VALUATION OF VACANT MICHIGAN INVESTMENT PROPERTIES

PREPARED FOR

KENT COUNTY ASSESSORS ASSOCIATION

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Facts About Lectures

- **8 MINUTES**= the average attention span of an adult in a lecture
- **25%**= at any given time during a lecture, the percentage of audience actively listening to the speaker. The other 75% are thinking about something else
- **66%**= the accuracy of correlation between what the speaker says and what the listener hears
- **20 MINUTES**= average amount of time to keep a group paying attention

INTRODUCTION

This seminar, Valuation of Vacant Michigan Investment Properties, explores the causes of distressed investment properties or why “good properties go bad.” Characteristics of distressed property types are examined together with actual examples (retail, office, industrial and apartments). The appraisal process from stabilized value to “as is” value is examined.

Practical case studies - a vacant “big box” retail store and a vacant office building - are used to demonstrate proper techniques and allowances.

Special appraisal considerations including changes in highest and best use of vacant land, contract rent above market rent and fractured developments will also be discussed.

Participants are cautioned that the materials and examples developed in this seminar are for educational purposes only. It may not be appropriate to specific appraisal problems encountered in your daily appraisal practice.

David Rice, MAI, CAE, MMAO 4

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The Appraisal of Real Estate, 13th Edition, Published by the Appraisal Institute, 2008

Dictionary of Real Estate Appraisal, 5th Edition, Published by the Appraisal Institute, 2010

Property Assessment Valuation, 3rd Edition, Published by the International Association of Assessing Officers, 2010

Appraising Distressed Commercial Real Estate, Published by the Appraisal Institute, 2009

Donald Wieme, MAI, SRA Provided case study examples and assistance

5540 Glenwood Hills Parkway S.E.
Grand Rapids (Cascade Township)
39,426 SF Built 1989

“It Will Be a Bottoming-out Year”

“Real estate will be a mess again this year, with only one halfway positive development: there will be an anemic housing recovery. … Housing will owe its better fortunes to the magic of cheaper interest rates.”

“This year will be another disaster for everything from construction industry employment to the federal budget which will have to be stretched again to bail out banks hurt by bad mortgage loans.”

“Recession wracked lenders are reluctant to roll over many landlords’ maturing loans. Tenants are getting rent cuts for lease renewals.”

What year did these headlines appear?

1981
1992
2002
2012

Does history repeat itself?

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Overview of Commercial Real Estate

To say that commercial real estate markets are in distress is an understatement. Value declines of 30 to 50 percent in major markets are not uncommon. Properties purchased at the height of the market (2005-2007) with too much debt and facing refinancing calls in 2010-2012 are at most risk. Let's look at an example:

A 20,000 square foot office building purchased in 2007 for $2,500,000 with a 20 percent down payment and the $2,000,000 balance financed at 7.00%, 25 year amortization with a 5 year term. The loan balance in 2012 is $1,823,000±.

It's five years later and the loan term is up. The property is appraised at $1,875,000 (25% decline) and the lender is willing to lend 70 percent of the appraised value or $1,312,000±. The borrower is upside down by over $500,000 not to mention the loss of the original $500,000 equity investment. However, the borrower can still pay the debt service under the original loan. The lender agrees to "extend and pretend" the loan.

Approximately $20 billion in loans made in 2007 mature in 2012. In the first quarter 2012 $9.5 billion came due and only 38% were paid off without loss. The balance either incurred a loss (9%) or remain outstanding (43%) reflecting a stricter lending environment (Wall Street Journal 4/4/12).

In June 2012 the delinquency rate (30 days late) for commercial mortgage backed securities loans (CMBS) hit an all time high at 10.16% according to Trepp, LLC. The delinquency rate in June 2011 was 9.37%. Loans considered seriously delinquent (60 days plus, in foreclosure, REO) increased to 9.73%. By property type delinquency rates in June 2012 were

Industrial	11.54%
Lodging	12.95%
Multifamily	15.17%
Office	10.45%
Retail	8.17%

The delinquency rate should begin to moderate as many loans originated in 2007 and due in 2012 have passed their due date.

What is Distressed Real Estate?

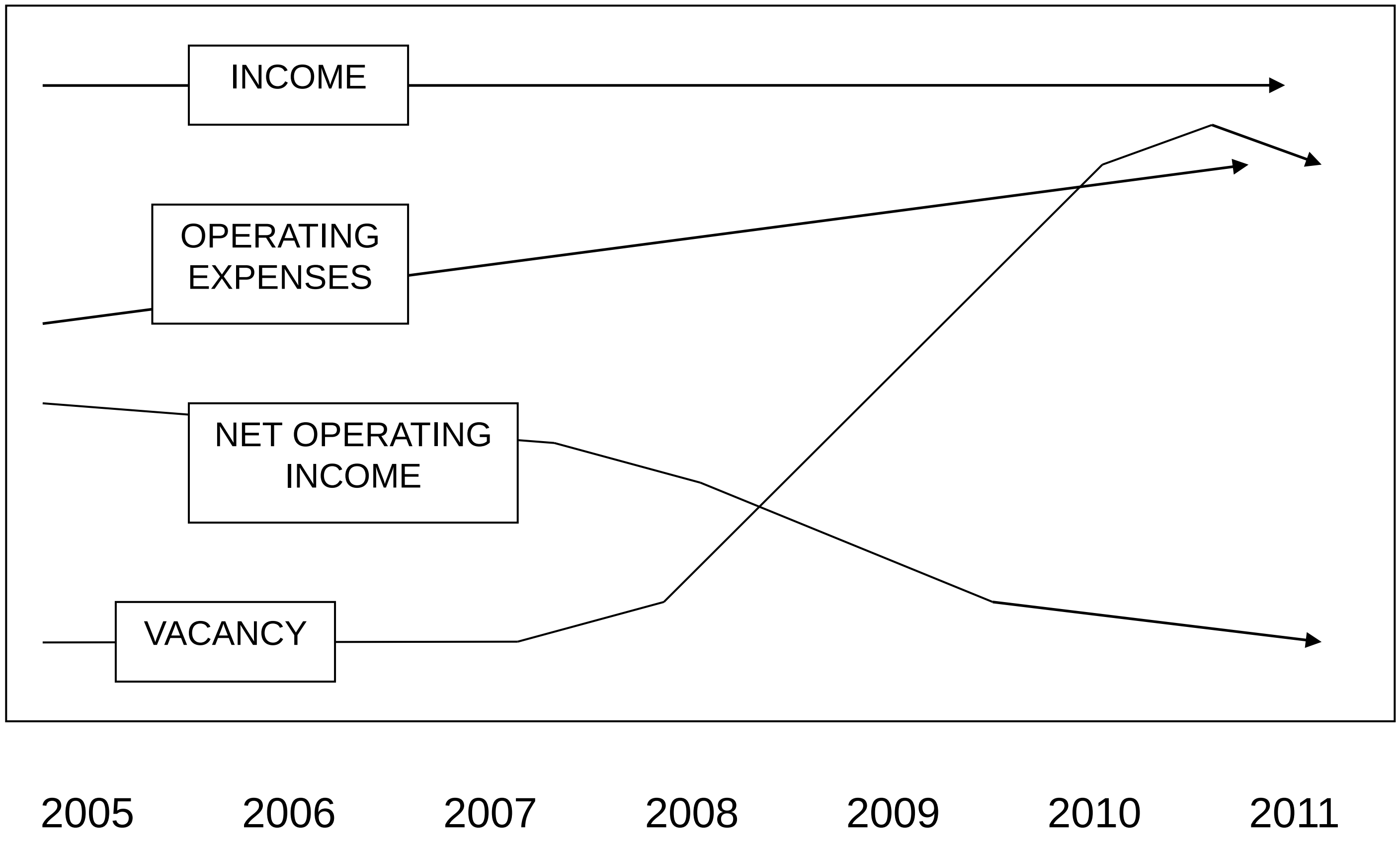
"Distressed real estate represents those properties suffering from higher than typical vacancies…properties where effective rents or prices have declined significantly in order to attain lease-up or sale."[1]

