

More than sticks and bricks

Why legal characteristics must be considered as part of the valuation process

by Eric C. Schneider, MAI, SRA, AI-GRS, and Alison E. Roach, MAI, SRA

When owners describe their properties, they typically focus on physical features, such as how the ranch is set on 80 acres or how the home has an ocean view. With income-producing real estate, buyers and sellers also discuss the economics of a property, such as rent levels or capitalization rates. How-

ever, two recent assignments from our office serve as case studies that illustrate why it's important for appraisers to consider another aspect, as well: the legal characteristics of a subject property.

Characteristics of a property, as cited in *The Appraisal of Real Estate*, 15th edition, are those "relevant to the type and definition of value and intended use of the appraisal." These include physical and economic attributes, but certain legal characteristics must also be identified and analyzed in order to achieve credible assignment results.

For example, one of the first steps in the valuation process is to identify the rights to be appraised. While real estate is physical in nature, what's being valued is the real property, defined in the Uniform Standards of Professional Appraisal Practice as "the interests, benefits, and rights inherent in the ownership of real estate." Moreover, interests associated with real estate, such as leases, easements and encumbrances, are to be analyzed as part of the valuation of real property. The process of identifying and analyzing all characteristics is critical because doing so supports an appraiser's highest and best use conclusion and helps identify relevant comparable data.

The case studies

The first assignment involved the appraisal of an industrial-zoned site in Southern California. The appraisal was to be used in a title defect matter: A title company had missed an easement that prevented a portion of the property from



being developed, and the assignment involved valuing any diminution in market value caused by the easement. The title company and the property owner had each hired their own appraiser; we were asked to provide an independent third analysis, with the title company and property owner as co-clients.

One of the main issues involved property rights. The property owner had negotiated to purchase the property as vacant, but while under contract they had signed a lease with a tenant to use it as a trucking facility. The lease term would begin once the owner finished improvements, which were only months from completion when the title defect was discovered. Based on the agreed-upon rental amount, the value of the property as a leased asset was significantly higher than as vacant land.

This increase in value was demonstrated by the value conclusions opined by the first two appraisers. One appraiser ignored the lease and only valued the subject's fee-simple interest in the land, reaching a value conclusion of \$780,000 without the easement. The other appraiser considered the lease and the subject's leased-fee interest, and provided an opinion of value of \$7 million based on capitalizing net income. The difference in what interest was appraised resulted in one value being almost 10 times higher than the other; the resulting diminutions in value were of a similar magnitude. Our analysis also considered the leased fee interest and the resulting value created by the lease.

This assignment demonstrates the necessity of identifying and analyzing a property's legal characteristics. While the property consisted of only partially improved land, considering (or not considering) the lease resulted in value opinions that were millions of dollars apart. That said, even if appraisers identify and analyze the same interests, the manner in which they are analyzed can differ.

The other assignment involved resetting the base ground rent for a large apartment complex for the next lease period, and determining land value, to which a contractual rate of return would be applied. A clause in the lease instructed that the "appraisal shall be based upon the then

existing use, but excluding therefrom the value of the buildings or improvements constructed thereon by [the] tenant." The lessor and lessee each hired appraisers, including our firm, and although both concluded that the instruction had substantial ramifications to determining the property's highest and best use, the analysis of the instruction varied significantly.

Our interpretation of the clause was that the subject property's highest and best use should be limited to apartment development at the same density as the developed property. Utilizing a sales comparison approach to valuing the land, our opinion of value was \$22 million. The other appraiser interpreted the clause with more specificity, concluding that the subject property could only be analyzed as it physically and legally existed: a 40-year-old, 240-unit apartment complex, subject to a ground lease with a remaining term of 30 years. Based on this interpretation, the appraiser utilized several land extraction techniques, made property rights adjustments to reflect the remaining ground lease term, and provided an opinion of value of \$8 million.

Both firms identified the instruction in the lease clause as a legal characteristic that they deemed relevant to their appraisal, yet the analysis resulted in two very different conclusions. Of course, other interpretations of the lease language are possible and can result in different opinions of value, as was demonstrated by the final arbitrated result that fell between the values.

These examples demonstrate the importance of identifying and analyzing the subject property's relevant characteristics — particularly the legal characteristics — in order to address the problem the appraisal is intended to solve. Appraisers must be able to provide reasoning for their conclusions regarding relevant property characteristics (for example, why an existing lease should be disregarded or why a certain interest was valued), because it sets the foundation for a credible conclusion. Doing so can sometimes be relatively straightforward, but as these two assignments illustrate, there are instances where recognizing and analyzing such characteristics is more challenging. ◀

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