Who's Afraid of the Big, Bad Cost Approach?

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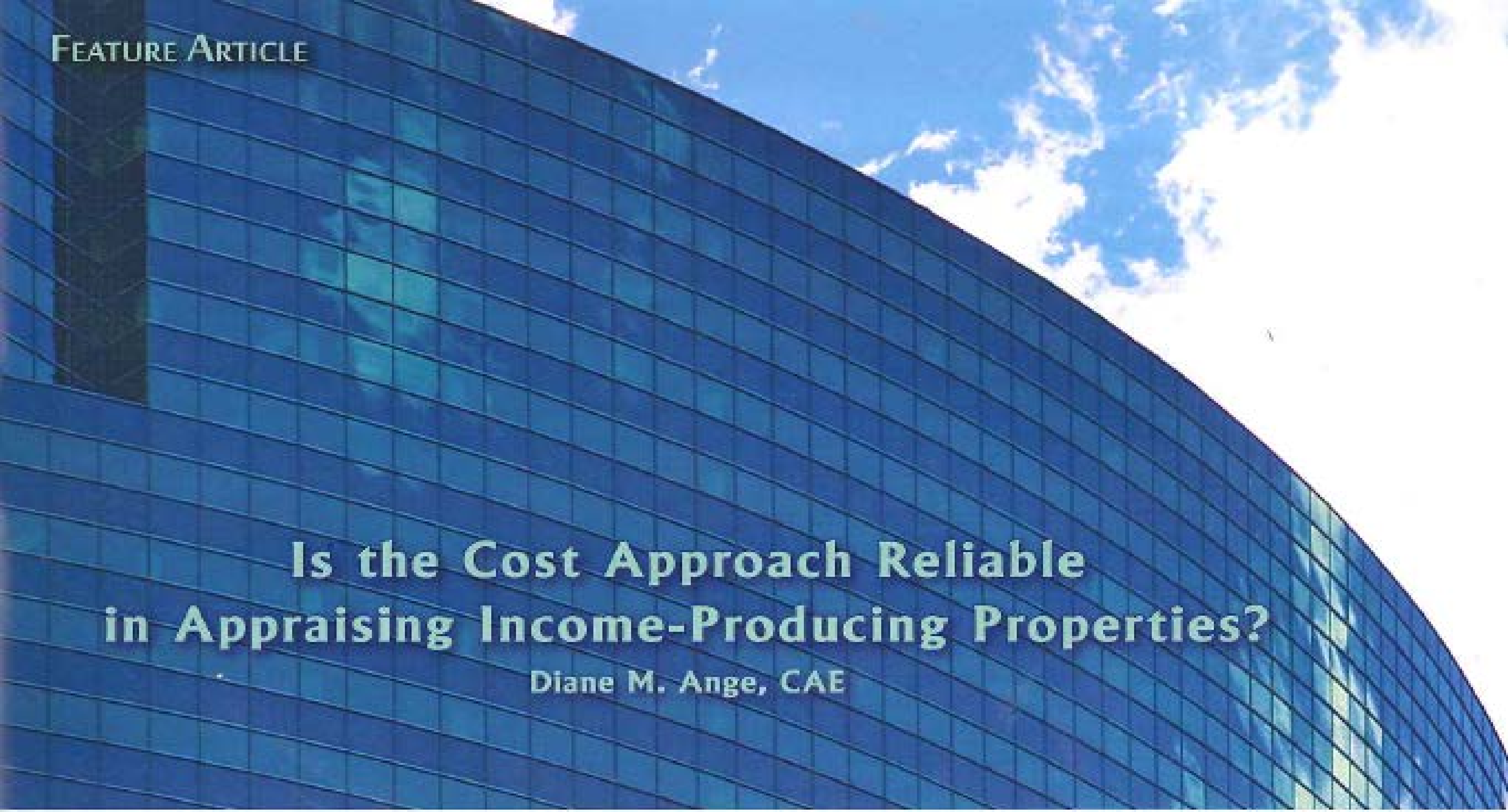
Cost Approach? Eww!!



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Reasons for the Cost Approach's Bad Reputation:

- Poor job of measuring physical depreciation.
- Poor job of measuring obsolescence.
- Not considered by market participants.

Distinguishing Ad Valorem Tax Appraisals from other Appraisal Assignments (It's a Different Animal!)