Characteristics of distressed properties

- Overleveraged with too much debt
- Loss of income including major tenant vacancy
- Decreasing rents to attain lease-up
- Vacancy levels at or exceeding market levels for comparable properties (supply/demand imbalance)
- Increasing operating expenses
- Declining net operating income
- Physical and functional issues

[1] Appraising Distressed Commercial Real Estate, Appraisal Institute, 2009

THE PERFECT STORM



IMPORTANCE OF ANALYZING MARKET TRENDS

Uniform Standards of Professional Appraisal Practice (USPAP)

Standards Rule 1-4

In developing a real property appraisal, an appraiser must collect, verify, and analyze all information necessary for credible assignment results.

(a) when a sales comparison approach is necessary for credible assignment results, an appraiser must analyze such comparable sales data as are available to indicate a value conclusion

(b) when a cost approach is necessary for credible assignment results, an appraiser must:

(iii) analyze such comparable data as are available to estimate the difference between the cost new and the present worth of the improvements (accrued depreciation).

(c) when an income approach is necessary for credible assignment results, an appraiser must:

(i) analyze such comparable rental data as are available and/or the potential earnings capacity of the property to estimate the gross income potential of the property.

(iv) base projections of future rent and/or income potential and expenses on reasonably clear and appropriate evidence.

Uniform Standards of Professional Appraisal Practice, published by the Appraisal Foundation, 2012-2013 edition.

The importance of understanding and analyzing market trends is difficult in declining markets populated with distressed real estate. “A declining market is generally characterized by few transactions and falling values.” The paucity of sales can strain the valuation process not only in the sales comparison approach but also in the cost approach and the development of entrepreneurial profit and accrued depreciation. In the income approach fewer sales make the stabilization of income and expenses and the extraction of capitalization rates problematic.

Sales that occur in declining markets require analysis and possible adjustment for unusual buyer and seller motivations and concessions to meet the definition of market value. Distressed sales including foreclosure sales, short sales and REO sales are typical in declining markets. While appraisers cannot discount these sales as potential comparables, the nature of the transactions require analysis to determine differences between the conditions of sale and the definition of market value.

<u>Guide Note II: Comparable Selection in a Declining Market</u>, published by the Appraisal Institute, 2011.

Retail Sector Overview

According to the 2007 economic census, there were approximately 1,122,700 retail establishments in the United States containing 14.2 billion square feet of space. Per capita that equals 46.6 square feet per person (was 18 SF in 1992). How does that United States compare to other nations?

United States	**46.6 SF**
United Kingdom	23.0
Canada	13.0
Australia	6.0
India	2.0
Mexico	1.5

The evolution of retail shopping continues. Traditional retail stores (bricks and mortar) become showrooms for internet shoppers. Online sales are now 8% of total retail sales in the United States but it was only 2% in 2000. Amazon is now the 13th largest retailer up from 19th place in 2010.

Sources: www.about.com/retailindustry, Wall Street Journal (4/11/12)

Major Retail Store Closings

	2009	2010	2011	2012*
Abercrombie & Fitch				180
Best Buy				50
Blockbuster	960	690	405	500
Borders		200	633	
Circuit City	567			
Fashion Bug				600
Game Stop			200	
Gap			189	
Foot Locker		117	100	
KB Toys	461			
Movie Gallery	450	2,415		
Rite Aid	117	58	60	
Sears				172
Talbots			100	

*projected

Retail Vacancy Rates

	U.S.[1]	Detroit[2]	West Michigan[3]
2007	7.8%	9.8%	8.0%
2008		9.9%	
2009		10.9%	
2010		10.5%	13.8%
2011	9.7%	12.0%	13.5%

Source: [1] Marcus & Millichap
[2] Costar Group
[3] Colliers International

Dunham’s Sports (former Frank’s Nursery)
5474 West Main Street
Kalamazoo (Oshtemo Township)

21,000 SF Built 1972
Sold: April 2010
Sale Price: $500,000 ($23.81/SF)
Remodeled/Expanded 2010

Former Circuit City
4600 28th Street SE
Kentwood

39,263 SF Built 1996
Sold: March 2012
Sale Price: $1,200,000 ($30.56/SF)
Proposed Use: Multi-Tenant Retail

Former Home Depot (closed 2009)
3530 West Shore Drive
Holland (Township)

103,477 SF Built 2006

List Price: $2,300,000 ($22.23/SF)

Former Sam's Club Warehouse
665 Mall Drive
Portage

97,992 SF Built 1990
Vacated by Sam's Club Spring 2006

Future Use ?

