

Valuation of Leased Fee Interests

Martin A. Skolnik, MAI
Manager, Property Tax
KPMG Peat Marwick
Baltimore, Maryland

Copyright © 1994 by Martin A. Skolnik

There is an bundle of rights inherent in the ownership of real property. The ownership of the complete bundle, or fee simple ownership (unencumbered), represents maximum value to the owner. Historically fee simple or absolute ownership meant from the center of the earth, through the earth's surface, and upward to infinity. Thus, from a theoretical standpoint, it can be said that real estate owned absolutely is in the form of an inverted pyramid. (Eaton 1987, 27) This absolute ownership is limited in practical application, however, by the government's inherent rights, constitutional provisions, and legislative actions. (Eaton 1987, 28) These governmental rights include the power of eminent domain, police power (zoning), taxation, and escheat, all of which limit property rights.

Ownership rights inherent in real estate include the right to use real estate, to sell it, to lease it, to enter it, to give it away, or to choose to exercise all or none of these rights. (Appraisal Institute [AI] 1992, 6) As mentioned, full ownership of these rights results in maximum value to the property. If one of these rights is exercised, say the right to lease all or part of the property, the value could be diminished.

In valuing property, whether for ad valorem taxes, for example, or for mortgage financing, it is important that the appraiser-assessor-analyst identify the ownership interest being valued and to choose the valuation method or methods most appropriate to that ownership interest. For example, a property held in fee simple is, by definition, not being leased. As such, an Income Approach is not necessarily an appropriate valuation technique for that type of property. In addition, the valuation of a property held subject to leases, or leased fee, should exclude a Cost Approach unless an adjustment is made to distinguish between the actual income from the leases versus current market rent terms.

• Definitions of Market Value

The basis for property taxation in this country is generally some form of "market value." The definition of market value will vary more or less state by state but there should be similarities among all the states.

For example, in Washington State, the basis of all assessments is the "true and fair value of property." True and fair means market value. (*Spokane etc. R. Company v. Spokane*, 75

Wash. 72 (1913); *Mason County Overtaxed, Inc. v. Mason County*, 62 Wn. (2nd) (1963).) Market value is the amount of money a buyer willing but not obligated to buy would pay for it to a seller willing but not obliged to sell. In arriving at a determination of such value, the assessing officer can consider only those factors which can within reason be said to affect the price in negotiations between a willing purchaser and a willing seller, and he must consider all of such factors. (AGO 65-66, State of Washington, No. 65, December 31, 1965.)

A coast away in Maryland, value is defined as "the full cash value of property." (*Maryland Annotated Code*. 1990. Tax-Property Article, Section 1-101(11)) The courts have held that the market value of a property is the value a willing purchaser will pay for it to a willing seller in open market, eliminating exceptional and extraordinary conditions giving the property temporarily abnormal value. Ordinarily, the full cash value is market value. (*St. Leonard Shores J. V. vs Supervisor of Assessments*. 307 Md. 441. 1986)

These are but two examples of state's similar, yet different, definitions of market value. Similarly worded definitions can be found in most, if not all, of the states.

In general, each state's property tax assessments are based on a variation of the "willing buyer, willing seller concept." However, how that is applied within each state or county varies significantly across the country. In the mid-Atlantic region alone there are significant variations between jurisdictions.

For example, in Maryland, the assessor is required to consider the leases of a property in his/her valuation of income-producing property. This, in essence, yields the valuation of the leased fee interest in the property.

In the District of Columbia, on the other hand, the leases at the property carry very little weight. The assessor is more concerned with economic rent than actual rents.

In Virginia, there is a mixed bag. In parts of Northern Virginia, the actual leases will be considered, but they will usually not consider a discounted cash flow analysis as the basis of value. In much of the rest of the state, a cash flow and the actual leases can be discussed.

Local practice and custom will usually be the final determinant as to which methodologies are accepted by the assessment office or appeals boards. However, in general to estimate the market value of a leased income-producing property, the assessor and the property owner cannot ignore leased fee value as being most representative of what a willing and knowledgeable buyer will pay for the real estate.