Other Appraisal Assignments

- Leased Fee interest
- Going concern value
- Use value
- Liquidation value

The above appraisal scenarios are not a good fit for the cost approach.

Property Taxation in Most States:

Fair market value of the fee simple interest

First Reason for the Cost Approach's Bad Reputation:

- Poor job of measuring physical depreciation.

Cost Approach and Physical Depreciation

- Physical depreciation – "…wear and tear from regular use, the impact of elements, or damage… ." - The Appraisal of Real Estate, 14th Edition, page 576

- Typical physical depreciation is well estimated via age-life, Marshall Valuation, etc.

- However, most commercial properties are well-maintained.

What about Atypical Physical Depreciation?

- Will income approach or sales comparison approach really do a better job?
- What is the likelihood of finding income or sales comparison comparables with the same attributes as the subject property and the same unique physical depreciation issues?
- Is income from subject affected by below or above market leases/poor management, etc.

Second Reason for the Cost Approach's Bad Reputation

- Poor job of measuring functional and external obsolescence.

Cost Approach and Functional Obsolescence

"Functional Obsolescence is caused by a flaw in the structure, materials, or design of an improvement when the improvement is compared with the highest and best use and most cost-effective functional design requirements at the time of the appraisal." The Appraisal of Real Estate, 14^{th} Edition, page 623.

Cost Approach and Functional Obsolescence

- Cost to cure (if curable)
- Subtract depreciated cost of item (if incurable)
- Remember, if a replacement cost is used (as opposed to a reproduction cost) then any *superadequacy* issues are already accounted for.

Income Approach and Functional Obsolescence

- Does the income approach do a better job?
- Perhaps, but…
- Subject property's income – Also affected by long-term lease, bad management, lack of stabilization?
- Rent comps – What is the likelihood the comparables also suffer from the same functional obsolescence?

Sales Comparison and Functional Obsolescence

- Does the sales comparison approach do a better job?

- What is the likelihood the comparables also suffer from the same functional obsolescence?

- What other adjustments must be made for physical, locational, legal and other dissimilarities? (How many and how much?)

Cost Approach and External Obsolescence

- Definition – loss in value by negative externalities
- Market obsolescence – the industry is suffering
- Locational obsolescence – property is in a poor location
- Same issues as with functional obsolescence with regard to income and sales comparables.

Using market extraction (sales or income) within the cost approach to measure obsolescence

Eurofresh, Inc. v. Graham County

- Subject – 168 acre hydroponic greenhouse
- Fully functioning and operational
- Property owner claimed 40% obsolescence
- Comparables – 3 other greenhouses
  (2 not in operation at time of sale.)
  (All three sold by lender out of foreclosure.)

Eurofresh, Inc. v. Graham County

- "It's not sufficient…to simply assert that a property's value should be reduced because of external obsolescence observed elsewhere. Particularly, when, as here, a taxpayer calculates obsolescence based on other 'comparable' properties, the taxpayer must prove that the subject property actually is affected by the obsolescence seen in other properties."

Menard, Inc. v. County of Clay

- Menard big box home improvement store

- "We reject Mr. MaRous' attempt to justify his high total obsolescence by applying the market extraction method to his two sales comparables. ...If a big box retailer has recently sold a store, why did it do so? ...Indeed, a developer quoted by MaRous commented, 'If there's a big box sitting empty, it's probably not a prime location.'"

Third Reason for the Cost Approach's Bad Reputation

- Not used by market participants.

Cost Approach as a Measure of Market Thinking

- An appraiser should use the approach used by market participants in determining value.
- But, do market participants really base their decisions on the fair market value of the fee simple interest in the property?
- Usually, they are buying the leased fee or going concern.

Cost Approach as a Measure of Market Thinking

"The cost approach reflects market thinking because market participants relate value to cost. Buyers of real property tend to judge the value of an existing structure not only be considering the prices and rents of similar buildings, but also by comparing the cost of create a new building with optimal physical condition and functional utility. Moreover, buyers adjust the prices they are willing to pay by estimating the cost to bring an existing structure up to the physical condition and functional utility they need."

