HOW TO VALUE AND DEFEND TRIPLE NET LEASED PROPERTIES

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GOAL:
- To discuss the valuation and defense of an assessment for a triple net leased property

METHOD:
- We will share excerpts from a report prepared for a Board of Review hearing for a triple net leased property
FOUNDATION

- STATUTORY FOUNDATION
- WISCONSIN PROPERTY ASSESSMENT MANUAL
- LEGAL FOUNDATION
FEE SIMPLE ESTATE:

- When a property owner possesses all the bundle of rights, they have a fee simple ownership interest (or fee simple estate) in a property.

- Fullest form of ownership subject only to governmental restrictions
IMPORTANT DEFINITIONS

- **LEASED FEE ESTATE:**
  - If a property encumbered by leases is sold, only the owner’s interest in the property (leased fee interest) is actually transferred to the buyer.
  - A lease conveys property rights from the landlord to the tenant. Fee ownership remains with the landlord, who is said to have a *leased fee* interest.
  - The tenant is said to have a *leasehold* interest.
IMPORTANT DEFINITIONS

TYPES OF LEASES

GROSS LEASE: Tenant pays rent and landlord pays expenses

MODIFIED GROSS LEASE: Tenant and landlord share expenses

NET NET NET LEASE: A lease in which the tenant assumes all expenses (fixed and variable) of operating a property except that the landlord is responsible for structural maintenance, reserves, and management
IMPORTANT DEFINITIONS

MARKET RENT: is the income that a property would most probably command on the open market were it being negotiated on January 1. Market rent can be determined through analysis of rental data of comparable sold properties or properties in the market area.
IMPORTANT DEFINITIONS

- CONTRACT RENT: is the amount of rent actually being paid per the terms of the lease.
Real estate, how valued.

(1) Real property shall be valued by the assessor in the manner specified in the Wisconsin property assessment manual provided under s. 73.03 (2a) from actual view or from the best information that the assessor can practicably obtain, at the full value which could ordinarily be obtained therefor at private sale. In determining the value, the assessor shall consider recent arm's-length sales of the property to be assessed if according to professionally acceptable appraisal practices those sales conform to recent arm's-length sales of reasonably comparable property; recent arm's-length sales of reasonably comparable property; and all factors that, according to professionally acceptable appraisal practices, affect the value of the property to be assessed.
MARKET VALUE is the most probable price, in cash or equivalent, which a property would bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently, knowledgeably, and without compulsion. Note that market value is either the highest nor the lowest price paid, but the ‘most probable price’.
WISCONSIN CASE LAW

- METROPOLITAN
- DARCEL
- WEST BEND
- WALGREEN
- GREAT LAKES
METROPOLITAN– 173 Wis.2d 628 (19
DARCEL–
WEST BEND– City of West Bend v. Cont. Fund Ltd. P’Ship,
193 Wis.2d 481 (Ct. App. 1995)
WALGREEN–
¶ 37 Each of these cases, unlike the present case, involved
properties encumbered by BELOW market rent, which is a LIMITED
exception to the general rule recognized by the Manual based on
a potential purchaser’s inability to obtain the market rate value of
the property due to to a lease encumbrance.
¶49– “In Darcel, Metropolitan Holding and West Bend … there is
no reciprocal exception requiring above market lease rates to be
substituted for market rate as well.”
¶51 “Darcel, Metropolitan Holding and West Bend all illustrate the
exception to the main rule, without undermining or conflicting
with the main rule itself.”
In *Darcel*, the court held that because below market rent encumbered the mall property, the recent sale price of the mall was the best evidence of its value rather than fair market rents, which were no longer available to purchasers of that property and therefore the sales price reflected the bargain rents.

This was inconsistent with the Manual at that time since the Manual said MARKET rent must be used.

- Walgreen court response: *Darcel* not applicable because the lease in Walgreens is above market, not below, and the City is not requesting an assessment based on an arms length sale. ¶40 (But see how the *Darcel* court defined “market value” in *Darcel*.)
- “We have not held as a general rule the existence of any encumbrance altering the value of the lease, whether increasing or decreasing it, requires deviating from the assessment procedures set forth in the Manual. ¶43
The court of appeals held in *West Bend*:

“Where property is encumbered by a bundle of rights we must appraise or assess the property at its value using the current value of those bundle of rights. In this case, we cannot speculate as to what the lease rights might bring on the market, but we must accept the rental payments agreed upon under the negotiated lease terms.”

