Convenience Stores & TRPs in Condemnation:

Special Valuation Issues in the Application of the Income Approach

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Thank you, Mr. Vasallo, for inviting me to speak. It is a pleasure to be here.

In the next 40 minutes, I am going to give an appraiser’s perspective on the application of the income approach to what the appraisal industry calls Trade Related Property.

Controversy has been raised across the country as to whether an earnings-based income approach can be rightfully applied in condemnation cases.

The question is, In states where lost business value is not compensable, can an earnings-based valuation procedure be used? Or, do earnings inherently include business value?

As a framework for our discussion, we are going to look at the *Presta* case out of Kansas. This is a ruling on a Motion in Limine concerning earnings-based evidence in the valuation of a gas station.

The reason I selected the *Presta* decision is because this is a 2013 case where the Court fully expressed itself on the issue.

As an appraiser, I am going to go over the statements made by the Kansas Court and give you the appraisal industry's view as to what was good and bad about the decision.

In several states where this controversy is still not settled, it is my hope that this presentation will equip attorneys to better argue and respond to the challenge.

The Kansas Court rejected what they termed an "EBITDA capitalization".

For reasons that we are going to see today, this ruling is unfortunate in the way the final wording came down and how narrowly the court examined the issue.

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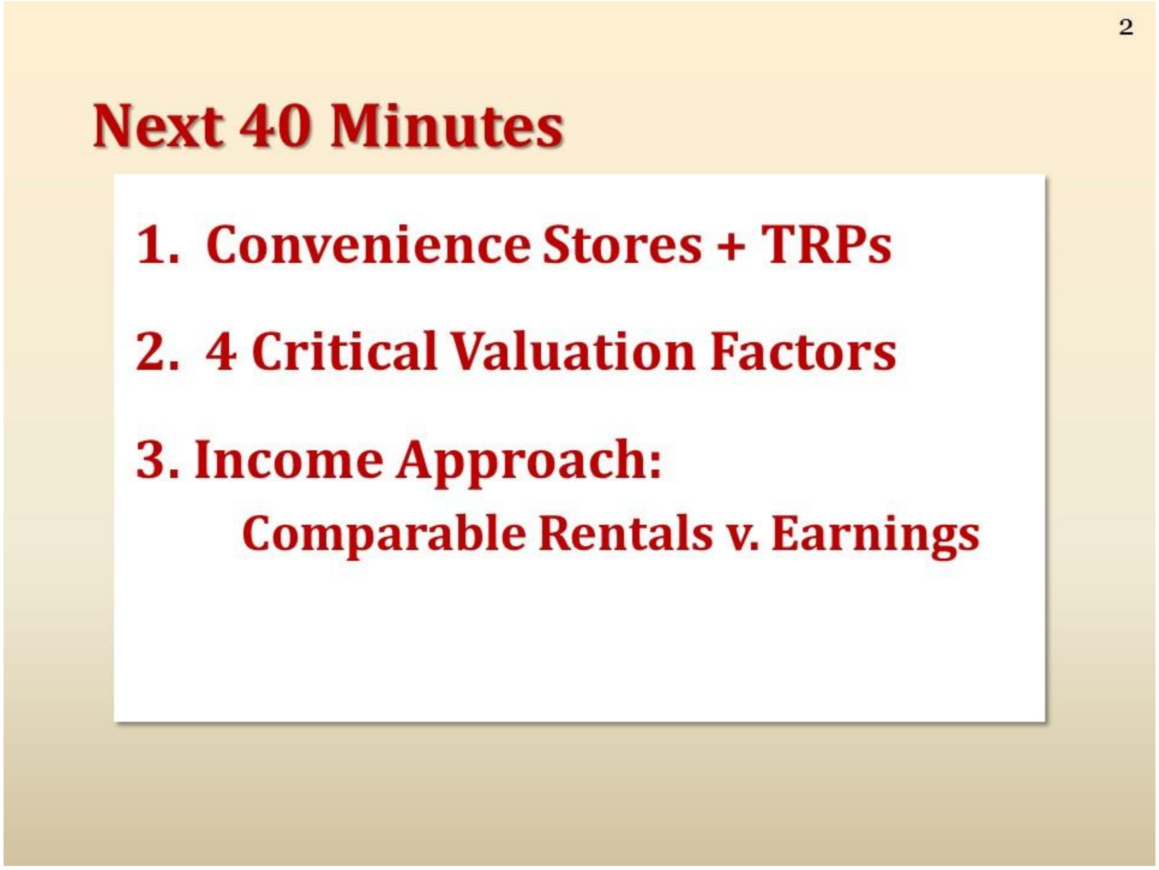

We will cover three topics.