Former Rite Aid Drugstore
5003 S. Westnedge Avenue
Portage

10,359 SF Built 1998
Vacated by Rite Aid in 2010

Leased 2012 to Family Dollar

Former Circuit City
6026 S. Westnedge Avenue, Portage

38,983 SF Retail Built 1996
Lease Rate: $13.90/SF fixed for 10 years,
    CPI increase to $15.15/SF in 2007
Circuit City closed in 2009 following bankruptcy

Space released to ABC Warehouse (34,000 SF) and Maurice's (5,000 SF) in late 2009.

Former Target Store
1740 E. Sherman Blvd., Muskegon

95,772 SF Retail Built 1996
Listed: Summer 2012, List Price: $2,250,000 ($23.49/SF)

Target closed this store in late 2006 and relocated in 2007 to Norton Shores. Tenants in the Sherman Shopping Center include Big Lots (former Circuit City space), Office Max and Petsmart.

501 Mall Drive, Portage

28,000 SF Retail Built 1993
Sold: April 2008
Sale Price: $1,736,000 ($62.00/SF)

Listed: Summer 2012 as REO @ $650,000
Sale Price: $544,000 ($19.42/SF)

Business closed in 2010 following expansion to this site in 2008. Basement showroom space.

Office Vacancy Rates

	U.S.[1]	Detroit[2]	West Michigan[3]
2007	13.2%	16.1%	15.9%
2008	14.0%	16.8%	
2009	17.4%	18.7%	
2010	17.8%	19.1%	
2011	17.3%	18.7%	23.3%

[1] Grubb & Ellis
[2] Costar Group
[3] West Michigan Research & Forecast Report
Colliers International

Former Pfizer Building (#298)
6901 Portage Road, Portage

364,000 SF Built 1989
Pfizer vacated in 2005
Sold: November 2009 @ auction
Resold: May 2011
Sale price: $1,400,000 ($3.85/SF)
Future use: ?

Former Pfizer “Quad Buildings”
1901 Romence Road, Portage

404,000 SF Built 1973 & 1979
Sold: 2001
Sale Price: $6,000,000 ($14.85/SF)
Pfizer vacated in 2005
New tenant 2011: Stryker
100,000 SF / 7 year lease, $11 million renovation
Residual Space: Asking $8.50/SF net

Milwood Office Center
4000 Portage Street, Kalamazoo

16,436 SF
Built 1971

Sold: 1/96
Sale Price: $625,000
($38.03/SF)

Resold: 6/98
Sale Price: $750,000
($45.63/SF)

Listed Summer 2012 @ $595,000 ($36.20/SF)
Functional obsolescence with basement space/second floor closed (HBU)

Multiple Family Vacancy Rates

	U.S.[1]	Detroit		Grand Rapids	
		M&M[3]	IREM[2]	M&M[3]	IREM[2]
2007	10.3%		14.6%		7.6%
2008	11.2%		9.6%		9.9%
2009	12.3%		7.7%		10.1%
2010	11.6%		11.2%	6.9%	13.2%
2011	10.3%	5.6%	13.7%	5.6%	5.3%

[1] National Multi Housing Council
[2] Institute of Real Estate Management
[3] Marcus & Millichap

Springport Glen Apartments
2951 Pheasant Run Drive
Jackson (Blackman Township)

312 Apartment Units, Built 1976-1978
91 - 1 Bedroom 1 Bath (650 SF)
221 - 2 Bedroom 1 Bath (750 SF)

Sold: November 1999
Sale Price: $8,525,000 ($27,324/unit)

Resold: March 2012 as REO
Sale Price: $4,550,000 ($14,583/unit)
R_O = 9.50%

Jackson apartment market suffered high vacancy levels from 2007 through 2011.

Foxcroft Apartments
636 36th Street SW
Wyoming

Sold: April 2004
Sale Price: $3,600,000 ($37,500/unit)

96 Apartment Units, Built 1968-1969
8 - 1 Bedroom 1 Bath (600 SF)
88 - 2 Bedroom 1 Bath (985 SF)

Resold: May 2012
Sale Price: $2,250,000 ($23,438/unit)
R_O = 9.12% (pro forma)

Grand Rapids apartment market suffered high vacancy levels from mid 2008 through 2011.

Nottingham Place Apartments
704 S. Drake Road
Kalamazoo (Oshtemo Township)

283 Apartment Units, Built 1974-1975
60 - 1 Bedroom 1 Bath (650 SF)
190 - 2 Bedroom 1 Bath (950-1,030 SF)
33 - 3 Bedroom 1.5 Bath (1,150 SF)

Sold: August 2011 as REO
Sale Price: $4,933,000 ($17,431/unit)
R_O = 9.58%

Property suffered high vacancy and deferred maintenance.
Kalamazoo apartment market suffered high vacancy levels from mid 2008 through 2011.

Devonshire Apartments
5427 Meredith Drive
Portage

311 Apartment Units, Built 1968-1970
32 - Studio (400 SF)
181 - 1 Bedroom 1 Bath (506 SF)
98 - 2 Bedroom 1 Bath (646-731 SF)

Sold: February 2004
Sale Price: $5,930,000 ($19,068/unit)

Resold: March 2009 as REO
Sale Price: $2,910,000 ($9,357/unit)

Property suffered high vacancy and functional obsolescence.

Arbor Park (f/k/a Northwinds) Apartments
3800 Madison Avenue SE
Wyoming

96 Apartment Units, Built 1971
72 - 1 Bedroom 1 Bath (554 SF)
24 - 2 Bedroom 1 Bath (713 SF)

Sold: July 2007
Sale Price: $2,945,000 ($30,677/unit)
R_O = 9.37%

Resold: February 2011 as REO
Sale Price: $850,000 ($8,854/unit)

Property suffered high vacancy and functional obsolescence.

Industrial Vacancy Rates

	U.S.[1]	Detroit[2]	West Michigan[3]
2007	7.6%	10.9%	9.2%
2008		11.4%	8.3%
2009	10.7%	13.2%	9.1%
2010	10.6%	14.2%	9.3%
2011	11.9%	12.5%	8.9%

[1] Grubb & Ellis
[2] Costar Group
[3] Colliers International

Imperial Beverage (former American Greeting)
3825 Emerald Drive
Kalamazoo

606,116 SF Built 1972-2000
Sold: October 2011
Sale price: $6,000,000 ($9.90/SF)
Use: owner/user to occupy 200,000 SF
400,000 SF for lease at $2.75/SF to $4.00/SF net

4141 Manchester Road
Kalamazoo

387,888 SF Industrial Built 1968
Sold: March 2008
Sale price: $6,100,000 ($15.73/SF)

Former Mead Corp. plant closed in 2000. Purchased by Fabri-Kal for the consolidation of its 3 locations.