Unless specifically defined contrary, strict interpretations of statutory and judicial definitions of market value require that market value (or full cash value or fair market value, or true market value, and the like) be represented by the leased fee value.

- **Definitions of the Leased Fee, Fee Simple, and Leasehold Estates**

A *lease* is a written document in which the rights to use and occupy land or structures are transferred by the owner to another entity for a specified period of time in return for a specified rent. Although a lease can be written to fit the requirements of any negotiated agreement, most leases fall into one of several broad classifications: flat rental, graduated rental, revaluation, index, and percentage. Leases may be applied on a gross rental basis (with the lessor paying all the operating expenses of the real estate), or on a net rental basis (with the tenant paying all expenses). Frequently, lease terms fall within these two extremes with a division of expenses between the lessor (landlord) and lessee (tenant). ([AI] 1992)

As discussed above, *fee simple estate* is the absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat (the power to acquire the property upon the death of the owner if no heirs are identified). ([AI] 1992)

A *leased fee estate* is the lessor's or landlord's estate. A leased fee estate is an ownership interest held by a landlord with the right of use and occupancy conveyed by lease to others; the rights of lessor and leased fee are specified by contract terms contained within the lease. The value of the leased fee estate is the present worth of a contractual net income stream and the present worth of the future rights in the property that are scheduled to revert back to the lessor at the expiration of the lease. ([AI] 1992)

The *leasehold estate* is the lessee's, or tenant's, estate. A leasehold estate is the right to use and occupy real estate for a stated term under the conditions conveyed in the lease. The value of the leasehold estate may be estimated as the present worth of the benefits of the leasehold estate. ([AI] 1992)

A *sandwich lease* is a lease in which an intermediate, or "sandwich" leaseholder is the lessee of one party and the lessor of another. ([AI] 1992)

- **Valuation Methodologies for Each of the Ownership Positions**

Leased Fee Estate

A leased fee estate means that the owner of the property is leasing all or part of the property to one or more tenants. The owner can still sell the property, but the leases' terms and conditions are binding on the new owner.

There are two primary methodologies which are most applicable to the valuation of a leased fee property -- the Income Approach and the Sales Comparison Approach. The third approach, the Cost Approach, is only considered a secondary valuation technique for a leased property.

Income Approach

The income which the owner receives from tenants depends on the terms of the lease(s). The three most important considerations are a) rent, b) expense reimbursements or pass-throughs, and c) length of lease. When placed on the market for sale, the price which the seller receives is dependent upon the lease terms under the umbrella of the *Principle of Anticipation* which states that market value is the present worth of all future benefits expected by market participants. (Eckert 1990, 88) This is the basis for the Income Approach to value.

It is the receipt of this anticipated net income which motivates buyers and sets sales prices. This anticipated net income is the quantification of future benefits. These future benefits are sometimes classified as the return on the investment and the return of the investment.

As mentioned, the Income Approach is concerned with understanding and quantifying the present worth of the future benefits which the ownership of a property would anticipate. These future benefits can be quantified using one of two valuation techniques -- *direct capitalization* and/or a *discounted cash flow analysis*.

It is the job of the appraiser-assessor to quantify the market's expectations of ownership for the return on and the return of the initial investment (i.e., sales price) using the direct capitalization and/or the discounted cash flow techniques.

Each of these two techniques, direct capitalization and discounted cash flow analysis, begins with the need to understand the nature of the leases in place at the subject property because the analyst must be aware of the legal and economic constraints and requirements on both the owner-landlord and the tenant(s) to determine the future benefits of owning the subject property.

For an income-producing property, the future benefits are generally considered as the annual net income from the operation of the property (before income taxes, debt and depreciation) as well as the potential sale of the property at some point in the future.

Annual net income is calculated by the subtraction of operating expenses (i.e., real estate taxes, insurance, utilities, management, repairs and maintenance, structural repairs or reserves, parking lot repairs, roof replacement, leasing commissions, tenant improvements, etc.) from gross income (rent, vending machine income, expense reimbursement income, an allowance for vacancy and/or collection losses, etc.).