“In the present case, the full value of the property, including the leasehold, which in this case is treated as an encumbrance on the property, was properly assessed at what could ordinarily be obtained at private sale.”
The West Bend court concluded that the controlling factor in the valuation was “the rental payments agreed upon under the negotiated lease terms.”
¶45 of *Walgreen’s* decision

“Rent is not a right in realty; it is what is exchanged for an encumbrance upon a right in realty. As such, a lease is not part of the “bundle of rights” described by *West Bend*, but is rather an encumbrance rendering an estate a “partial interest” due to the fact an owner does not have full access to the property.”
The Supreme Court held in Metropolitan that where a federally funded housing complex was encumbered by HUD restrictions, including limits on rents, types of tenants, and net profits, actual rents rather than market rents were the proper measure of assessment.

Walgreen court response, ¶38 – case not on point because it “was a public housing case” and specifically within the exception in the Manual that assessor’s must use market rent and not contract rent “unless valuing federally subsidized housing.”

Note: the exception for “federally subsidized housing” in the Manual was added AFTER the Metropolitan decision and as a result of it – the Manual was not the basis for the Metropolitan decision. This is one of the inconsistencies addressed in the 2009 revisions.
The Walgreen’s decision is narrow in its focus and limited to the facts in that case.

¶35 – “Consequently, although the Manual describes both the income and cost approaches as being the best methods of assessing large retail property absent comparable sales data, we confine the remainder of the analysis to the narrow dispute of the appropriate income approach methodology to be used in this case.”

Thus, is not applicable to a tier 1 or tier 2 case.
Walgreens Limited Facts

Elements of the case:
- That the rents were “above market” – court said undisputed.
- That Walgreen’s employs a unique “uniform business model” with its real estate acquisitions. (Walgreens rents property rather than purchasing it, working with developers to build the properties) Query – Are build to suit or sale/leasebacks all that unique in today’s real estate markets?
- Court found that the Walgreen lease was significantly above market in part as a result of “certain unique business and financing terms being incorporated into the rent.”
- That the properties are developed with “super adequacies” to suit Walgreens needs.
– The court found that the parties did not dispute that the inclusion of:

1. Compensation to the developer for financing costs and a developer's entrepreneurial profit resulted in higher than market rate rental payments. ¶6 (yet—these are normal costs for any developer to charge for and must be included when doing a cost approach).

2. Or that the rent was “higher than normal” in part because the developer is recovering costs on a building with “super adequacies”. (yet –there was no evidence presented that there is no market for the features deemed “super adequate”.)
Walgreens convinced the court that its contract rent was not typical of the market. Walgreen’s convinced the court that the lease included “unusual” financing terms.
Immediately after the *Walgreen’s* decision the cry went out that in applying the income approach—Assessor must use the LOWER of contract or market rent.

Efforts for legislative clarification was sought by municipalities who viewed the decision as unfair to residential homeowners and local neighborhood retail owners.

The efforts to restore tax fairness resulted in a provision in the budget bill that would have required assessors to consider actual rent and the terms of a lease when determining the value of leased property using the income approach. (amending 70.32(1a))
Supreme Court in *Walgreen’s* said – “The power to determine the appropriate methodology for valuing property for taxation purposes lies with the legislature. ¶19

§73.03(2a) – the DOR shall publish a property assessment manual that “reflects court decisions reflecting assessment practices”.

The Manual must be followed absent a conflict between the Manual and statutory requirements per Supreme Court. (not case law)
Governor’s veto –

“I am vetoing this provision because I object to changing valuation methodology through the legislative process. Currently, property assessment methods and standards are set forth in the Wisconsin Property Assessment Manual. The Manual is developed in accordance with professionally accepted appraisal practices and is researched thoroughly by experts working in the appraisal field. Changes to property assessment practices should be pursued as updates to the manual to ensure sufficient review by property appraisal experts.”

Governor Doyle’s veto occurred in July 2009 AFTER the Manual had been revised in Spring 2009.
Changes to the Assessment Manual

- **Background**
  - Walgreen’s Court of Appeals Decision Request to DOR to “Fix” the Manual
  - DOR Official Response—Wait until case finished
  - Walgreens decided by Supreme Court in July 2008
  - Heavy reliance on manual language
  - Late fall 2008 DOR actively working on revisions
  - Manual changes issued to assessors in early 2009 with substantial revisions to Chapters 7 and 9
WHY IMPORTANT TO REVISE MANUAL?
- NO PRESUMPTION OF CORRECTNESS APPLIES TO ASSESSMENTS THAT DO NOT APPLY THE PRINCIPLES OF THE MANUAL per Supreme Court
- ASSESSORS MUST FOLLOW MANUAL per 70.32 Stats.