2538 S. 26th Street
Kalamazoo (Comstock Township)

26,294 SF Distribution Built 1996
Sold: July 2007
Sale price: $1,825,000 ($69.41/SF)
Resold: September 2009
Sale Price: $982,500 (37.37/SF)

Property purchased by DHL Logistics in 2007 for its Kalamazoo distribution center. Center closed in 2009.

Characteristics of Vacant Investment Properties

- Increased physical depreciation (deferred maintenance)
- Functional obsolescence
  - space not competitive in today's market (too large/too small)
- Locational obsolescence
  - external factors effecting property
  - movement from "B" to "A" locations
- Ownership and management issues
  - under capitalized – can't support negative cash flows
- Changing highest and best use
  - existing improvements no longer functional
  - land value exceeds building value
- Legal restrictions affecting existing use
  - Comstock GM stamping plant – restrictive covenant precluded sale to tier 1 automotive manufacturer
  - Walmart sales of existing properties prohibit retail use

Midlink Business Park
(Former GM Stamping Plant)
Sprinkle Road @ I-94
Kalamazoo (Comstock Township)

2,000,000 SF Built 1965
GM vacated in 1998 (closing announced 1992)
Sold: December 1999
Sale price: $23,000,000

Renovated into multiple tenant (400,000 SF demolished)
- Midlink East (854,256 SF)
- Midlink West (811,927 SF)

Major Tenants:	
Kaiser Aluminum	435,000 SF
Kenco	216,000 SF
Mann & Hummel	142,000 SF
Polymer Solutions	107,800 SF
W. Soule & Co.	68,000 SF
Erickson Flooring	51,200 SF
Softball Fans	35,000 SF

Former GM Stamping Plant
300 36th Street SW
Wyoming

1,926,000 SF   Built 1936
Land Area: 75.00 acres

GM vacated in 2009

Sold: April 2011 General Motors Liquidation to Racer Properties, LLC
Resold: June 2011 to City of Wyoming

Existing automotive stamping plant being razed

Former X-Rite property
3100 44th Street SW
Grandville
209,200 SF   Built 1986
Land Area: 34.83 acres

Sold: January 2009   Sale Price: undisclosed

Purchaser razed existing industrial buildings and is constructing a strip retail development including Target and Cabella's.

Former Walmart store
300 N. Opdyke Road
Auburn Hills

151,000 SF Retail Store
Built 1995
Land Area: 21.63 acres

Sold: April, 2011   Sale Price: $2,250,000 (14.90/SF)

Sale included a 25 year deed restriction prohibiting use as grocery, wholesale or discount store. Purchaser rezoned the property to industrial and converted the building into a warehouse ($2,000,000 +/- conversion cost).

Valuation Issues

- Forecast rent and rent growth often lower than first user
- Second generation rents (i.e. drug stores @ $15 to $20/SF versus general retail @ $8 to $10/SF)
- Vacancy forecast and time required to reach stabilized occupancy

  extended lease-up typical for vacant or distressed properties
- Operating expenses on a vacant property paid by the owner (real estate taxes, insurance, utilities, maintenance)
- Net operating income likely lower than amount achieved from first user
- Higher capitalization rate (Ro) and equity requirements (Re and Ye)

  Walgreens Ro at 6.50% to 7.50% versus Family Dollar/Dollar General at 8.00% to 9.00%
- More difficult to finance

  lower loan to value ratios = more equity ($)

  higher debt coverage ratios

  higher interest rate

  shorter amortization

  covenants (personal guarantees)

  focus on tenant credit

Valuation Process

- Properties typically purchased “as is”
- Developer considerations
    - has the highest and best use changed?
    - are the building improvements obsolete justifying demolition?
    - has property value changed to land only?
- Estimate the value at stabilized occupancy
    - if 100% vacant and stabilized occupancy is 90% then improvement in
    - occupancy needed is 90%
    - absorption rate necessary to reach stabilized occupancy
- Deduct costs of stabilization
    - tenant improvement costs ($/SF)
    - deduct rent loss during lease-up period
    - deduct leasing commissions
    - deduct entrepreneurial incentive (profit)

Costs of Stabilization

Tenant Improvement (TI) Allowance – are an amount provided to the tenant by the landlord to pay for all or a portion of remodeling cost. It is usually expressed as dollars per square foot. Tenant improvement allowances fluctuate with economic conditions.

Rent Loss During Lease-up – are the monies foregone during the time required to reach the projected stabilized occupancy level. A key consideration is to accurately forecast the absorption rate for the property type and the subject's fair share rate.

The rent loss is calculated to the stabilized occupancy rate (i.e. 50,000 SF vacant with a 10% vacancy rate = 45,000 SF to lease).

Lease Commissions – are the periodic charges paid to real estate brokers or agents for leasing tenant space. Commissions paid over the term of the lease or upon renewal may or may not be included in the reconstructed operating statement. It all depends on the local market. In larger multiple tenant properties leasing commissions are a typical expense after the initial lease-up which is likely a development expense.

Entrepreneurial Incentive – is the amount the developer, investor or entrepreneur expects to receive as compensation for the coordination, expertise and risk assumed in bringing a development to market. Incentive differs from profit as profit represents the difference between the total cost of the project and its market value.

The dollar amount of entrepreneurial profit is more important than the percentage amount to the entrepreneur.

Retail Building
Case Study

You are appraising a partially vacant big box retail property. The building contains 87,535 square feet constructed in 1987 as a K-Mart discount store. K-Mart occupied the building until 2002 when the store was closed. It remained vacant until 2006 when Hobby Lobby leased 56,479 square feet. At that time $400,000 was spent to divide the space for multiple tenants and $200,000 to replace the roof. The remaining 31,056 square feet (35%) is vacant.