In the first part of our discussion we will look at what constitutes a TRP and why these properties are different and require different valuation methods than other types of properties.

We will also identify four critical valuation factors for TRPs that should be considered by the appraiser, regardless of the valuation procedure.

And finally, we will compare and contrast the use of comparable rentals as opposed to the use of an earnings allocation in the income approach.

SLIDE 3:

All income-producing real estate can be divided into two classifications: those that are built for rental income and those that are not.

Trade Related Property, or TRPs, are not built for rental income. These properties are built to facilitate a particular business enterprise.

Let’s look at some of the characteristics of TRPs.

1. Single economic purpose. i.e. they are built to generate earnings as opposed to rent.

2. They cannot be easily converted to another use.

3. Often the value of the real estate is very sensitive to access.

4. Usually they have high visibility requirements.

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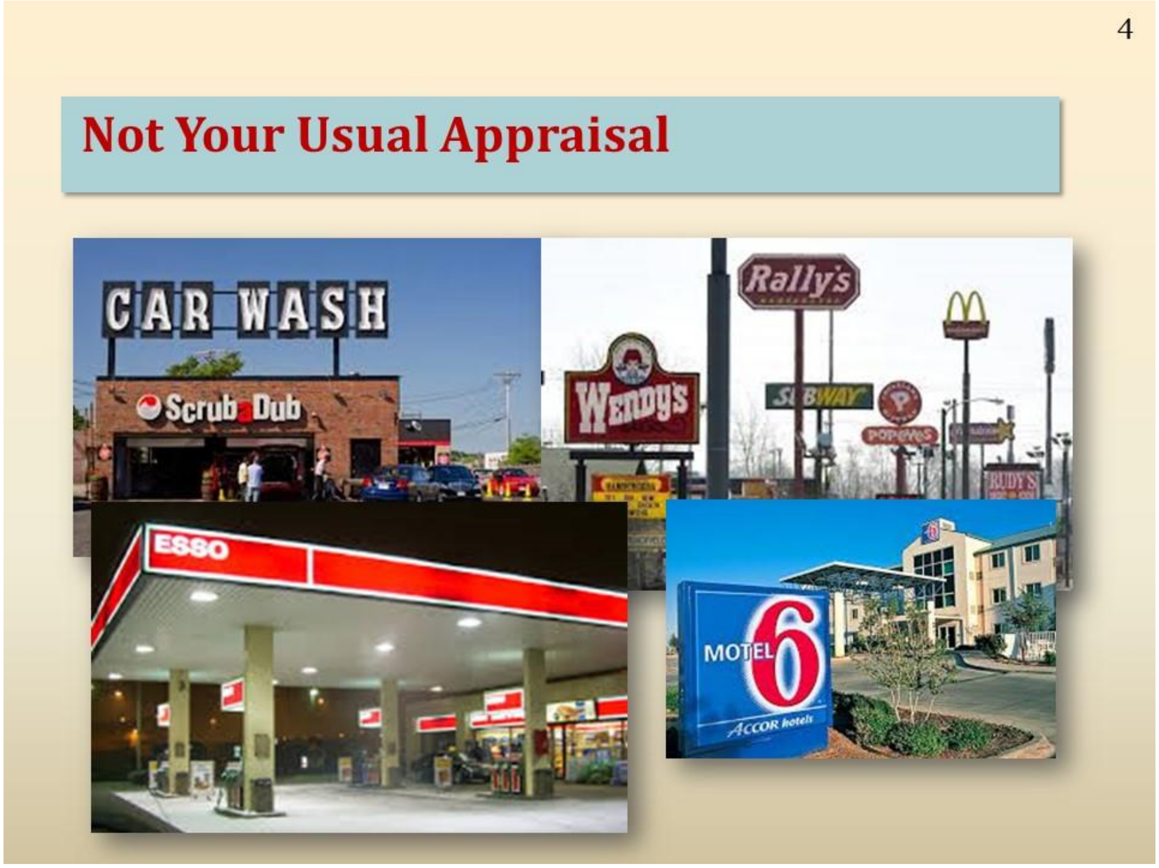

Here are some examples of TRPs that you have all seen.

Car washes, fast-food restaurants, motels and hotels, convenience stores and gas stations.

These properties - and how they should be appraised - are quite different from apartments, offices and multi-tenant retail and others that are built for rental income.