The potential future sale of the property, called the reversion or reversionary value, is the quantification of the lump-sum cash flow which the owner receives in the future when the

property is sold. In practice, it does not matter if the owner sells the property at that point in the future or not. The reversion value is the mathematical quantification of the receipt of the annual net income stream into perpetuity. The reversion value is calculated similarly to the direct capitalization methodology which follows. The financial theory behind this is that a single capitalization rate which contains a blend of return on and return of the investment is applied to stabilized net operating income to yield a value representing all the future income accruing to the property's ownership.

In direct capitalization, there is no specific quantification of the return on and the return of the investment. A single rate, a capitalization rate, is applied to net operating income to yield the expected valuation from that net income.

Capitalization rates must be derived from market information. This market information can be sales of similar properties, from investor surveys and from published sources, and from competing alternative investments. In addition, a capitalization rate may be mathematically derived using basic investment data in a mortgage-equity contribution calculation.

The prime advantage of a direct capitalization approach is that it is fairly easy to produce, is not time consuming, and is easy to understand by the reader. In addition, the derivation of the capitalization rate is fairly straightforward. However, its main drawback is that it cannot easily be adapted to account for fluctuations in the income stream (specific vacancies, absorption, tenant rollover, non-linear changes in market rent, variations in expense inflators, etc.). In reality, most income streams do vary and fluctuate annually, so the direct capitalization methodology can at best only yield an approximation of the potential variation in income flows.

A discounted cash flow analysis (DCF), however, can easily be modeled to account for almost any variation in the property's income stream. A DCF can be produced with an over-the-counter spreadsheet program such as Lotus, Excel, or QuatroPro, or a more complicated property can be modeled using one of the more sophisticated "canned" packages such as ARGUS or Pro-Ject.

The basic structure of a discounted cash flow analysis is a model of the net operating income resulting from the anticipated gross income minus the operating expenses over a projected holding or investment period (return on the investment), with a lump sum reversion value at the end of the period (return of the investment). These cash flows are then discounted to present value using a discount rate which represents the anticipated ownership returns.

As mentioned, the prime advantage of the discounted cash flow model is that it can readily take assumptions of variable income and expense streams. In addition, it mimics the analytical process of most buyers in the market so that the resulting valuation more closely resembles market value. The major disadvantage of a DCF is that the discount rate selection is a more

subjective process than the derivation of a capitalization rate. However, with adequate research and documentation, the appraiser can place a lot of confidence in the chosen rate.

Sales Comparison Approach

The Sales Comparison Approach is also a useful tool for estimating the value of the leased fee estate. In most markets, sales of leased, income-producing properties are found for most property types. Any sale of an income-producing, leased property is the sale of the leased fee interests in that property. It is not a sale of the fee simple estate.

To apply the Sales Comparison Approach in a leased fee analysis, the appraiser-assessor must make the usual adjustments to the comparables for condition of sale, time and physical attributes. The analyst must also be aware of the rent structure of the comparable sale and how it compares to the subject's rent structure and make a "financial attribute" adjustment as well.

For example, are the comparable's leases at or close to market, or were they written many years ago and are significantly below market? If they are below market, do they expire soon and are they expected to roll to market? Is this similar to or different than the subject? What is the structure of the leases -- net, gross, full service, pass-throughs? What about the tenants themselves -- are they national, triple-A tenants, or are they local businesses with questionable credit or stability?

It is important to make the "apples to apples" comparison correctly. Investors and owner-users have different motivations for purchasing. Investors are looking for cash flow and are motivated by the financial returns of a property based on the underlying leases. Owner-users are more interested in the physical attributes of the property -- its location, building height, configuration, condition, as well as the *business* attributes of the property (i.e., corporate image, visibility for suppliers, etc.). *It is incorrect valuation methodology to use investor sales as a comparison to an owner-user property, and visa versa.*

Cost Approach

Can a depreciated replacement cost approach be used when valuing a leased fee property?

Maybe.

As with most properties, the Cost Approach is best applied to a new or newer property, one which has not experienced much accrued depreciation. In addition, it also best applies to a property whose rent and lease structure most closely represents market rent. This, then, will be for properties which have new or nearly new leases, or whose leases are written so that their terms and conditions are periodically changed to assure they are kept close to market.