Asking rents and leases for similar large retail spaces were:

Location	SF Leased	Rent/SF	Lease Date
Battle Creek	12,000	$6.00	2/11
Battle Creek	52,679	$7.29	listing
Battle Creek	56,479	$5.43	1/06
Battle Creek	47,523	$6.13	listing
Battle Creek	12,000	$8.00	2008
Battle Creek	46,680	$6.50	listing
Battle Creek	39,698	$7.22	1/03

Overall vacancy in the retail market is trending between 10% and 20%. Leases are net with the tenant responsible for real estate taxes, maintenance and insurance (typically $3.00/SF). Lessor operating expenses and management fee (3% of EGI), structural repairs (.20/SF annually and common area expenses (taxes, insurance and CAM) for vacant space.

Conventional financing is available at a 65% loan to value ratio, 7% interest, 20 year amortization and term (mortgage constant = .093036). Equity dividend rates for similar retail properties are typically 12%.

Sales and listings of retail properties in this market were:

Location	Size/SF	Price/SF	Vacancy	Ro
Battle Creek	180,500	$34.24	25%	10.00%
Battle Creek	47,500	$48.40	100%	11.00%
Muskegon	95,700	$23.50	100%	N/A
Grand Rapids	60,900	$97.74	16%	8.73%

Reconstruct the income and expense statement for the subject property. What is the:

1. Potential gross rental income?

2. Effective gross income?

3. Operating expenses?

4. Net operating income?

5. What is the capitalization rate?

6. What is the value of the property (rounded to nearest $1,000)?

Retail Building Case Study

Potential Gross Rental Income (_______ SF x $______)	$_____________
- Vacancy/Collection Loss (______%)	-___________
+ Miscellaneous Income	+ 0
Effective Gross Income	$_____________
Operating Expense Analysis	
Lessor Expenses	
Management Fee (_____% of EGI)	$__________
Structural Repairs (____/SF)	________
CAM (_______ SF x $_____/SF)	________
Total Operating Expenses	$__________
Net Operating Income	$____________
Capitalization Rate	________
Value	$____________ (r)

ANSWER

Retail Building Case Study

Potential Gross Rental Income (87,535 SF x $6.00)	$525,210
- Vacancy/Collection Loss (15%)	-78,780
+ Miscellaneous Income	+ 0
Effective Gross Income	$446,430
Operating Expense Analysis	
Lessor Expenses	
Management Fee (3% of EGI)	$13,390
Structural Repairs (.20/SF)	17,500
CAM (13,130 SF x $3.00/SF)	39,390
Total Operating Expenses	$70,280
Net Operating Income	$376,150
Capitalization Rate	10.00%
Value	$3,760,000 (r)

The Rest of the Story

Tenant: Big Lots (opened 7/12)

Lease Term: likely 10 year with options

Lease Rate: not disclosed

Tenant Expenses: pro rata taxes, insurance and snow removal

Fractured Properties

The conversion of ownership interests from a single entity to fractional ownership interests is not a new real estate phenomenon. Condominium conversions accelerated during the 2000's due to the availability of cheap financing and profit potential. A condominium unit would sell at higher prices thereby increasing cash flow and developer profit. It was not uncommon for rental apartments to be converted into for sale condominiums in addition to other property types (i.e. office, retail, etc.).

The onset of the recession and declining real estate values led to many developments which were partially sold to individual users/investors with the remaining units owned by the developer. One option for the developer was to rent units versus selling units at reduced prices. Condominium properties with a mixture of sold units and rental units are called fractured condominiums.

The appraisal of a fractured development is difficult because there are alternate highest and best uses to consider. Several scenarios include:

•If no sales have occurred and the developer owns all the units then the likely use is for rental with the primary valuation method being the income approach.

•If a few sales have occurred and the developer is attempting to revoke the condominium declaration then the likely use is for rental with the income approach as the primary valuation method.

•If the property is continuing to market units for sale then the likely use is condominium ownership with the primary valuation method being the sales comparison approach.

•If too many sales have occurred preventing the developer from dissolving the condominium then the likely use is individual condominium ownership.

•If due to a distressed market the developer has suspended sales and is renting units as an interim use, then the likely use is individual condominium ownership.

"Fractured Condo Projects: Highest and Best Use Determines Valuation Approach," published in Fair & Equitable by the International Association of Assessing Officers, July 2012

The Reserve Apartments
6035 Chablis Lane, Portage

44 units all 2 bedroom, 2 bath (1,080 SF)
Built 1995 as condominiums
2 units sold later repurchased by developer
Current rents @ $979 to $1,069

Problem: Constructed next to a Section 42 apartment development (same developer). No market acceptance.

Lakeview Apartments	280 units	70 - 1 Bedroom, 1 Bath (624 SF)
1902 Colgrove Avenue	Built 1966	140 - 2 Bedroom, 1 Bath (825-988 SF)
Kalamazoo Township		70 - 3 Bedroom, 2 Bath (1,200 SF)

Sold: May 2005 $5,600,000 ($20,000/unit)
Converted to condominiums in 2008 (10 sold to a related party)
Property renovated in 2008-2009
Sold: February 2011 $7,300,000 ($26,071/unit)

Problem: older property (circa 1966), high density (21 units/acre), no market acceptance. Condominium association terminated in 2011.

Westgate Village Townhomes
680 Pinckney Court NW
Grand Rapids (Alpine Township)

120 Units, Built 1976 as Rental Townhomes
24 - 1 Bedroom 1 Bath (670 SF)
96 - 2 Bedroom 1.5 Bath (900 SF)

Sold: January 1996 $3,750,000 ($31,250/unit)
Converted to condominiums in 2006 (49 sold @ $69,900 to $119,900)

Sold: June 2010 @ foreclosure $3,100,000
Resold: August 2011 $910,000 ($12,817/unit)

71 units currently rented, 1 bedroom @ $575, 2 bedroom @ $775-$850

Stratford Village of Sterling Heights
43081 Burlington Drive, Sterling Heights

92 units in Phases 1-3 built 2002-2004, all units sold
36 units in Phase 4 2 Bedroom, 2 Bath (1,324 SF)
Built 2005 (partially finished)

Sold: December 2007 (29 units) deed in lieu of foreclosure

Valuation Date: September 27, 2008

Highest and Best Use Options

Option No. 1 Sale of individual condominium units

Market Overview
Attached Condo Building Permits

	Macomb County	Sterling Heights
2004	2,063	464
2005	1,715	264
2006	981	159
2007	320	18
2008	82	0

- Only resales of units between 9/07 and 9/08. No sales of new units from builder to home buyer.
- Sale prices less than cost of construction and/or less than loan balance.
- No indication that market has reached bottom or when recovery would occur.

