores may close their doors after they have operated and made profits, and also true that these stores sometimes sit vacant for months or years before retrofit or demolition, critics of the dark store theory argue that vacant big-box stores have a highest and best use different from those of occupied ones.

For tax assessment purposes, the date of value is established and value is based on what actually physically exists—not what is hypothetical. Critics of the dark store theory also believe the value of the property in its current use, if rents-in-place are shown to be in line with market rents, is reflective of market value, and that leased-fee value is equal to fee simple value. Further, an occupied property is evidence that demand for the property exists, and valuing an occupied property as if it is a vacant property would require the appraiser to disclose a hypothetical condition. Hence the debate. This paper seeks to address these issues and provide the assessor with guidance on valuing these property types.

### **III. EXECUTIVE SUMMARY**

During the research process, the following arguments were identified as repeatedly arising in the appeal of big-box retail ad valorem valuations. The following list summarizes some significant and recurring issues.

- *Dark store theory.* This theory suggests that occupied big-box stores should be valued as-if-vacant and available for sale or rent to a future hypothetical user rather than in the current use, which is often a functioning, occupied store.

Valuing an occupied subject property as-if-vacant requires a hypothetical condition that the appraiser would be required to disclose. This is not to say that when the subject property itself is vacant as of the valuation date, the use of vacant comparables is inappropriate.

- *Build-to-suit and sale-leaseback transactions.* It is asserted that these transactions are based either on financing or on costs of customized improvements plus a premium paid for land acquisition. Thus, the rents reflect inflated costs. These transactions are non-arm's-length and should be excluded as comparisons for the subject property.

Sales of first-generation transactions are scarce in the market, and an appraiser should examine whatever data are available. Neither build-to-suit nor sale-leaseback transactions should be automatically disregarded as improper comparables. As with all sales, the appraiser must carefully analyze the transaction to determine whether it is reflective of the market value of the fee simple estate, and if not, determine whether sufficient information is available to make the proper adjustments.

- *Value-in-use versus value-in-exchange.* Valuing the subject property with a lease-in-place sometimes raises the concern that the appraiser is arriving at value-in-use rather than value-in-exchange.

If the appraiser determines the lease terms, including rent, are reflective of the market, then contract rent is equal to market rent and value-in-use is reflective of value-in-exchange.

- *Functional obsolescence in improvements designed for a specific user.* Improvements made for a specific big-box retailer are claimed to be functionally obsolete as soon as they are built, because they are worth something only to the current user and would contribute little or no value in the open market. In other words, improvements may cost \$15,000,000 to build but are worth only a fraction of that amount to another user.

Most big-box improvements are in fact not unique (with the likely exception of signage). Further, the value of the property is as of the date of valuation, not as of a future date, to a hypothetical prospective buyer. It will be for the market to determine whether the improvements are in demand, and it will be for the future buyer to make the economic decision to purchase the property and retrofit, demolish, or continue to use the improvements.

- *Abandoned, vacant stores.* The assertion is that abandoned, vacant stores are evidence of functional obsolescence and lack of market demand.

Abandoned stores may or may not be evidence of functional obsolescence. Moreover, subsequent sale prices for those properties are often the result of the detrimental impact of deed restrictions or of changing demand in the marketplace on the pool of potential buyers.

- *Impact of restrictive covenants.* Big-box retailers often assert that deed restrictions have no significant impact on property value.

The impact of deed restrictions on value is difficult to quantify, because it is virtually impossible to determine the number of potential buyers who walked away from a deed-restricted sale. It is certain that deed restrictions, by design, are imposed to limit competition and force a change in highest and best use.

- *Fee simple is not unencumbered.* This notion suggests a fee simple valuation assignment (whether big-box or other types of property such as a corporate office center, office building, industrial property, among others) is the value unencumbered by a lease, i.e. a vacant property.

A lease does not factor into the definition of fee simple absolute. A lease is a possessory right, and a property may be held in fee simple, subject to a lease. In a jurisdiction where market rent is the criterion for the calculation of rental income in an appraisal (market rent jurisdiction), sales of leased properties can and should be used as comparables, if adjustments are made for above- and below-market rents. In a jurisdiction where contract rent is the criterion for the calculation of rental income in an appraisal (contract rent jurisdiction), sales of leased properties can and should be used as comparables, with no rental adjustments required.

- *Highest and best use of big-box properties.* If a property is a certain size, regardless of investment class, occupancy, or deed restriction, it serves as an appropriate comparable for a subject property that is occupied and is not burdened with such a restriction.

The appraiser should be wary of arriving at an overly broad highest and best use conclusion of *general retail*. Market segmentation analysis indicates the existence of multiple investment classes of retail properties, similar to other property types such as offices, apartments, hotels, and other commercial properties. Simply because a property is similar in size to the subject property does not alone make it an appropriate comparable. Also, the appraiser is highly encouraged not to use a deed-restricted comparable if the subject property does not have a similar restriction.

#### **IV. REAL PROPERTY RIGHTS IN REAL ESTATE**

Ad valorem tax valuation is a legal construct. The specific laws, regulations, and case law of a jurisdiction control what is valued and how it is valued. This is one reason there is a jurisdictional exception in the *Uniform Standards of Professional Appraisal Practice* (TAF 2016). Because ad valorem tax valuation is a legal construct, interpretation of the law and regulations is controlled by legal analysis, not by appraisal analysis; thus, in some jurisdictions, what is required for ad valorem valuation may not be consistent with fee appraisal theory and practice. The appraiser must know exactly what a jurisdiction means by fee simple estate and what encumbrances must be taken in account.

##### **A. Fee Simple Absolute**

Many jurisdictions require a valuation of the fee simple absolute estate (or *fee simple*). *Black's Law Dictionary* defines fee simple as,

*An interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs; esp., a fee simple absolute. Often shortened to fee.* (Garner 2014)

Alternatively, the *First Restatement of Property* §14 defines an estate in fee simple as follows:

An estate in fee simple is an estate which

- (a) has a duration
  - (i) potentially infinite; or
  - (ii) terminable upon an event which is certain to occur but is not certain to occur within a fixed or computable period of time or within the duration of any specified life or lives; or
  - (iii) terminable upon an event which is certain to occur, provided such estate is one left in the conveyer, subject to defeat upon the occurrence of the stated event in favor of a person other than the conveyer; and
- (b) if limited in favor of a natural person, would be inheritable by his collateral as well as by his lineal heirs.”