A Cost Approach can be adjusted by using economic obsolescence, however, to account for leases that are either below or above market terms. For example, for a property with below-market leases, the external obsolescence adjustment requires that the appraiser-assessor

compare each lease in the property to current market conditions and subtract from depreciated replacement cost the present value of the difference between each lease's market rent and actual rent.

Without an adjustment for the difference between the leases and the current market conditions, the appraiser-assessor is applying the Cost Approach as a fee simple analysis. This is incorrect. The assumption basic to the Cost Approach is that the replacement cost is the cost to build at today's economic conditions and terms. If the leases represent an income stream at levels below the economics of the present, then the replacement cost analysis will value the property without fully considering the lease terms.

Leasehold Estate

The leasehold estate is the tenant's interest in the property. A leasehold estate is created when market rents exceed actual rent. The tenant then has an economic advantage because s/he is paying less than the rent s/he would have to pay if the space were to become available today. The present value of the difference between market and actual rent is the leasehold advantage. Although marketable, the leasehold advantage is rarely ever a) quantified or b) transferred on the open real estate market.

For property assessment purposes, the leasehold estate may not even be subject to taxation in some areas; local laws will vary. For example, in Maryland, the Maryland Annotated Code specifically states that leasehold interests are not subject to taxation. As such, the assessor must value the leased fee of an income-producing property only, not the leasehold interests. If the fee simple estate were to be valued, the leasehold value would be subjected to taxation. The State law draws the distinction between the two.

Sandwich Leases

The valuation of a sandwich lease position is a series of present value calculations.

As mentioned previously, a sandwich lease is one in which one entity is a tenant to the owner of the property but is also a landlord to a subsequent tenant. Using letters as examples, A is the owner, B leases from the owner, but B subsequently leases all or part of its space to C. A is the owner, B is the tenant of A but the sub-lessor to C, and C is the sub-lessee or sub-tenant of B. When the rent is due, C pays B and B pays A.

A common application of this is a land lease situation in a shopping center where the land owner leases a pad site to a fast food company for the construction of a restaurant, and then the fast food company in turn leases the building to a franchisee.

The valuation of the sandwich position, or B, begins with understanding the terms of the two leases, A to B and B to C. The present value of the income stream from B to A is calculated (B is the tenant), followed by the present value of the income from C to B (where B is the sub-

landlord). The value of B's position is the difference between the present value of the cash it pays out to A minus the present value of the net income it receives from C.

In performing these discounted cash flows, the analyst must consider that these segregated income streams could be riskier than valuing the full leased fee position. The added risk is only partly due to the credit-worthiness of the tenant since the C position could be an IBM or a General Motors. The added risk is in the ability of the sandwich position to sell its interests in the property. Depending on the setup of the various leases, there may not be a ready re-sale market for the middle position, thus creating additional investment risk and increasing the indicated discount rate. It should be noted that the sum of the lease parts may not equal the whole fee simple value.

• **Who is the "Owner" of the Property?**

The valuation of income-producing, leased property can create some real brain teasers for the assessor and property owner. Assume the following scenario:

- State law follows the "willing buyer, willing seller" definition of market value;
- State statutory law and legal precedents require the assessor to consider leases in valuing property;
- The subject property is a 25,000 sf shopping center built in 1960 as a grocery store;
- The land and building are owned by the parent company of the grocery store chain (Store Owner);
- In 1985 the grocery store ceased operations and leased the entire property "as is" to a real estate developer (Developer);
- The Developer subdivided the building into four tenant spaces and subsequently leased them "as is" (except for paint, rest rooms, demising walls) to four new businesses (Tenants);
- Store Owner receives \$120,000 in net income from Developer;
- Developer receives a total of \$140,000 in net income from Tenants;
- Developer's net income of \$140,000 has already been adjusted for its rental payment to Store Owner;
- If it could lease all the space today at current market rents, the Developer would be able to achieve net income of \$260,000;
- These leases all terminate concurrently and, for the ease of calculations, run into perpetuity;
- Assume that the appropriate capitalization rates for the Store Owner's and Developer's positions are 12% and 10% respectively, (9% if all leases were at market).