Conclusion: Sales of individual units unlikely

Option No. 2 Bulk sale of 29 units in "as is" condition to investor/developer

Resales in Stratford Village

Date of Sale	Sale Price	Conditions of Sale	Sq. Ft. Area	Price/SF	Year Built	Previous Sale	Previous Sale Date	Loss in Value
05/30/08	$106,000		1,244	$85.21	2003	$132,352	07/07/04	19.91%
01/23/08	$102,000	Lender Sale	1,446	$70.54	2003	$152,000	08/26/03	32.89%
05/30/08	$ 98,000	Lender Sale	1,244	$78.78	2003	$139,700	03/26/04	29.85%
10/03/07	$113,300		1,446	$78.35	2003	$144,900	08/16/04	21.81%
04/22/08	$100,000		1,244	$80.39	2003	$139,900	10/14/04	28.52%
03/17/08	$ 83,000	Lender Sale	1,446	$57.40	2003	$158,150	09/07/04	47.52%

-The weighted loss in value from all 2007-2008 sales compared to previous sales was 30%. This parallels the loss in value (-31%) observed from other condominium units sold in Sterling Heights in the same time frame.

-Competitive pricing in the range of $100,000 to $113,000 or an average price of $106,500 ($80/SF).

Absorption*

Year 1	0 sales	Year 4	6 sales
Year 2	3 sales	Year 5	6 sales
Year 3	6 sales	Year 6	8 sales

*Absorption estimate is a guess.

The combined present value of the anticipated future net revenues for the 29 unsold units is identified at $575,000 or $19,828. This amount is representative of the market value. It is a price that an individual purchaser could affordably pay for the subject development “as is” in a single lump sum sale price.

	B	C	D	E	F	G	H	I	J	K	M
1											
2						INPUTS					
3	CASH FLOW ANALYSIS										
4	FINISHED CONDO SITES										
5	Stratford Village - Phase IV										
6	Assumptions:			Scheduled line item profit		0%					
7	Prime Rate		n/a	Tax Rate Per Thousand		$ 48.09					
8	Yield Rate/Discount Factor		25.00%	R.E. Tax Total B4 Re-assmt							
9	Number of Sites		29	Re-Assessment Year							
10	Avg Unit Price		$ 95,000	Sales Commission Rate		3%					
11	Annual Trend Rate:		3.00%	Closing Cost Rate		2.00%					
12	Absorption Rate / Quarter		[illegible]	Advertising Cost Rate		$200/unit					
13	Number of Presales		0	Developer's overhead		1.00%					
14	Dev Cost-Infrstrc/Lot			Administration Rate		$200/unit					
15	Construction cost of units/unit		$ 17,241	Maint, Util, Ins. Rate		$100/unit					
16	Land Cost/Value Per Lot			Loan to Value Ratio							
17						c:\documents and settings\kirstenc\local settings\temporary internet files\olk7\[dcf.xls]dcf-sites					
22					100%		PROJECTED ABSORPTION RATES & POTENTIAL GROSS REVENUES				
23											
24	Quarters				2008	2009	2010	2011	2012	2013	
25	SS Version	0304			1	2	3	4	5	6	
26	MV Rounding	25000		Analysis Date							TOTALS
27					-------	-------	-------	-------	-------	-------	-------
28	PROJECTED REVENUES DURING SELLOUT PERIOD										
29	UNSOLD LOTS BEGINNING OF YEAR:				29	29	26	20	14	8	
30	LOTS SOLD DURING YEAR (Including Presales):				0	3	6	6	6	8	29
31	UNSOLD LOTS AT END OF YEAR:				29	26	20	14	8	0	
32	TRENDED HOUSE PRICES:				$ 95,000	$ 95,000	$ 95,000	$ 95,000	$ 95,000	$ 97,850	
33	TOTAL GROSS SALE PROCEEDS:				$0	$285,000	$570,000	$570,000	$570,000	$782,800	$2,777,800
34											
51	PROJECTED EXPENSES DURING SELLOUT PERIOD										
52					2008	2009	2010	2011	2012	2013	
53					1	2	3	4	5	6	TOTALS
54					-------	-------	-------	-------	-------	-------	-------
55	REAL ESTATE TAXES:		$1,997		($57,913)	($53,480)	($42,372)	($30,550)	($6,743)	($9,260)	(200,319)
56	SALES COMMISSIONS:		6.00%		$0	($17,100)	($34,200)	($34,200)	($34,200)	($46,968)	(166,668)
57		(Paid as funds are received)									
58	CLOSING COSTS:		2.00%		$0	($5,700)	($11,400)	($11,400)	($11,400)	($15,656)	(55,556)
59	CONSTRUCTION COSTS:		$ 17,241		$0	($52,111)	($105,004)	($105,791)	($106,584)	($143,178)	(512,668)
60	DEVELOPERS OVERHEAD		1.00%		$0	($2,850)	($5,700)	($5,700)	($5,700)	($7,828)	(27,778)
61	ADVERTISING		$200	unit	($5,800)	($5,200)	($4,000)	($2,800)	($1,600)	($800)	(20,200)
62	ADMINISTRATION		$200	unit	($5,800)	($5,200)	($4,000)	($2,800)	($1,600)	$0	(19,400)
63	CONDO ASSOCIATION FEES		$115	unit/month	($40,020)	($36,956)	($29,281)	($21,111)	($12,426)	($6,399)	(146,194)
64					-------	-------	-------	-------	-------	-------	-------
65	TOTAL EXPENSES:				($109,533)	($178,597)	($235,957)	($214,353)	($180,253)	($230,090)	(1,148,783)
66											
67	NET REVENUES BEFORE DEBT SERVICE:				($109,533)	$106,403	$334,043	$355,647	$389,747	$552,710	1,629,017
68	DISCOUNT FACTOR AT YIELD RATE OF			25.00%	0.80000	0.64000	0.51200	0.40960	0.32768	0.26214	
69	(Opportunity cost of money)				-------	-------	-------	-------	-------	-------	-------
70	PRESENT VALUE OF FUTURE NET REVENUES:				($87,626)	$68,098	$171,030	$145,673	$127,712	$144,890	569,777
71	Pv OF FUTURE NET REVENUES										
72	(MARKET VALUE):			$ 569,777							
73	MARKET VALUE ROUNDED TO:			$ 575,000							