The important aspect to note is that “fee simple” has absolutely nothing to do with leases/mortgages/liens/deed restrictions or any other encumbrance or distribution of any of the property rights to others. It simply means that the current owner has full control of the



disposition of the property. The fact that a property may have a deed restriction, lease, lien, or easement does not diminish or defeat the fee simple absolute property rights.

The legal concept of fee simple merely states that the owner has a fee simple estate, rather than another lesser estate, such as a life estate, fee simple determinable, or other various estates. It does not address government limitations or private encumbrances on the property.

## **B. Encumbrances**

Although the legal definition of fee simple implies the fee owner retains all rights in the property, all private property has limitations imposed by the government powers of taxation, eminent domain, police power, and escheat. These government restrictions on property are encumbrances.

In addition to government encumbrances, there may be private encumbrances placed on property, such as mortgages, deed restrictions, easements, covenants, and liens, to name a few. While none of these private encumbrances result in the owner not holding the property in fee simple, they can raise or lower the value of the real property.

*Black's Law Dictionary* defines encumbrance in part as follows:

*A claim or liability that is attached to property or some other right and that may lessen its value, such as a lien or mortgage; any property right that is not an ownership interest. (Garner 2014)*

The Uniform Commercial Code defines encumbrance as follows:

*Encumbrance means a right, other than an ownership interest, in real property. The term includes mortgages and other liens on real property. (Legal Information Institute n.d.)*

As noted above, the existence of these governmental and private encumbrances on real estate does not affect the fee simple estate.

It is critical that jurisdictions, courts and the property tax community specify what encumbrances the appraiser should and should not recognize when performing a property tax appraisal. Simply using the phrase “fee simple” is insufficient.

Sometimes the phrase “fee simple” is appended with the term “unencumbered”. The problem with the word “unencumbered” from an appraisal standpoint is that the term is inconsistently applied and subject to misinterpretation. An appraisal of the fee simple unencumbered interest would mean the appraiser would ignore governmental restrictions, utility easements and the like – an unlikely assignment in property tax or any other appraisal assignment.

Because of this confusion, a primary debate in big-box valuation is whether stores should be valued based on the sale prices of vacant stores or on the sale prices of leased and owner-

occupied ones. This debate arises in part when the appraiser reads the term “unencumbered” (or appends the term to the phrase “fee simple”) and concludes that the appraisal assignment must ignore the existence of a lease. The appraiser then takes the further step of determining that the property must then be valued as-if-vacant, even if the subject property is occupied. This same logic is then extended to sales of leased stores, which are also excluded because they too are encumbered. Excluding sales of leased properties leaves only vacant ones as potential comparables. To take this logic to the end assumes that all commercial property should be valued as-if-vacant. This erroneous conclusion is addressed below in Section V. Definitions of Value.

How jurisdictions treat encumbrances is a public policy issue. One overriding principle in ad valorem property taxation is that a parcel of property is typically assessed to one owner. Thus, regardless of whether the fee simple owner has transferred interests in the property, the holder of the fee simple estate is assessed for all of the property rights.

Jurisdictions may ignore the transfer of rights associated with liens, leases, and mortgages. However, not all jurisdictions treat easements and restrictive covenants similarly, and some jurisdictions continue to struggle with the issue.

### **C. Leased Fee (Fee simple subject to a lease)**

The term *leased fee* is an appraisal term defined in *The Dictionary of Real Estate* (Appraisal Institute 2015). It is not a legal term and is rarely used by market participants in the sale transaction market. *Leasehold* is a legally defined term as well as an appraisal term. *Black’s Law Dictionary* (Garner 2014) defines leasehold as, “a tenant’s possessory estate in land or premises... .” The terms are used as follows:

- *Leased fee*. The ownership interest held by the lessor, which includes the right to receive the contract rent specified in a lease plus the reversionary right when the lease expires. (Appraisal Institute 2015, 128). The term is used by appraisers as a basis to estimate the lessor’s value subject to a lease. It is based usually on the capitalization of net operating income (NOI) or the sum of the present value of the forecast NOI over a holding period and the present value of the reversion. In reality, leased fee is synonymous with fee simple, subject to a lease when possession but not the ownership is temporarily transferred to another.
- *Leasehold*. This is the possessory interest held by a tenant. The term is used by appraisers as a basis to estimate the value of the lessee’s interest, usually calculated by capitalizing the difference between market rent and contract rent. If a lease exists that reflects market characteristics, including market rent, then the leasehold has no market value. However, if the tenant pays less than market, the difference between the present value of what is paid and the present value of market rents would be a positive leasehold value in the real estate for the tenant.

## **D. The Fee Simple and Leased-Fee Issue**

Technically what is being referred to is a *fee simple interest subject to a lease*. However, the term *leased fee* is common appraisal terminology and is used throughout this document.

When arriving at a fee simple valuation value for ad valorem taxation, the appraiser must recognize that leases, easements, and estates other than fee simple exist in the real world of comparables the appraiser considers. A lease fulfills the basic wish of an owner to receive rent. It is not an encumbrance to ownership of real property rights—it is a contract for the use of the property to provide rental income to the owner. The appraiser must be able to make any necessary market-based adjustments to those comparables in order for them to be useful in arriving at the appropriate valuation goal required by the law of the jurisdiction.

If the appraiser is considering using leased-fee sales, then it must be determined whether the contract terms and contract rents are equivalent to market terms and market rents as of the valuation date or whether supportable adjustments can be made to the leased-fee sales.

## **V. DEFINITIONS OF VALUE**

### **A. Jurisdictional Requirements**

Most jurisdictions require a market value estimate; however, a jurisdiction may also use the terms market value, fair market value, cash value, or true cash value, among others. An appraiser should identify the applicable value as it is defined by the jurisdiction and carefully follow that definition. Usually the term market value is defined by statute or the courts and constitutes a willing seller and a willing buyer acting in full knowledge without duress in an open-market, arm's-length transaction. In general, the market value will be the *as-is* market value. If other value-related terms apply, they also should be examined for possible application in the assessment valuation.