What then, is the value of this property for ad valorem tax purposes?

That answer cannot be calculated until the "owner" for tax purposes is identified.

For a valuation for mortgage loan or asset management purposes, the "owner" of the property or the position to be valued will be identified by the client. For a mortgage, for example, the security interest in the loan is the subject of the appraisal. The lender wants to know how much the property is worth so it can lend on that value.

For ad valorem taxes, however, the position being valued is not as easy to discern.

The answer to the "How much is it worth?" question is "It depends." In some states, the assessor is legally able to send multiple assessment notices covering each ownership position to each entity. The Store Owner would get a \$1,000,000 assessment notice and the Developer would receive a \$1,400,000 notice.

In other states, the valuation of the leased fee interests is meaningless since their interpretation of "market value" is always fee simple. In those states, the valuation would be \$2,900,000.

However, in many states the assessor must consider the leases and can only send one assessment notice per property. In these states, the assessor must define the ownership position which then would become the taxable entity.

In the example above, the owner-in-possession could be defined as either the underlying lessor since all the improvements will eventually revert to it, or as the Developer since it has day-to-day control over the operation of the property and probably has the most marketable position. In either event, the assessor cannot ignore the lease structure if his/her task is to estimate market value.

• **Conclusions and Summary**

The valuation of the leased fee interests in a property begins with an understanding of the income which the ownership of the property anticipates from the leases. This income, or cash flow, is what potential buyers will translate into a sales price when they purchase the property.

The valuation of the leased fee interests can be completed applying the three basic approaches to value -- the Income, the Sales Comparison and the Cost Approaches. The Income Approach is concerned with the present value of future benefits accruing to the owner of the property. A discounted cash flow or a direct capitalization approach may be used to estimate the value.

The Sales Comparison Approach is also a useful analytical tool for valuing leased fee interests as long as the appraiser-assessor recognizes that the appropriate comparable sales properties should all be income-producing properties. It is important that any differences in rent structure, terms of leases, or ownership be accounted for in the adjustment process.

The Cost Approach would be considered only a secondary valuation technique for an income-producing property, especially if the property has leases which have significant below or above market terms. As noted, the Cost Approach best represents properties with leases at or nearly at market rents and terms. For properties whose leases have terms which are not current to the market, the analyst must make an obsolescence adjustment as a factor of accrued depreciation.

It is important to understand how the local laws, both statutory and case law, impact the valuation of property for ad valorem purposes. In states where fee simple valuation is required, the assessor would not necessarily be concerned with the underlying leases of the property nor its fiscal operation. There should be no need to review operating statements or copies of rent rolls for these properties. In addition, the only sales which should be permitted as part of the assessor's or property owner's appeal of any assessment should be those which also were fee simple transactions. For fee simple properties, the Cost Approach does not need to be adjusted for lease conditions.

In those states where market value has been defined as being reflective of the actual motivations of buyers and sellers in the real estate market, the actual leases and operations of the subject properties must be considered. In addition, the assessor and property owner must ensure that comparable sales are truly comparable; leased fee sales used to evaluate income-producing properties and owner-user sales used to evaluate fee simple properties.

Footnotes

Appraisal Institute. 1992. *The Appraisal of Real Estate*. Chicago: Appraisal Institute.

Attorney General Order 65-66, State of Washington, No. 65, December 31, 1965

Eaton, James D., MAI. 1987. *Real estate valuation litigation*. Chicago: Appraisal Institute.

Eckert, Joseph K., Ph.D., 1990. *Property Appraisal and Assessment Administration*. Chicago: The International Association of Assessing Officers.

Maryland Annotated Code. Tax-Property Article. 1990. Section 1-101(II).

Spokane etc. R. Company v. Spokane, 75 Wash. 72 (1913); *Mason County Overtaxed, Inc. v. Mason County*, 62 Wn. (2nd) (1963).

St. Leonard Shores J.V. vs. Supervisor of Assessments. 307 Md. 441. 1986.

Conference

proceedings

a boundless vision

**IAAO's 60th Annual Conference
on Assessment Administration**

October 16-19, 1994

Seattle, Washington