Option No. 3 Interim use as a 29 unit rental property until market recovers

Condo Rent Comps

Development	Date of Lease		Lease Price	Sq. Ft. Area	Price/SF
Pendleton Village	12/14/07		$ 900	1,456	$0.62
Moravian Manor	10/06/07		$ 999	1,303	$0.77
Moravian Manor	08/08/08		$1,000	1,716	$0.58
Pendleton Village	09/11/08		$1,050	1,400	$0.75
Glenmere Estates	02/06/08		$1,200	1,580	$0.76
Stratford Village	04/07/08		$1,000	1,244	$0.80
Marsh Creek	03/04/08		$1,250	1,400	$0.89
North Pointe	02/22/08		$1,300	1,775	$0.73
		Avg.	$1,087	1,484	$0.74

Market rent estimated at $975/month or .74/SF

Gross potential annual rental income at $339,300

Potential Gross Rental Income		$339,300
- Vacancy/Collection Loss (10%)		-33,930
+ Miscellaneous Income		+2,610
Effective Gross Income		$307,980
Operating Expense Analysis		
Fixed Expenses		
	Insurance	2,900
	Real Estate Taxes	66,250
Variable Expenses		
	Management Fees	18,480
	Condo Fees	40,020
	Utilities	1,500
	Advertising	4,350
	Maintenance	8,700
	Office/Telephone	2,030
Reserves for Replacement		
	Carpeting/Appliances	5,800
Total Operating Expenses		$150,030
Net Operating Income		$157,950

Capitalization Rate

Conventional financing is available at a 75% loan to value ratio, 6% interest, 25 year amortization and term (mortgage constant = .077316). Equity dividend rate at 10%.

75.00 x .077316 = 5.7987
25.00 x .100000 = 2.5000
Ro = 8.2987 or 8.50%

Sales and listings in the Detroit metro market illustrate overall capitalization rates.

Kirts Village	4/08 sale	7.37%
Kingsview Manor	7/07 sale	7.59%
Cedarbrook	4/07 sale	7.00%
Providence Court	9/07 sale	7.85%

Overall capitalization rate of 8.25% is reasonable.

Value via Income Approach

$$\frac{\text{NOI}}{\text{Ro}} = \frac{\$157{,}950}{.0825} = \$1{,}914{,}545 \text{ or } \$1{,}900{,}000$$

Stabilized Value versus As Is Value

The value developed via the income approach reflects a stabilized property in a typical operating posture. What expenses are incurred during this time?

Cost to Complete (units are partially finished)	$ 500,000
Lost Rental Income (15 units @ $975 x 6 months)	87,750
Operating Expenses	150,000
Entrepreneurial Incentive (20%)	380,000
Total Holding Costs	$1,117,780
As Is Value	$ 782,220 or $800,000

The Rest of the Story

- Development purchased “as is” by J & F Holdings, LLC in November 2009

- Sale price @ $709,847 ($24,477/unit)

- Purchaser invested $500,000+/- ($17,250/unit) to complete construction

- Units continue to be rented until market improves and condominium sales resume

Office Building
Case Study

The subject property is a four story steel frame and masonry construction “class B” office building constructed in 1973. Gross building area is 70,000 square feet and useable area is 65,800 square feet.

Location is the I-75/Stephenson Highway office corridor in Troy. The property was originally constructed for multiple tenant use. The building was occupied by Beaumont Hospital as a billing/accounting center. It has been vacant since second quarter 2009.

Market conditions in the Detroit office market can best be described as tepid. Vacancy rates as of first quarter 2012 at 18.8% exceed national averages across building classes. The Troy submarket is the softest market with vacancy at 32.4%. That rate, though fluctuating slightly at 30%, is unchanged since 2009.

Aerial View

Stephenson Highway & I-75 Office Corridor 14 to 15 Mile Roads
I-75 & Stephenson Highway

MARKET RENT

SUMMARY OF RENT COMPARABLES

	Location	Bldg. Size Space Leased	Lease Date	Rental Rate & Basis
1	Troy	75,600 sf 11,614 sf	11/11	$13.77/sf – Gross + Elec.
2	Troy	275,000 sf 18,450 sf	6/11	$16.50/sf – Gross + Elec.
3	Troy	188,305 sf 15,820 sf	4/11	$15.90/sf – Gross + Elec.
4	Troy	84,735 sf 40,034 sf	Mid 2011	$15.00/sf – Gross + Elec.
5	Troy	505,411 sf 94,571 sf 40,294 sf 63,356 sf	12/11 2/12 7/12	$12.92/sf – Gross + Elec. $16.23/sf – Gross + Elec. $11.92/sf – Gross + Elec.
6	Troy	94,318 sf 11,621 sf	12/11	$12.25/sf – Gross + Elec.
7	Troy	54,337 sf 54,337 sf	11/11	$9.67/sf – NNN
S	Troy, MI	70,000 sf	Current Offer	$13.50/sf – Gross + Elec.

Rents at the upper end ($15.00 to $16.00/SF) are in superior locations and are influenced by rent concessions and tenant improvement allowances. In this market up to 6 months free rent and a $7.50/SF tenant improvement allowance are typical.

Operating Expense Comparables

Location	Bldg. Size	Age	Expenses/SF
1. Livonia	111,227	1990	$ 7.73
2. Troy	69,978	1974	$ 9.62
3. Farmington Hills	39,728	1971/1987	$10.22
4. Southfield	195,355	1971	$ 4.97
5. Clinton Twp.	50,753	1987	$ 7.48
6. Southfield	125,682	1969/1971	$ 5.00
7. Troy	49,900	1986	$ 9.34
8. West Bloomfield	88,000	1986	$ 6.17
9. West Bloomfield	65,304	1988	$ 6.70

The subject property historical operating expenses as a vacant building were $3.57/SF (2010) and $3.50/SF (2011). These expenses were not representative of stabilized expenses due to minimum utilities, maintenance, janitorial and management.

Capitalization Rate

Capitalization rates could not be extracted from properties in the subject area due to a lack of comparable sales with similar tenancies and income streams. Soft market conditions and a lack of buyers have been driving capitalization rates higher.

National investor surveys as of the 4th quarter 2011 indicate the following range of capitalization rates for national "CBD office properties".