### **B. Market Value**

#### **1. Definition**

*The Dictionary of Real Estate Appraisal* defines market value as follows:

*The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.* (Appraisal Institute 2015, 141)

## 2. Market Value and Big-Box Retail

An appraiser's conclusion of the market value of a big-box property should reflect the actual condition of the property on the date of valuation, including whether the property is occupied or vacant. If the property is occupied, whether by an owner or a tenant, the property should be valued as occupied. If the property is vacant as of the date of valuation, then the market value conclusion should arrive at a value as vacant.

This issue frequently arises in the sales comparison approach, in which an appraiser uses vacant comparables to value an occupied property without applying an appropriate adjustment to the vacant comparables. In fact, valuing the subject property as vacant when the subject property was occupied as of the date of valuation requires a hypothetical condition that the appraiser would be obliged to disclose.

*Hypothetical condition* is defined as follows:

1. A condition that is presumed to be true when it is known to be false.
2. A condition, directly related to a specific assignment, which is contrary to what is known by the appraiser to exist on the effective date of the assignment results, but is used for the purpose of analysis. Comment: Hypothetical conditions are contrary to known facts about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis. (TAF 2016)

The issue is clarified when the appraiser considers the other two approaches to value. Quite obviously, in an income approach, the appraiser is valuing the subject property as occupied, using market income and expense data. Less obviously, the cost approach also arrives at a value of the subject property as occupied (stabilized). As noted in *The Appraisal of Real Estate*,

*The value of a property indicated by the cost approach is the value of a fee simple estate. For properties that are leased, the cost approach assumes stabilized occupancy and income.* (Appraisal Institute 2013, 565–566)

Thus, it now becomes clear that using vacant sale comparables (without adjustment) to value an occupied property is not proper appraisal practice.

If the subject property is vacant as of the date of valuation, lease-up costs should be considered when the comparables are leased at market terms, including the time it takes to lease the space. However, because of the speculative variables in these unknown lease-up assumptions, the appraiser is encouraged to use similarly comparable properties, that is, vacant with vacant and occupied with occupied.

### C. Value-in-Use

*The Dictionary of Real Estate Appraisal* defines value-in-use as follows:

*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. Value-in-use may or may not be equal to market value but is different conceptually. See also use value. (Appraisal Institute 2013, 245)*

When the highest and best use of a property is defined as how the property currently exists in use, the value-in-exchange of the property is equivalent to the value-in-use of the property.

## **VI. THE HYPOTHETICAL SALE**

As noted above, the classic definition of market value as arriving at an estimate of what the real property interest would sell for between a willing buyer and willing seller requires that the appraiser create a hypothetical sale of the property as of the date of valuation.

Although the appraiser is hypothesizing a sale of the property, what should not be hypothetical are the physical aspects of the subject property and the economic conditions surrounding the subject property. The appraiser cannot ignore the subject property's physical depreciation or functional obsolescence in the hypothetical sale. Nor can the property's location, market demand, or economic conditions be ignored.

While this seems obvious, appraisers sometimes erroneously attribute negative aspects of a comparable sale (such as a poor location with weak market demand, functionally obsolete features, and the like) to the subject property by failing to make adjustments for those differences.

### **A. Hypothetical Seller**

When there is an actual sale of a property, the appraiser knows the identity of the seller of the property. However, in a hypothetical sale of the subject property as of the date of valuation, the actual owner of the property is not the hypothetical seller. Instead, the identity of the hypothetical seller is both unknown and not relevant. However, as the definition of market value requires, that unknown seller is knowledgeable and acts prudently and with self-interest.

### **B. Hypothetical Buyer**

In a hypothetical sale, the appraiser does not have to identify an actual buyer of the property. As long as the appraiser identifies demand for the property, the market will supply a buyer. However, if the subject property is functionally obsolete, even a hypothetical buyer would take that obsolescence into account.

When determining demand for the subject property, the appraiser should not ignore the current owner/user as a part of that demand. If the current owner/user is ignored as part of the market demand, then the appraiser is improperly analyzing the market demand for the property.

## **VII. HIGHEST AND BEST USE**

Highest and best use analysis must be conducted for both the subject property and other properties the appraiser is considering using as income or sales comparables.

*Highest and best use is a theoretical concept that underlies valuation analysis. An appraiser must first perform general market analysis in order to then analyze the characteristics of the market that cause the subject property to have value. ... Highest and best use is the use that generates the highest net return to the property over a reasonable period of time. (Thimgan 2010)*

The highest and best use of the land as-if-vacant and available for use may be the same as the existing use or may differ from the highest and best use as-improved. It is different when existing improvements are either an interim use or are approaching the end of their economic life but still contribute value to the real property in excess of the value of the land.

Analysis of highest and best use for as-if-vacant requires four tests done in the order listed below.

### **A. As-if-Vacant**

#### **1. Legally Permissible**

Legally permissible uses considered first in a highest and best use analysis include legal limitations, such as zoning regulations or deed conditions and restrictions, that may have an impact on development potential. These constraints may be attributable to zoning, private restrictions, easements, historic districts, building codes, and environmental regulations.

#### **2. Physically Possible**

Factors such as site size, shape, frontage, topography, soil composition, flood zone, and access to utilities may limit use of the site to its fullest potential. A use may be legally permissible but only realized if the physical characteristics of the land support the use. Thus, a proposed property may or may not be a viable development on the site.

#### **3. Financially Feasible**

The determination of financial feasibility is largely dependent on supply and demand for the legally permitted and physically possible uses and the costs associated with the future development. Recent construction of other big-box properties in the market is evidence that a big-box use is financially feasible and shows that demand for such big-box properties exists.

#### **4. Maximally Productive**

The highest and best use for as-if-vacant is the use that produces the highest residual land value.

## **B. As-Improved**

The same four criteria for the highest and best use analysis for as-if-vacant should be considered in the highest and best use analysis for as-improved.

### **1. Legally Permissible**

The appraiser should determine whether the current use is a legally conforming use. If zoning has changed or if the improvements were built under a conditional use permit, reconstruction of the same type of building may not be allowed if the improvements are destroyed. When a first-generation big-box retailer vacates, it often places deed restrictions on the property to prohibit competition. This forces a change in highest and best use to something other than the property's original design.