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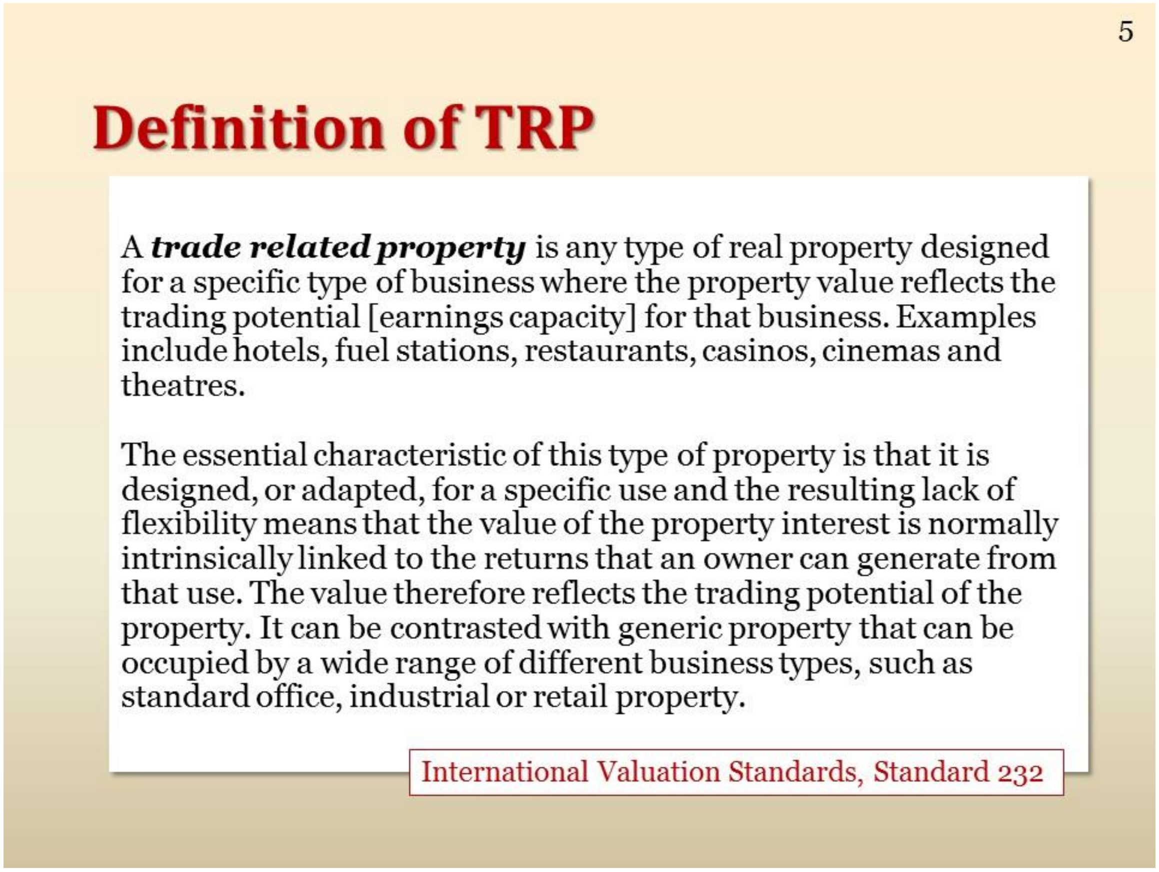

This is the definition of a Trade Related Property according to International Valuation Standards.

Quote:

> A ***trade related property*** is any type of real property designed for a specific type of business where the property value reflects the trading potential [earnings capacity] for that business. Examples include hotels, fuel stations, restaurants, casinos, cinemas and theatres.

They go on to say:

The essential characteristic of this type of property is that it is designed, or adapted, for a specific use and the resulting lack of flexibility means that the value of the property interest is normally intrinsically linked to the returns that an owner can generate from that use. The value therefore reflects the trading potential of the property. (in other words, the earnings capacity, as related to the business operation). It can be contrasted with generic property that can be occupied by a wide range of different business types, such as standard office, industrial or retail property. (close quote)

SLIDE 6:

In attempting to understand this a little better, let's think of a gas station. Where does net operating income to the real estate come from?

Said another way, where does the owner get the money to pay for the mortgage and equity requirements of the real estate?

The answer is NOI to real estate is taken from the cash drawer, just as is the money to pay for everything else. So, it makes sense that someone would pay more for the assets of a store that earns a lot of money, day-in and day-out, year-after-year, than one that is the opposite, one that every day, there is not enough money to pay the bills.

