APPRAISING SPECIAL-PURPOSE PROPERTY

For special-purpose properties, market value and value-in-use can be significantly different; knowing the difference can help investors and lenders avoid major financial loss.

by William F. Schoenhut, Jr.

Investors, lenders, property owners, and others concerned with the management and transfer of real property assets frequently request valuations of their property for a variety of purposes: Among the most frequent reasons are financing, partnership dissolutions, tax allocation, merging of one corporation or other financial entity into another, and estate settlements. For many types of specialized property (e.g., manufacturing plants, steel mills, breweries, churches, hospitals) an important but often overlooked pitfall is the failure to distinguish between the property's market value, as that term is generally used, and what lenders, owners, and users term value-in-use. The relationship between these two values is often complex and can have important consequences for the viability of a transaction.

Value-in-use may come into play, for example, when the subject property is a complex industrial plant, a highly specialized commercial building, or any other single-purpose building such as a church or school. With such properties, there ordinarily is little or no prior market activity available to assist an appraiser in developing a supportable value. These are known as special-use or special-purpose properties, and special techniques must be applied in deriving an appropriate estimate of value.

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Value

From the appraiser's point of view, property owners and sellers most of the time use the term "value" much too loosely. Value is used as a synonym for market value—the price the property would be expected to bring in an arm's-length transaction under prevailing market conditions in the region.

But the notion of market value presumes that a broad market does in fact exist for a given type of property, with a reasonable number of buyers and sellers. Put another way, for market value to have valid meaning, there must be a consider-

able number of properties for sale and a significant number of buyers to reasonably balance the number of sellers at any given price level. This condition in turn presumes the existence of a substantial number of properties that have roughly similar utility.

On the other hand, value-in-use generally has a limited number of buyers and sellers and property for sale. The value is based on the contribution of that asset to the user.

The sale or purchase of a factory or specialty chemical plant is not something that happens every day, especially in a small community. To reach an appropriate value estimate for such special-use properties, the appraiser must be able to draw on reliable expertise in the relevant industry or economic sector. Almost invariably, there are particular trends that a specific industry is facing at any given time and that can impact value in a variety of ways. The downturn in the auto industry, for example, can cause a downturn in the foundry and steel production industries, as well as for auto dealerships. Only after these trends have been analyzed completely, to provide an economic barometer for that business, is it possible to determine the property's value.

There are other factors that may have a bearing on value if the subject business is for some reason at a marginal point with respect to the basis of its strength. The business may be subject to possible legislative changes or to restrictions in volume and controls. It may be particularly sensitive to international trade problems, or it may be in the midst of internal problems. In these cases, due diligence is critical to ensure that the business will survive and continues to be the highest and best use for the site and improvements.

Identifying Special-Purpose Properties

Consider, first, a parcel of real estate that is *not* a special-use property but rather is readily available in the market for rent or purchase and could be suitable for a number of alternative uses. A typical example might be a standard, functional 30,000-square-foot industrial building. Used by its current occupant as a manufacturing facility, it could just as easily have been used as a warehouse or R&D facility. For such a property, the principles of market value and of market value for continued use (value-in-use) are identical in practice. This is often evident in the appraiser's discussion of highest and best use, where the appraiser's report says, in effect, that "the highest and best use for the site is its present use."

The complexities arise when the improvements on the property are unique and are related to one specific need for which there would be a limited identifiable market for either rent or purchase. The highest real estate worth then becomes a value-in-use rather than the market's value concept of value-in-exchange. The key concept under value-in-use is the contribution of an object *to a user.*

"User value" (value-in-use) differs from other valuation concepts in that it can be determined only subjectively. It is logical, when estimating the value of an item of production (e.g., realty, machinery and equipment, special patents) to attempt to relate that special contribution to the total enterprise. The economic principle of contribution is actually the principle of increasing and decreasing returns as applied to different segments of business. In this instance, the specific value to be measured is the real estate contributory value.

How does an appraiser decide that the value-in-use concept is appropriate when dealing with a specialty property? Five basic questions can help establish guidelines to be applied in classifying such a property:

1. Does the real estate in question currently fulfill the economic demand for the services to the enterprise?
2. If there are building improvements, do they have any significant remaining economic life?
3. Does the business have a history of responsible and competent ownership? Is it profitable?
4. Is the property readily marketable for alternative uses (sale or rent) without being greatly discounted in value?
5. Is it reasonable to presume the continuation of the property's present use, either by the present occupant or by similar occupants?

If the answer to all five of these questions is yes, that property is probably at its highest and best use already. Note, however, that the answers to these questions may involve numerous complex variables. To determine the answer to question 3, for example, the appraiser may be required to acquire substantial education as to how to access the information for an R&D facility as part of a large corporation.

Other Considerations. On the other hand, it is often reasonable to say that a parcel of real

estate may have more than one highest and best use during its life cycle. Such highest and best use may not, however, be the type that can be measured easily by the usual criteria. The most profitable use cannot always be determined on a monetary basis and may at times be based on interpreting its contribution and support to the business enterprise.

The extreme case, of course, is a property being used by a not-for-profit entity, whose value must be judged in terms of its contribution to the community as a whole. The appraiser must be able to develop an appropriate index to measure how well a church, a playground, or a prison is "working"—how closely it is meeting its own stated goals and achieving its intended uses. What is the value of a playground that saw heavy use a generation ago in a community that now has few youngsters? Or of a correctional facility whose occupants would otherwise menace the city's residential district? The benefits in these examples may range from public safety to the recreational or the spiritual well-being of the community as a whole. The professional appraiser, whose work combines elements of both art and science, is called on to make extremely fine and sensitive judgments to arrive at objective, supportable values.