The following is an example of such a deed restriction:

TO HAVE AND TO HOLD said Land unto Grantee, and its successors and assigns, forever, with all tenements, appurtenances and hereditaments thereunto belonging, subject to easements and other matters of record, and subject to the following restrictions: For a period of TWENTY-FIVE (25) years from the date hereof, said Land may not be used as a discount department store whose overall retail concept is based on a discounting price structure, a wholesale membership club or warehouse store, a grocery or supermarket or similar type store, or a pharmacy (collectively, the "Use Restrictions"). Those portions of the building leased to (intentionally omitted for confidentiality) (collectively, the "Leases") shall be exempt from the Use Restrictions for those periods the Leases shall be in effect, however, in no instance shall the exemption for the building area leased by (ABC retailer) last beyond May 31, 2018. The aforesaid restrictions shall run with and bind said Land and shall inure to the benefit of and be enforceable by Grantor or an affiliated company or its successors, by any appropriate proceedings at law or in equity to prevent violations of such conditions and restriction and/or to recover damages for such violations from the then current owner of the Land. However, such conditions and restrictions shall remain in effect for Twenty-Five (25) years from the date hereof.

### **2. Physically Possible**

Consider the land-to-building ratio. If the land-to-building ratio is greater than what is typical for the current use, the improvements may be an underutilization of the site, suggesting that a larger building may be developed. Underutilization may indicate the current improvements are not the highest and best use as-improved.

### 3. Financially Feasible

The third step in a highest and best use analysis is financial feasibility. This analysis requires consideration of the demand for the property. This step typically incorporates some degree of a marketability study. When considering market demand, the appraiser considers the likely *users* of the property, which include likely buyers/tenants. The result of this analysis in the consideration of operating properties versus vacant properties is often that the operating property is still financially feasible for its current use, whereas the vacant store is vacant because of a diminishing or absent demand. If the property is occupied, this is evidence that demand for the property exists.

For most properties with big-box stores and related improvements, one of the following four possible highest and best use conclusions is likely:

- Retain existing improvements for their current use.
- Renovate to address physical and functional items that need to be cured and/or convert to a different use to recognize changing trade area demand trends.
- Demolish existing improvements and redevelop the site with a different use that represents the highest and best use of the site.
- Demolish existing improvements and hold the site for future development.

Techniques such as the land residual, feasibility rent analysis, and the use of profitability index are methods that may be used to test financial feasibility. Another practical method that may be considered is a simple analysis showing that an improved property should not be worth less than vacant land. This methodology is particularly useful for big-box stores. Consider the following hypothetical:

An occupied store of 150,000 square feet has a typical land-to-building ratio of 5:1 or land area of approximately 750,000 square feet. Purportedly the building is worth \$20/square foot based on comparable sales of deed-restricted, converted stores, and/or vacant properties. This value implies the subject property is worth  $\$20 \times 150,000$  square feet, or \$3,000,000. This \$3,000,000 for 750,000 square feet of land area also indicates that land must be worth less than \$4/square foot. If comparable land sales indicate a value for land greater than \$4/square foot, then the market value of the subject property is either greater than \$3,000,000 or the occupied property has reached the end of its economic life because the improvements offer no contributory value.

From this example, the comparable properties are not appropriate for comparison to the occupied property or the current use is not the highest and best use. If continued use of the operating store is financially feasible, then the comparable properties are inappropriate because the resulting value is less than the land value.



The same test may also be used with rents. The \$3,000,000 value implies that net operating income for the subject property would be approximately \$270,000 annually using a market-based capitalization rate of 9 percent as an example. An annual net rent of \$270,000 for 150,000 square feet implies a net rental rate of \$1.80/square foot. If comparable leased properties in the subject's market reflect net income significantly higher than \$1.80/square foot, then either the comparable leased properties are inappropriate or the property is approaching or has reached the end of its economic life. Again, the test reveals that the value of the land exceeds what is proposed as the contributory value of the improvements.

Comparable land sales provide the benchmark for the lowest value a property can be as-if-vacant; thus, the proper identification of land sales is an important step in determining the correct highest and best use.

#### **4. Maximally Productive**

According to *Property Assessment Valuation*,

*In mass appraisal, the current highest and best use is usually considered to be the current use; that is, buildings will not be immediately demolished or replaced (Thimgan 2010, 44).*

If the subject property is occupied, that fact supports the premise that there is demand for the use for which the property was originally designed. Highest and best use is likely for the continued use of the property in its current use.

### **VIII. MARKET SEGMENTATION AND HIGHEST AND BEST USE**

For retail properties, value is affected by size, age, condition, access, traffic counts, proximity to major employment centers, the concentration of surrounding properties, population size, and household purchasing power, to name just a few considerations. The competitive advantage of a property determines its relative position within the market. A property that has significant advantages over other properties of the same use because of location, demographics, and economic forces will command a higher price and rent. As such, stratifying properties into investment classes creates a logical hierarchy that reflects potential market participants' actions. This method assists the appraiser in identifying the highest and best use of the subject property and in selecting appropriate comparables.

#### **A. Investment Class A**

Investment class A big-box retail properties sell at the highest prices and lowest capitalization rates. The first-generation user generally occupies these properties. Buyers of investment class A big-box retail properties typically are national investors, such as real estate investment trusts, insurance companies, and retirement funds, looking for newer improvements with a creditworthy national or regional retail chain tenant under a long-term, generally triple-net, lease. These properties often have locations that generate high retail sales per square foot, usually above the

chain's nationwide average. The locations typically have greater visibility, such as a corner lot and high traffic counts. Leased class A properties generally are subject to long-term leases and are purchased with significant years remaining on the lease.

### **B. Investment Class B**

Investment class B big-box retail properties are usually slightly older properties that sell in the mid-range price level at mid-range capitalization rates. These first-generation properties are in good locations but not as well located as class A properties. The retail sales per square foot usually meet or may exceed the chain's nationwide average sales per square foot. These properties may still attract national and regional investors. Remaining lease terms on these properties, while not as long as for investment class A properties, generally exceed 10 years.

### **C. Investment Class C**

Investment class C big-box properties are nearing the end of their economic life for first-generation use and may be classified as second-generation space. These locations do not meet the minimum requirements for a new improvement of the same use or renovation of the current improvements by the first-generation user. Retail sales at these properties are usually below the chain's nationwide average. These properties sell toward the low end of prices and high end of capitalization rates. The continued use of the current use is likely an interim use. Remaining lease terms are relatively short, usually less than 10 years.