	Range	Average
PWC Real Estate Survey	4.50% - 10.00%	6.84%
Realtyrates.com		9.98%
CBRE cap rate survey	9.00% - 12.00%	

Note that national survey data typically report rates for institutional grade real estate or the most desirable properties.

Current financing is available at a 65% loan to value ratio, 7% interest, 20 year amortization and term (mortgage constant = .093036). Equity dividend rates for similar office properties are typically 13% (realtyrates.com report an average equity dividend rate of 13.1% for national CBD office properties).

Reconstruct the income and expense statement for the subject property. What is the:

1. Potential gross rental income?

2. Effective gross income?

3. Operating expenses?

4. Net operating income?

5. What is the capitalization rate?

6. What is the value of the property (rounded to nearest $1,000)?

7. Is the indicated value what an investor would pay?

Potential Gross Rental Income	$________
- Vacancy/Collection Loss	-________
+ Miscellaneous Income	+________
Effective Gross Income	$________
Operating Expense Analysis	
Fixed Expenses	
	________
	________
Variable Expenses	
	________
	________
	________
	________
	________
	________
Reserves for Replacement	
	________
	________
	________
Total Operating Expenses	$________
Net Operating Income	$________

ANSWER

Potential Gross Rental Income	(65,800 SF X 12.50/SF)	$822,500
- Vacancy/Collection Loss	(20%)	-164,500
+ Miscellaneous Income		+0
Effective Gross Income		$658,000
Operating Expense Analysis		
Fixed Expenses		
Variable Expenses		
Reserves for Replacement		
Total Operating Expenses	($7.16/SF)	$471,500
Net Operating Income		$186,500

Net Operating Income	$ 186,500
Capitalization Rate	10.6%
Market Value	$1,750,000 (R)

The indicated market value at $1,750,000 equals $25.00 per square foot (GBA) and $26.60/SF (UA). This value presumes that the subject property is leased and operating in a stabilized posture. It is not and given market conditions an extended marketing period could be required.

Thus, the value conclusion is a future “as stabilized” value.

Stabilized Value versus As Is Value

The value developed via the income approach reflects a stabilized property in a typical operating posture. What expenses are incurred during this time?

Absorption	1 to 2 year absorption period would not be unusual. The subject property has been vacant 2+ years.
Lost Rental Income	1 year = $658,000 (65,800 SF x $12.50/SF x .80%)
Operating Expenses	= $230,300 ($3.50/SF)
Lease Commission	= $164,500 (65,800 SF x $12.50/SF x .80% x 5 years x 5%)
Total Holding Costs	= $1,052,800

SUMMARY OF COMPARABLE SALES

No.	Location	Sale Date	Sale Price	Gross Building Area	Year Built	Price/SF
1	525 E. Big Beaver Troy	3/11	$2,000,000	40,060 SF	2001	$49.93/SF
2	17187 N. Laurel Park Livonia	6/11	$1,820,000	123,693 SF	1985	$14.71/SF
3	32991 Hamilton Ct. Farmington Hills	9/11	$2,800,000	70,933 SF	1989	$39.47/SF
4	26200 American Dr. Southfield	10/11	$2,500,000	72,935 SF	1985	$34.28/SF
5	5225 Crooks Rd. Troy	11/11	$2,350,000	55,454 SF	1999	$42.38/SF
6	30445 Northwestern Hwy. Farmington Hills	12/11	$4,200,000	106,117 SF	1986	$39.58/SF

The more recent transactions summarized above involve buildings ranging in size from 55,454 square feet to in excess of 123,000 square feet and the range of prices paid per square foot falls between a low of $14.71 and a high falling just below $50.00.

Comparable No. 1 was 77% occupied at time of sale. Comparable Nos. 3 and 5 were 100% vacant. All sale comparables are newer than the subject property.

The Rest of the Story

Income Approach – Stabilized	$1,750,000
Sales Comparison Approach	$2,100,000
"As Is" Value	$700,000-$1,200,000

Brokers Opinions

1. Suggested Asking Price	$2,200,000
Probable Achievable Price	$1,200,000
2. Suggested Asking Price	$2,700,000

Name that Building

Many of you will recognize this property as the former Pontiac Silverdome. It was the home of the Detroit Lions for many years and after the Lions built their own stadium in downtown Detroit, this property pretty much fell into disuse. It was owned by the City of Pontiac and over a period of several years, they solicited proposals for alternate uses of the facility. Virtually all were rejected by the City and during this timeframe, the market continued to implode and this facility became a huge burden on the tax roll of Pontiac. It went up for auction and was eventually purchased for a total of $580,000 by a Canadian group heavily involved in soccer. This facility was originally constructed at a cost of about $59,000,000 and after the Lions vacated it, several proposals were received from the City wherein purchase prices from $5,000,000 to $20,000,000 might have been possible.

Questions and Answers

"Come with me. I've found someone who'll talk square footage with you."

BIOGRAPHICAL SKETCH

David Rice, MAI, CAE, MMAO 4 has been an instructor for the MAA continuing education courses since 1985. Over that period he developed the basic and advanced income approach courses utilized in the MAA educational program.

He is the developer of the following seminars:

- Apartment Markets and Valuation Issues (2004)
- Developing Capitalization Rates (2010)
- Commercial Property Appeals (2011)
- Analyzing Operating Expenses (2011)
- Valuation of Vacant Michigan Investment Properties (2012)

His professional career began with the Plainfield Township Assessors' office in 1974. In late 1981 he moved to the private sector employed by Edward Rose & Sons, a midwestern based real estate development company. From 1988 to 1994 he joined Poppen & Mackie, Inc., a Grand Rapids fee appraisal company. He rejoined Edward Rose in 1994.

Mr. Rice holds the MAI designation from the Appraisal Institute and the CAE designation from the International Association of Assessing Officers. He also holds MMAO 4 certification from the State Tax Commission. He is licensed by the State of Michigan as both a certified general appraiser and broker.

He has served as Professional Designation Advisor for IAAO in the western half of the state since 1991. He has held various leadership positions in the Great Lakes Chapter of the Appraisal Institute including President (1998) and as its Education Chair since 2001. In 2004 he was the recipient of the Connie Vickroy Distinguished Service Award. During 1990 he was recognized by MAA with its Subscribing Member Award and its Education Award in 2003.

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