The Appraisal of Real Estate, 14th Edition, page 561

Cost Approach as a Measure of Market Thinking

"The principle of substitution is basic to the cost approach. This principle affirms that a knowledgeable buyer would pay no more for a property than the cost to acquire a similar site and construct improvements of equivalent desirability and utility without undue delay. In the cost approach, existing properties can be seen as substitutes for the property being appraised, and their value is also measured relative to the value of a new, optimal property. In short, the cost of property improvements on the effective date of the appraisal plus the accompanying land value provides a measure against which prices for similar improved properties may be judged." The appraisal of Real Estate, 14th Edition, page 563-564.

Cost Approach as a Measure of Market Thinking

"The cost approach may be used to develop an opinion of market value… of… special purpose or specialty properties, and other properties that are not frequently exchanged in the market. Buyers of these properties often measure the price they will pay for an existing building against the cost to build less depreciation or against the cost to purchase an existing structure and make any necessary modifications."
The Appraisal of Real Estate, 14th Edition, page 566.

Advantages of the Cost Approach

- New properties
- Older but-well-maintained properties
- Special purpose properties
- Owner-occupied properties
- Properties with an absence of market data

Comparison of Cost Approach to Sales Comparison and Income Approaches

- Valuing the fee simple interest.

  Eliminates the criticism that the appraiser is valuing something other that the fee simple interest. (Business/franchise/intangible value or leased-fee interest.)

- Adjustments necessary under cost approach as compared to income or sales comparison approaches.

Comparison of Cost Approach to Sales Comparison and Income Approaches

"The accuracy of an appraisal is determined by the quality of the data and the reasonableness of the adjustments made to each comparable property analyzed. For example, how reliable is the data supporting depreciation and cost estimates, estimates of income and expenses, and the selected capitalization rate?"
The Appraisal of Real Estate, 14th Edition, page 645.

Comparison of Cost Approach to Sales Comparison and Income Approaches

"The number of comparable properties, the number of adjustments, and the magnitude of the gross and net dollar amounts of adjustments may suggest the relative accuracy of a particular approach."

The Appraisal of Real Estate, 14^{th} Edition, page 645.

Comparison of Cost Approach to Sales Comparison and Income Approaches

"When the physical characteristics of comparable properties differ significantly, the relative values of these characteristics can sometimes be identified more precisely with the cost approach."

The Appraisal of Real Estate, 14th Edition, page 566.

WHY? WHY? WHY?
Sales Comparison Approach and Retail Properties

- Owner’s Appraisal: Second generation uses and dark stores as comparables.
- Government’s Appraisal: Leased-fee sales; sale-leaseback sales.
- Guess what? – the court’s don’t like either one!
- There is no fee simple market for these properties at the same HBU
- Leads to erratic and illogical decisions

List of Adjustments Necessary Under the Sales Comparison Approach

- Location
- Physical features
- Atypical financing
- Sale date (market adjustment)
- Age
- Inclusion of tangible personal property
- Leasehold-interest (non-market rents)
- Business/intangible/franchise value/goodwill
- Highest and best use compatibility
- Arms-length transaction
- Distressed sale
- Sale-leaseback
- Expenditures immediately after sale

List of Adjustments Necessary Under the Income Approach

- **Location**
- **Physical features**
- **Age**
- **Non-market rents**
- **Unstabilized income**
- **Non-market expenses**
- **Bad management**
- **Business/intangible/franchise value/goodwill**
- **Income derived from tangible personal property**
- **Cap rate determination**

COST APPROACH COURT CASES

Daniel v. Canterbury Towers, Inc., 462 So. 2d 497 (Fla. 2d DCA 1984); Havill v. Lake Port Properties, Inc., 729 So. 2d 467 (Fla. 5th DCA 1999)

Life care facilities with entrance fees and monthly charges was a special purpose property with a convoluted income stream properly valued by the cost approach.

Calder Race Course, Inc. v. Overstreet, 363 So. 2d 631 (Fla. 3d DCA 1978)

Cost approach approved to value race course, as opposed to income approach, where value of intangible pari-mutuel license would be difficult to extract.

Town of Bay Harbor Island v. Lancelot Assoc., 243 So. 2d 437 (Fla. 3d DCA 1971)

Cost approach approved to value newer apartment building, where income stream did not exist for a sufficient amount of time.

COST APPROACH COURT CASES

Nordstrom, Inc. v. Maricopa County, 88 P.3d 1165 (Ar. Ct. App. 2004)

Fair market value of an anchor tenant (a Nordstrom's department store) in a mall. Court rejected the income approach as a valid approach, noting that income was not the landlord's goal in building the anchor store. Court also rejected the sales comparison approach because anchor tenant properties are not frequently exchanged on the market and determined the cost approach was the best approach.