### **D. Investment Class D**

Investment class D big-box retail properties sell at low prices and, when leased, indicate high capitalization rates. They are often vacant or soon-to-be-vacant properties with a highest and best use for a second-generation use. The original market demand for these properties has moved to more desirable retail locations. These vacant properties possibly are ready for redevelopment for a different use (e.g., low-end retail, office, or warehouse). The original design is no longer valuable or viable in the marketplace except by second-generation users at low prices or rents.

## **IX. THE THREE APPROACHES TO VALUE OF FEE SIMPLE PROPERTY RIGHTS**

### **A. The Cost Approach**

*The cost approach to value provides a value indication that is the sum of estimated land value and the estimated depreciated cost of the building and other improvements (Thimgan 2010).*

The cost approach is a two-step process that provides a value indication of the land and an estimate of value for the cost to build a new or substitute property. Adjustments for depreciation caused by age, utility, or external factors are applied to the improvements, and the depreciated value of the improvements is added to the land value to arrive at a total value. The approach is premised on the Principle of Substitution, which asserts that,

*[A] rational, informed purchaser will pay no more for a property than the cost of acquiring an acceptable substitute with like utility, assuming that no costly delay is encountered in making the substitution (Thimgan 2010).*

This approach reflects market behavior, especially in the valuations of new properties, well-maintained properties, proposed construction or renovations, and special-purpose properties or, in the case of big-box properties, when comparable sales and unrestricted-use sales are scarce.

### **1. Strengths of the Cost Approach**

Courts frequently rely on the cost approach because it inherently values the fee simple property rights and eliminates the debate about leases and deed restrictions. The cost approach is useful when comparable sales and rental data are insufficient or lacking. Replacement cost new, rather than reproduction cost new, typically excludes any functional obsolescence relating to design and utility, such as superadequacies, for example. The cost approach can serve as a test of reasonableness against claims that build-to-suit costs exceed the market value of new improvements. For these reasons, the cost approach is especially useful for investment class A and class B properties that tend to be newer, well-maintained buildings. Big-box retailers consider land and improvement costs when determining financial feasibility for a project, so the application of the cost approach directly replicates market behavior.

### **2. Weaknesses of the Cost Approach**

Limitations in the cost approach are attributed generally to estimating depreciation and entrepreneurial profit/incentive. The economic age-life and market extraction methods are widely used by appraisers to estimate depreciation because of their simplicity in application. However, lump-sum deductions and straight-line depreciation are often criticized for being oversimplified approximations. Effective age is based on an appraiser's opinion. Remaining economic life is based on the appraiser's judgment but can also be supported by a study of typical economic lives of similar buildings. Both tend to be less reliable as the property ages. Although the breakdown method is more detailed in measuring depreciation, many forms of depreciation are difficult to support with market evidence. In these cases there is a greater likelihood of a methodology's misapplication. With regard to big-box retail properties, some of these shortcomings are diminished, because these properties typically tend to be well-maintained and generally have minimal functional obsolescence.

### **3. Land Valuation**

An accurate land value estimate is critical to the development of a reliable cost approach. Comparable land sales should have the same highest and best use as the subject property and should be similar in location, traffic count, demographics, zoning, size, visibility, access, and any other attributes deemed important by buyers and sellers. Often, investment classes C and D big-box properties may be approaching the end of their economic lives, and while depreciation and functional obsolescence may be difficult estimates to quantify, a reliable valuation of land may reveal whether the subject property is approaching or has reached the end of its economic

life. If the value of the land is close to the value of the property as-improved, this may indicate that the property is ready to be torn down or possibly redeveloped.

#### **4. Entrepreneurial Profit/Incentive**

Entrepreneurial profit is defined as,

*[A] market-derived figure that represents the amount an entrepreneur receives for his or her contribution to a project and risk; the difference between the total cost of a property (cost of development) and its market value (property value after completion), represents the entrepreneur's compensation for the risk and expertise associated with development (Appraisal Institute 2015, 76).*

Entrepreneurial incentive is defined as,

*The amount an entrepreneur expects to receive for his or her contribution to a project. Entrepreneurial incentive may be distinguished from entrepreneurial profit (often called developer's profit) in that it is the expectation of future profit as opposed to the profit actually earned on a development or improvement. The amount of entrepreneurial incentive required for a project represents the economic reward sufficient to motivate an entrepreneur to accept the risk of the project and to invest the time and money necessary in seeing the project through to completion (Appraisal Institute 2015, 76).*

Entrepreneurial profit/incentive, based on analysis of recent sales of similar properties and/or interviews with developers of similar improvements, is often difficult to support because of the lack of sufficient market evidence. It is often calculated as a percentage of direct and indirect costs and included in the total replacement cost of the improvements.

#### **5. Functional Obsolescence**

The issue of functional obsolescence often arises in the valuation of big-box retail properties in the context of whether the properties are in fact special purpose. A special-purpose property is defined as follows:

*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; also called a special-design property (Appraisal Institute 2015).*

*The functional utility of a special-purpose building depends on whether or not there is continued demand for the use for which the building was designed. When there is demand, functional utility depends on whether or not the building conforms to competitive standards. (Appraisal Institute 2013)*

If the appraiser finds there is still demand for the uses served by the subject property that are similar to those for other newly constructed properties in the market, the property is probably not special purpose and there is likely no or limited functional obsolescence.

## **6. Signage/Facade**

Some modification and level of customization are expected when a new tenant takes over a space. This does not make the property functionally obsolete. The appraiser may find that the signage and/or facade may be minimal and easily removed without significant damage to the underlying real estate.

## **B. The Sales Comparison Approach**

Based on the concept of value-in-exchange, the sales comparison approach to value compares the property being appraised with similar properties that have recently sold. The characteristics of the sold property are analyzed for their similarity to those of the subject of the appraisal (Thimgan 2010).

The sales comparison approach to value is commonly employed in the appraisal process because it closely reflects how buyers and sellers in the marketplace engage in property transactions. The sales comparison approach is also heavily influenced by the economic Principle of Substitution, which holds that properties demonstrating similar economic utility command similar prices. Hence, the value of a property or highest price a property will likely obtain is determined by the cost of purchasing a substitute property of similar design, function, and utility. This is a straightforward approach that studies the market's reaction to similar properties and is especially reliable when there are ample data available in the market from which to make appropriate comparisons.