For commercial properties (i.e., in most business situations) the difficulty arises when an enterprise is becoming marginally profitable, and thereby losing substantial support for the property's highest and best use. For example, an automobile plant that was designed expressly for assembly and painting of cars may become marginally profitable, even with upgraded production facilities, as a result of new, competing technologies and slow auto sales. In this case, the alternative uses and the cost of conversion may make it impractical to change the use of the property. If the profitability or degree of profitability is contingent on additional construction costs, such costs may not be warranted.

Industrial Properties

In many cases, the appraiser elects to use the value-in-use concept with respect to industrial properties. All too often, the property, such as an atmosphere-controlled warehouse, is so highly specialized that the "special use" criterion must be the only consideration. When special-use industrial real estate does change hands, however, it generally does so because the property has *lost* its usefulness to the current owner. A common occurrence in the industrial sector is the situation where a facility's use to the owner has become marginal, and it cannot readily be adapted to a different use without prohibitive additional investment. In this case, the current owner generally has no choice but to sell in a buyer's market, usually at a price that reflects the discount for the cost of conversion to another use or demolition. (See sidebar, "An Example From the Field.")

The Cost Approach to Value

The cost approach in traditional valuation involves the market value of the land presumed vacant added to the replacement/reproduction cost less depreciation of the improvements. This technique, as appraisers are aware, is fraught with many weaknesses when applied to a value-in-use situation.

Most obviously, a specialty manufacturing enterprise may enjoy substantial benefits from a site due to its strategic location next to a distribution center or because of some special characteristics of the structure itself—all of which may be vulnerable to external changes. Take for example a specialized and profitable truck maintenance and bulk tanker cleaning facility. If distribution methods change, or if significant technology advances occur within the industry, both functional and external obsolescences could develop that would seriously modify the worth of this particular property at this particular location and type of construction. The appraiser (and the investor) must always be alert to such potential problems in special-use properties.

On the other hand, the appraiser must also be alert to the effects of the cost approach and to the difference between *reproduction cost* and *replacement cost* of a facility. The appraiser must consider the cost of reproducing an identical facility versus the replacement cost of a new facility with current operating efficiency that would eliminate any existing built-in functional obsolescences of the current facilities.

The inherent weakness of applying the cost approach as the only source for the value-in-use determination is that the depreciation estimate is usually based on opinion (i.e., the opinion formed in the eye (and mind) of the evaluator). However carefully this is done, even the most ex-

perienced appraiser must rely on his or her subjective judgment. Such subjective estimates may err on the high or low end of value, which may result in unusual profits or losses in a sale. Any major appraisal firm can be assumed to back its judgment with financial accountability; even so, a wise investor will learn as much as possible, ahead of time, about the extent and type of the appraiser's professional experience.

A Comparative Approach to Depreciation Estimates

To offset the depreciation deficiencies of the cost approach, supplemental evaluation methods are needed to accurately assess the benefits from the industrial property that is assumed to provide profits to its users. In theory, this comparative method is nothing new. It has been discussed in numerous technical articles over the years and is precisely the type of methodology that appraisal professionals are supposed to apply in estimating depreciation of a facility.

In actual practice, however, this sometimes critical step is dropped because the appraiser does not fully understand it or because appraisers who do know the method fail to realize the importance of applying it in this particular case. The result may be a significantly inaccurate estimate of value, which can come back to haunt anyone involved in the transaction.

The comparative method involves three steps:

1. "Design" a (hypothetical) modern, efficient substitute property that would serve the same function, and estimate the current cost for such a modern property;
2. Estimate the benefits of such a property to an owner (being sure to take into account the ownership cost (i.e., depreciation, interest, and property taxes)) and its operating advantages as compared to the subject property; and
3. Compare the construction, land, and operating costs to the existing property to estimate the depreciation.

In essence, this supplemental approach to depreciation in the cost approach offers an economic overview of the future benefits of the hypothetical property, as opposed to those already existing. Comparing the hypothetical new substitute building—ideally designed and located to meet the full requirements of the user—to the existing building measures the loss of utility of the existing property. This approach is often known as the "green field" approach.

AN EXAMPLE FROM THE FIELD

Under favorable conditions, a property that will continue to be used for its present purposes may well have a higher market value, as future users are often willing to pay the higher price.

A typical recent situation involved valuation of a 250,000-square-foot metal manufacturing and assembling plant, located on thirteen acres of land in a Midwestern Rust Belt state. Research was carried out on arm's-length sales (i.e., nonforced, nonliquidation sales) in the area, involving buildings of similar design, similar age, and similar use. The appraiser found that plants selling for a value-in-use averaged $11 per square foot, while plants that sold for alternative uses sold at $7 per square foot. The difference reflected a $4-per-square-foot loss of value, or $1 million overall.

While price differentials are not always so dramatic as this, clarifying the possible value-in-use factors ahead of time can help a seller in setting the asking price for a property building and help to establish a more reliable bottom-line value.

In such a hypothetical facility, annual building operating expenses would be at a minimum—for example, no excess manufacturing expenses would be attributed to the building or its location—as compared to the existing one. In addition to costs essential to its operation, other annual costs (e.g., interest, depreciation, and property taxes) may be quantified and added to the regular operating cost. These considerations would produce the total annual cost to the user of the hypothetical substitute building.

The Depreciation Factor. The difference between the construction costs, land, and operating costs for the hypothetical building and those for the existing building is the depreciation attributable to the existing property. For example, a 1950-vintage, concrete manufacturing building, lacking appropriate insulation, ceiling heights, utility layout, and structural features of its modern counterparts, located in an aging industrial park, may sustain a heavy depreciation.

As an illustration, the existing facility's reproduction cost may be $40 per square foot, land at its present location may be $0.30 per square foot, and operating costs may be $2.70 per square

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