Wellmark, Inc. v. Polk County Bd. of Review, 875 N.W. 2d 667 (Ia. 2016)

600,000 sq. ft. single tenant corporate headquarters w/ LEED certification

"What happens when we try to value a distinctive but not unique property that has a limited market but there are no reliable comparable sales upon which to base a market value?"

"Based on our de novo review of the record, we conclude that the cost approach provides the best mechanism for determining market value."

COST APPROACH COURT CASES

HD Salem OR Landlord LLC v. Marion County Assessor, 2012 Ore. Tax LEXIS 349
Home Depot "mega distribution center" of new construction and subject to a recent lease. Court held cost approach was best methodology.

Best Foods v. Englewood Cliffs Borough, 19 N.J. Tax 266 (2001)
Corporate headquarters consisting of 4 connected buildings comprising 265,000 square feet and built 30 years prior to assessment date and suffering from functional obsolescence and containing asbestos. Court held cost approach was best methodology.

Redding Life Care, LLC v. Town of Redding, 2011 Conn. Lexis 433 (Conn. Super. Ct. Feb.23, 2011)aff'd 61A.3d 461 (Conn.2012)
Court rejects use of going concern income analysis and adjusting for non-realty for continuing care retirement community (CCRC). Court dismissed that logic because the buyer of a CCRC is buying the business, but the city property appraiser is valuing the real estate only, and cost is relevant in that scenario.

"As previously noted above, Boehm rejected the use of the cost approach and the plaintiff maintains… that 'buyers and seller rely exclusively on the income approach to establish fair market value'…Boehm's rejection of the cost approach is based on his reasoning that a purchaser of the CCRC would consider only the going concern value. This is contrary to what the assessor seeks to do determining the value of the real estate for the purpose of taxation, not the value of the CCRC as a business.

COST APPROACH COURT CASES

Valley River Center v. Dept. of Revenue, 6 OTR 368 (Ore. Tax Ct. 1976)
"While the income approach is theoretically very appealing, a convincing presentation of testimony in its support is fraught with difficulty. The two components of the income approach, the expected income stream and the capitalization rate, must be separately scrutinized. Both factors can be easily manipulated by the parties involved. Slight variations of a percent or two may result in huge swings in the final result. …The first factor, the expected income, is certainly a difficult figure to arrive at under any circumstances. …The second component to the income approach is the capitalization rate to be used by the appraiser. Even a slight variation in the capitalization rate can radically affect the ultimate outcome in a given case." (Hotel case.)

Sahalee Country Club, Inc. v. State of Washington Bd. of Tax Appeals 735 P. 2d 1320 (Wa. 1987)
Cost approach was appropriate methodology to value country club, not income approach, as property not designed as a profit-making venture and country clubs are special purpose properties.

Lewis v. Cnty of Hennepin, 623 N.W. 2d 258 (Minn. 2001)
Cost approach value used to determine value of luxury home.

Eurofresh, Inc. v. Graham County, 187 P. 3d 530 (App. 2007)

COST APPROACH COURT CASES

Menard, Inc. v. City of Escanaba, 2016 Mich. App. LEXIS 1090 (Mi. App. 2016)

166,000 sq. ft. "big box" home improvement store. Property owner's appraiser used sale comparison approach using dark stores containing deed restrictions on retail use.

"The tribunal rejected the cost-less-depreciation approach advanced by Escanaba. However, because the deed restrictions imposed by other big-box store owners drastically limited the actual market for such properties, it is appropriate to look at the cost-less-depreciation approach."

"The tribunal committed an error of law requiring reversal when it rejected the cost-less-depreciation approach and adopted a sales-comparison approach that failed to fully account for the effect on the market of the deed restrictions in those comparables."

CVS Corporation v. Turner

13th Judicial Circuit – Hillsborough County Florida
Final Judgment – July 3, 2013

- "The Court finds that the cost approach is a logical appraisal method to apply to the currently operating stores. As noted, the properties suffer little in the way of physical depreciation, functional obsolescence or external obsolescence. That, according to *The Appraisal of Real Estate* 13th Edition, makes them a prime candidate for the cost approach."
- "...Finally, the cost approach completely avoids one of CVS; primary concerns, the influence of the existing lease upon any sale of the property."

The End

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