### **1. Strengths of the Sales Comparison Approach**

The sales comparison approach is a well-founded methodology when there are abundant, truly comparable properties in the market that serve as appropriate substitutes to the subject in terms of functional utility and other relevant market characteristics. This straightforward approach is widely understood and relied upon by the courts. It reflects the actions of buyers and sellers and is used to estimate market value. For big-box properties, the appraiser will likely be able to find sales in the marketplace of such properties if he or she is willing to broaden the search area for other similar investment class sales that have a similar highest and best use.

### **2. Weaknesses of the Sales Comparison Approach**

Properties that are not true comparables can lead to unreliable conclusions. For example, simply because a property is similar in size does not make it an appropriate comparison for another property. Closed sales transactions are historic and may not reflect current market value. There are generally few first-generation sales that convey to users, and sale-leasebacks and build-to-suit transactions may be the only first-generation sales available to an appraiser who is valuing investment class A properties.

### **3. Sales in the Big-Box Market**

Some appraisers reject a comparable sale as a valid, open-market transaction if the property exchanged is a build-to-suit property, a sale-leaseback transaction, or a private sale. As indicated in the IAAO *Standard on Verification and Adjustment of Sales* (IAAO 2010, 12, 31), it is up to the appraiser to verify the transaction details. The standard suggests that during the sale verification process the appraiser ask first whether the sale was a sale-leaseback and then whether this influenced the sale price.

For big-box and single-property retailers overall, the current practice for financing construction of a new improvement is through a build-to-suit arrangement. This arrangement is as common, if not more so, than traditional mortgage financing. The developer obtains the financing to build the improvements for the occupant, and the occupant opts to make lease payments instead of mortgage payments to a bank. This is an economic decision of the user. It does not mean the transaction does not represent market value. While sale-leasebacks often relate to new construction, these types of transactions may also involve existing properties. In either scenario, subject to verification of the above facts, these may be regarded as potential open-market transactions.

Build-to-suit rents, sales of properties with a build-to-suit lease, sale-leasebacks, and private sales should not be automatically dismissed. Unless there is evidence to the contrary that is inconsistent with the applicable market value definition, these types of sale transactions may be used as comparable sales if they are arm's-length and verified to be reflective of market rent and price.

#### ***a. Build-to-Suit***

To illustrate a market-driven transaction in a build-to-suit arrangement, consider the following. ABC Retail wishes to enter a new market location as part of its overall plans for expansion. ABC Retail is a creditworthy, regional player in its retail segment and has been making strides to expand nationwide. ABC Retail makes a business decision that the best way for it to continue a steady expansion is to not finance the new development with its own capital, for which it has sufficient funds available, and to forgo traditional lender financing.

ABC Retail sends invitations to bid to various developers and negotiates with Developer Jones to purchase the land and build the improvements as ABC Retail specifies, and on completion ABC Retail will lease the property from Developer Jones. Developer Jones obtains mortgage financing for the development. The lease rate is based on a negotiated rate to cover all of Developer Jones's soft and hard costs for the development (return of capital) and to provide Developer Jones with a profit margin (return on capital).

On the reverse side, ABC Retail knows its cost of capital for mortgage financing if it owned the subject. ABC Retail also knows its cost of capital for financing the purchase of personal property and inventory. It also has calculated expected sales at the new location and the associated costs of owning the subject rather than leasing it. In the negotiation of the lease rate, it too has

negotiated a rent that, when amortized over the life of the lease term, will be comparable to its cost of capital through other financing mechanisms.

ABC Retail and Developer Jones are not related. Both are knowledgeable, sophisticated parties. Neither party is forced into this arrangement. Both parties act in their own self-interest. Either party can walk away if the arrangement is not mutually beneficial. Developer Jones will not undertake a project that it does not think will be profitable. ABC Retail will not use Developer Jones if it cannot get what it needs for no more than its costs of capital from another developer or other sources. This build-to-suit arrangement, when both parties agree that the rental reflects market rent, is potentially an open-market transaction and may be used as a comparable rental.

### ***b. Sale-Leasebacks***

Now consider the same facts as above but in a sale-leaseback context. ABC Retail finances the project with its own capital or by mortgage financing because it allows for faster development than a build-to-suit plan. While the project is in development, ABC Retail markets the property on the triple-net lease market through a broker and negotiates with NNN Investments to purchase the subject from ABC Retail on completion and to lease the subject back from NNN Investments. Subject to verification, the purchase price and the rental rate are usually set at market, as agreed to by the parties.

ABC Retail and NNN Investments are not related parties. ABC Retail and NNN Investments are fully knowledgeable, sophisticated parties who negotiate an agreement that meets NNN Investments' required return on its purchase price, and ABC Retail has negotiated an agreement with NNN Investments for a market rental rate. ABC Retail is not paying more or less than what it would pay in rent through a direct lease with a developer. NNN Investments is not engaged in usury nor has it colluded with ABC Retail so that ABC Retail receives more benefit than it would have received by any other store development arrangement.

It is essential that each sale is verified to ensure it meets the necessary requirements of an arm's-length transaction between a willing buyer and a willing seller. Any sale that is not a valid market transaction should be disqualified. Especially in the case of sale-leaseback transactions, the appraiser should verify the sales, rather than simply rely on information provided by data services. It is important to determine whether the circumstances meet the market value criteria that would allow the transaction to be used in a sales comparison approach. If the sale is verified and qualified as arm's-length, additional consideration should then be given to the sale to determine whether it is reflective of market.

### ***c. Private Sales***

Now consider both scenarios in which Developer Jones or NNN Investments puts the property on the market and sells it to Retirement Fund subject to ABC Retail's leasehold. The transaction is not between related parties. All parties are knowledgeable and acting in their own self-interest and without duress. ABC Retail's prior business relationships with Developer Jones or NNN Investments are not relevant. This transaction is not a build-to-suit or a sale-leaseback transaction. This is an open-market transaction.