SUMMARY PREPARED BY ED JUDT – PLEASANT PRAIRIE

CHANGES TO CHAPTERS 7 AND 9
- SHOWS LANGUAGE DELETED FROM THE MANUAL
- SHOWS NEW LANGUAGE SUBSTITUTED FOR DELETED LANGUAGE
- LANGUAGE SUPREME COURT RELIED UPON IN WALGREENS – DELETED

MANUAL NOW REFLECTS THE STATE OF THE LAW IN EFFECT PRIOR TO JANUARY 1, 2009
To clear up any inconsistencies in the Manual.
- The Manual was never revised or changed to reflect the *Darcel* or *West Bend* decisions.
- Per old 7–4 – “To accurately estimate the market value of the full interest in leased property, both the lessor's and the lessee’s interest (the leased fee and the leasehold interest) must be included.
- The Manual was only revised to reflect the *Metropolitan Holdings* subsidized housing limitation.

To provide uniform treatment throughout the Manual for the assessment of all properties.
INFORMATION FROM LITIGATION

- DEPOSITION OF DEPARTMENT OF REVENUE APPOINTED REPRESENTATIVE REGARDING MANUAL REVISIONS.

- OPEN RECORDS REQUESTS FROM ASSESSOR DISCUSSION GROUP OF NNN SALE PROPERTIES
WHAT INTEREST ARE WE VALUING IF OUR TARGET IS MARKET VALUE?

A MARKET VALUE SALE DOES NOT REFER TO THE TYPE OF INTEREST (FEE SIMPLE OR LEASED FEE) BEING TRANSFERRED.
“The lessor’s interest in a property is considered a leased fee interest regardless of the duration of the lease, the specified rent, the parties to the lease, or any of the terms in the lease contract. A leased property, even one with rent that is consistent with market rent, is appraised as leased fee interest, not as a fee simple interest.”

The Appraisal of Real Estate, 13th edition
VALUATION
FOLLOW THE HIERARCHY!

SALE OF THE SUBJECT
VALUATION BY SALE OF SUBJECT

Acquisition of the Subject Property:

The subject property was purchased from the


Grantee: ARCITERRA WG MILWAUKEE, LLC

1. The Real Estate Transfer Return (RETR) filed in connection with the sale of this property showed a total of $4,667,000 allocated to real estate and none of the purchase price to personal property.

2. The RETR filed and attested to by both the Grantor and the Grantee indicated that there was no relationship between the two; full ownership of land and building was transferred; financing was conventional and that the predominant use would be as a retail drug store.

3. ARCITERRA WG MILWAUKEE, LLC executed a Mortgage and Security Agreement in favor and to Wachovia Financial Services, effective July 17, 2007 for $3,733,600. (80% of value)

The subject property sold in an arm’s length transaction on July 17, 2007. The seller was MRED (85th / Brown Deer) Associates, A Wisconsin Limited Partnership and the purchaser was the present owner, Arciterra WG Milwaukee WI, LLC. The Wisconsin Real Estate Transfer Return indicated a sale price of $4,667,000, all for real estate with no exclusion for financing or personal property. The full amount of $14,001 was paid for the real estate transfer tax and the return was attested to by the Grantor and Grantee.

Indicated value by the Sale of the subject is:

$ 4,667,000
VALUATION
COMPARABLE SALES ISSUES

- Adjustments for interests being valued
- Importance of Market Study and Highest and Best Use
- Importance of Economic Adjustments
LEASED FEE VALUATION
INCOME APPROACH

- CONTRACT RENT OR MARKET RENT?
INCOME APPROACH – ISSUES

“In theory, contract rent and market rent will be the same because contract rent reflects the behavior of typical lessors and lessees in the marketplace.”

The market value of a leased fee interest in a rental property generally depends on how the contract rent relates to the market rent. If the contract rent is at the same level as the market, the leased fee interest has the same value as a fee simple interest.
Examples of when contract may not equal market:

- rental rates for subsidized housing which are generally below market
- long-term tenants, particularly long-term residential tenants, are sometimes given rent reductions/incentives to renew their lease
- changes in market conditions since a multi-year lease was signed
- items and/or services in the lease payment which are not directly related to the real property itself
- circumstances of the lessee or lessor which motivated them to enter into a lease with disadvantageous terms (not arms-length)
INCOME VALUATION

- LONG TERM TENANTS –
  - VACANCY ALLOWANCE?
- EXPENSES
  - ??
- RELATIONSHIP TO CAPITALIZATION RATES
  - IRV FORMULA
INCOME VALUATION

- CAPITALIZATION RATES
  - From sales
  - From investor surveys
  - Other sources

- PROPERTY TAX TREATMENT
COST APPROACH ISSUES

- PROPER LAND VALUE COMPONENT
- WHAT SUPERADEQUACIES?
- DEVELOPER’S SKILL AND EFFORTS
QUESTIONS AND ANSWERS

- ???