Given the uniqueness, size, and location of the property, the broker knows that there is a specific group of market participants who would be interested and financially capable. One in this group buys the property. This may be termed a private sale, but it is a valid market transaction. None of the parties are related; no one was under duress; and all parties acted in their own self-interest. The broker used segmentation marketing to target the most likely buyers. This is an arm's-length transaction.

#### **4. Market Segmentation**

In general, big-box properties are configured as single-tenant properties that may be modified to accommodate a variety of users. While it is ideal to narrow the property's highest and best use and those of the comparable sales as much as possible, care must be taken not to identify a specific user, because this may be interpreted as a value-in-use. Characteristics such as size, age, condition of the property, access, traffic counts, proximity to major employment centers, the concentration cluster of surrounding properties, and population size are among factors that influence a big-box retail property's competitive position in the market. These determinants contribute to establishing the appropriate trade area and also the suitable comparisons to use in the sales comparison approach. As such, differentiating the subject property and comparable properties into segments such as investment classes or retail types creates a logical hierarchy.

The proper selection of comparable sales is essential for the sales comparison approach to reach a reliable conclusion of value. Narrowing the highest and best use of the comparables assists an appraiser in identifying those properties most similar to the subject. Once the highest and best use of the subject and potential sales are determined, they may be classified into one of the investment classes (A, B, C, or D as described earlier) and/or segmented by type, such as home improvement, discount department store, and so forth. Segmenting sales properties into investment classes ensures that similar properties are being used as comparisons to the subject property, ideally with first generation compared to first generation and so on. With regard to vacant properties being used as comparisons with occupied properties, until vacant properties have tenants in-place, it is somewhat uncertain what investment class is appropriate or what adjustment would be required for the speculative lease-up period. Unless the property leases up quickly and this information is available, similar properties should be used in trying to measure market prices and investment classes.

#### **5. Deed-Restricted Comparable Sales**

Deed restriction is defined by *The Dictionary of Real Estate Appraisal* as follows:

*A provision written into a deed that limits the use of land. Deed restrictions usually remain in effect when title passes to subsequent owners. (Appraisal Institute 2015, 6)*

If the subject property does not have a deed restriction, comparable sales with such deed restrictions should not be used as comparisons to the subject. It is difficult, if not impossible, to quantify an adjustment that accurately captures the number of prospective buyers who turned



away from a property that sold with a deed restriction. By design, deed restrictions are imposed to limit competition by forcing a change in that property's originally intended highest and best use, rendering the sale unsuitable as a comparable substitute for the subject property.

The following excerpt was taken from a deed restriction on a big-box property and serves as an example of the types of limitations that may be imposed:

This conveyance is expressly subject to the following conditions and restrictions:

- (a) The Property will not be used for or in support of the following: (i) a grocery store or supermarket, as hereinafter defined below; (ii) a wholesale club operation similar to that of a (*retailers intentionally omitted*); (iii) a discount department store or other discount store, as hereinafter defined; (iv) a pharmacy (the "Property Restrictions"). "Grocery store" and "supermarket," as those terms are used herein, shall mean a food store or a food department containing more than thirty-five thousand (35,000) square feet of gross leasable area, for the purpose of selling food for consumption off the premises, which shall include but not be limited to the sale of dry, refrigerated or frozen groceries, meat, seafood, poultry, produce, delicatessen or bakery products, refrigerated or frozen dairy products, or any grocery products normally sold in such stores or departments. "Discount department store" and/or "discount store," as those terms are used herein, shall mean a discount department store or discount store containing more than fifty thousand (50,000) square feet of gross leasable area, for the purpose of selling a full line of hard goods and soft goods (e.g., clothing cards, gifts, electronics, garden supplies, furniture, lawnmowers, toys, health and beauty aids, hardware items, bath accessories and auto accessories) at a discount in a retail operation similar to that of (*retailer intentionally omitted*) or any parent company, affiliate subsidiary, or related company.
- (b) The property Restrictions shall remain in effect for a period of twenty (20) years from the recording of this deed. The aforesaid Property Restrictions shall run with and bind the Property, and shall inure to the benefit of and be enforceable by Grantor, or its successors and assigns, by any appropriate proceedings at law or in equity to prevent violations of such aforesaid Property restrictions or to recover damages for such violations.

### **C. Income Capitalization Approach**

In the income comparison approach, market value is defined as the present worth of future benefits arising from the ownership of the property. This definition reflects the Principle of Anticipation. Income-producing real property typically is purchased for the right to receive the future income stream of the property. The assessor analyzes this income stream in terms of

quantity, quality, and duration and then converts it by means of an appropriate capitalization rate into an indication of market value (Thimgan 2010).

Big-box properties are mostly owner-occupied by retailers, but often these properties are owned by investors and occupied by the retailers under a long-term lease. Thus, the use of the income capitalization approach to value can be utilized with empirical evidence supporting market rent estimates and overall capitalization rates. The income capitalization approach emulates market behavior from the perspective of investors, particularly of big-box, net-leased sale transactions. Investors buy a property for the income stream, and they understand that there is a direct relationship between income characteristics and property value.

### **1. Strengths of the Income Capitalization Approach**

Big-box properties are often leased. Thus, it is likely that the fee simple owner of the real estate is interested in the income stream of the property and consequently looks to an income approach to determine the value of the property. There are a few parameters to consider for a single-tenant, triple-net-leased, big-box property. Typically an appraiser ascribes market rent, nominal vacancy, a small amount for management and miscellaneous expenses, and a market-supported capitalization rate in order to derive an estimate of market value.

### **2. Weaknesses of the Income Capitalization Approach**

A major concern with the income capitalization approach is the selection of an appropriate capitalization rate. While estimating the income and the projected operating expenses may be challenging, any slight error in either estimate is magnified on capitalization.

### **3. Yield Capitalization versus Direct Capitalization**

A criticism of this approach, in jurisdictions in which market rent is the underlying valuation requirement, is that it incorporates speculative modeling criteria and is rarely used by market participants in the sale and purchase of big-box properties. Also, courts are often skeptical about the reliability of yield capitalization. Direct capitalization, on the other hand, uses the relationship of one year's net income, usually the first year of ownership, to determine a value. This method is preferred by buyers and sellers of big-box properties and is often quoted on broker marketing flyers and emails. This is the method generally accepted by appraisers and generally receives greater acceptance in courts. For mass appraisal, direct capitalization is used because it is simpler and less speculative and has more market evidence.

### **4. Direct Capitalization Methodology**

#### ***a. Identification of Lease Comparable Properties***

The first step in the direct capitalization approach is to determine market rent:

*[T]he most probable rent that a property should bring in a competitive and open market reflecting the conditions and restrictions of a specified lease*

*agreement, including rental adjustments and revaluation, permitted uses, use restrictions, expense obligations, term, concessions, renewal and purchase options, and tenant improvements (TIs) (Appraisal Institute 2015, 140).*

Market rent is the essential basis of fee simple valuations:

*Market rent is the rental income a property would command in the open market. It is indicated by the current rents that are either paid or asked for comparable space with the same division of expenses as of the date of the appraisal ... .*

*Rent for vacant or owner occupied space is usually estimated at market rent levels and distinguished from contract rent in the income analysis. In fee simple valuations, all rentable space is estimated at market rent levels. (Appraisal Institute 2015, 447)*

For a fully occupied, well-maintained, functional big-box property, recent comparable rents for first-generation space (investment classes A and B) should be used:

*First-generation space—a building or space designed to be functionally and economically efficient for the original tenant or a similar class of tenants over a period of time during which the space retains its original utility and desirability (Appraisal Institute 2015, 210).*

Investment classes C and D improvements are losing or have lost their appeal to first-generation users and may be suitable only to second-generation users. Recent comparable rentals of these types of properties are appropriate for consideration of market rent estimates for properties that are no longer prime investments or are nearing the end of their useful lives for their intended use and utility when built.

*The Dictionary of Real Estate Appraisal* defines second-generation space as follows:

*Second-generation space—a building or space used by a tenant other than the original tenant; often functionally obsolete before refurbishment but sometimes containing tenant improvements that can be reused by a new tenant (Appraisal Institute 2015, 210).*

We propose the following alternative definition, which is consistent with the concepts underlying the definition of first-generation space shown above and is a more accurate depiction of second-generation space:

*Second-generation space—a building or space whose design is no longer functionally and/or economically desirable for the original tenant or a similar class of tenants. The space may no longer retain its original utility and/or desirability for the original tenant but may be used by a tenant other than the original or similar class of tenant.*

### ***b. Vacancy and Collection Loss***

Vacancy is typically determined by examination of the market. However, in the case of national credit, single-tenant, big-box retailers, the likelihood of incurring any vacancy or collection loss during the term of the lease is highly improbable. Nonetheless, a vacancy and collection loss, even if negligible, may be justified for future uncertainty.

### ***c. Operating Expenses***

In big-box retail, the lease structure generally is triple net or absolute net, so expenses to the owner are nominal. In the triple-net lease, the owner may be responsible only for structural repairs and a management fee. Because a big-box property is occupied by a single tenant, management involvement is minimal.

### ***d. Capitalization Rates***

Data extracted directly from market transactions may be the most reliable source for capitalization rates. However, when sales transactions and such data are scarce, additional examination should be given to investor surveys. Some surveys reflect investor expectations, not actual market transactions, and it is essential to understand the range indicated in investor surveys rather than simply relying on the average. Investor surveys cast a wide net and may not be market-specific, so care should be taken in considering what the surveys actually measure. The average will likely be higher than the capitalization rate for investment classes A and B big-box properties and lower than the capitalization rate for investment classes C and D big-box properties. The band-of-investment technique may also be used to determine overall capitalization rates using criteria that factor in current debt and equity parameters.

## **X. RECONCILIATION**

In estimating a value for the subject property, the appraiser must consider and resolve multiple value indications produced by the three approaches to value. The reconciliation can also serve as a test of reasonableness in support of one approach over another or as additional support for an indication of value arrived through any of the approaches used.

The cost approach is useful when there is a scarcity of comparable sales in the market and another approach is needed to develop a well-founded valuation. The cost to acquire land and construct improvements is a fundamental financial feasibility analysis that big-box investors perform to assess the economic viability of new big-box construction, so this approach directly replicates investor behavior.

The cost approach also serves as a reliable indication of value, particularly for investment classes A and B properties that are new or well-maintained and for which depreciation is minimal. A supportable land valuation may also provide valuation support to investment classes C and D properties that are approaching the end of their economic lives. A well-founded estimate of land

value assists the appraiser in determining when a property is approaching or has reached the end of its economic life, as class D properties are often interim uses or potential redevelopment sites.

The sales comparison approach provides strong support when there are ample data with suitable substitute properties, but it is less reliable when true comparables are not available. Again, investment class identification for the subject property and stratification of potential sales will reveal which comparable properties are most appropriate comparisons for the subject property and whether the search may be broadened to identify other similar class properties for use in this analysis.

The income capitalization approach is a method used by investors to convert income into value, but this approach is dependable only when the data obtainable are comparable to the property being appraised. Investment classes A and B properties generally have the highest rents and lowest capitalization rates. By grouping the properties into investment classifications, the appraiser will be able to identify the appropriate estimate of market rent and market-supported capitalization rates to use for the subject property.

It is difficult to address all these big-box retail valuation issues in one approach to value; developing all three approaches reinforces one another. Each approach to value has its strengths and its weaknesses. Strengths are magnified when more approaches are applied, and weaknesses are amplified when approaches are eliminated.

When all three methodologies are used, they enhance the credibility of an equitable big-box retail property assessment. When using more than one approach to value, the appraiser should reexamine the entire appraisal, especially for accuracy, relevance, and market support of all of the data in each approach, and reconcile the differences in the value conclusion between the approaches. The final step is to exercise judgment in determining the approach or approaches to rely on for a final conclusion of value.

## **XI. CONCLUSION**

Recent controversy and litigation surrounding big-box valuation claims that assessments are not equitable have prompted a need for this position paper. This paper provides guidance with using appraisal methodologies to derive the appropriate value required by the jurisdiction for big-box retail stores' assessments. A myriad of issues are involved in the valuation and defense of big-box retail, and it is recommended that an appraiser develop all three approaches to value when determining a property's market value.

The appraiser may ultimately discard or give no or little weight to a particular approach if a jurisdiction has specific requirements for methodologies to consider, disqualify, or rely on. Otherwise, it is important to employ all appraisal valuation approaches that will lead to credible conclusions.

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