And, because the real estate is a part of that collection of those assets, a typical buyer would pay more for the real estate of a higher-earning store. That observation is the essential insight into the valuation logic for TRPs.

SLIDE 7:

Let’s look at some reasons as to why TRPs require special valuation considerations.

Appraisers do not normally consider these factors with other types of income-producing property.

SLIDE 8:

We will use a convenience store as an example.

Location factors that impact the value of the real estate of a convenience store include:

1. Supply and Demand in the within the Trade Area. The Trade Area is usually defined as the 3-minte drive-time.

2. Customer demographics, such as age, income levels, and the propensity to shop at a convenience store. Not every population group is the same.

3. Traffic Count. Up to a certain point, higher traffic locations are usually better.

4. And, hypermarket competition, or what we call cross-channel competitors. These are competitors that are not in the same business, yet draw away customers. An example is a Walmart store selling gasoline.

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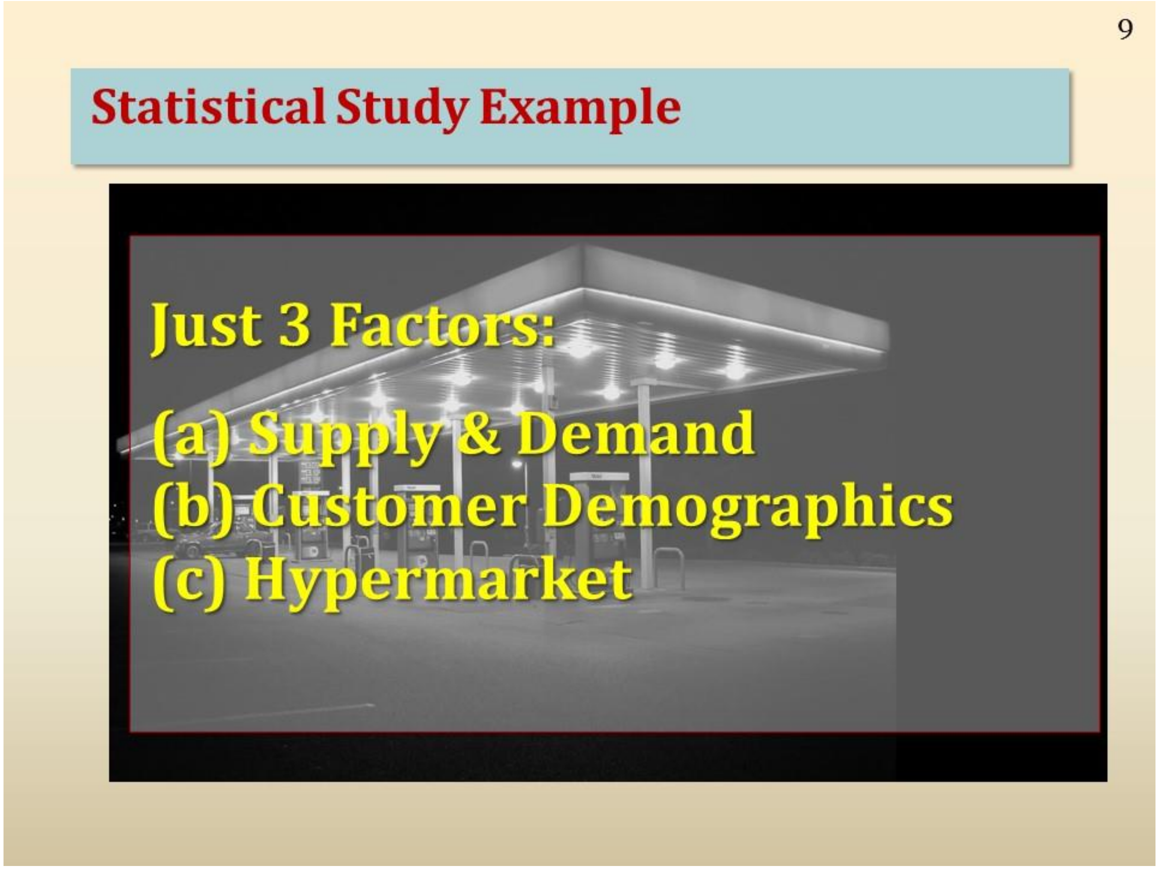

We did a statistical study looking at just three of these real estate-related factors: Supply & Demand in the Trade Area, Customer Demographics and Hypermarket Competition. We found that…

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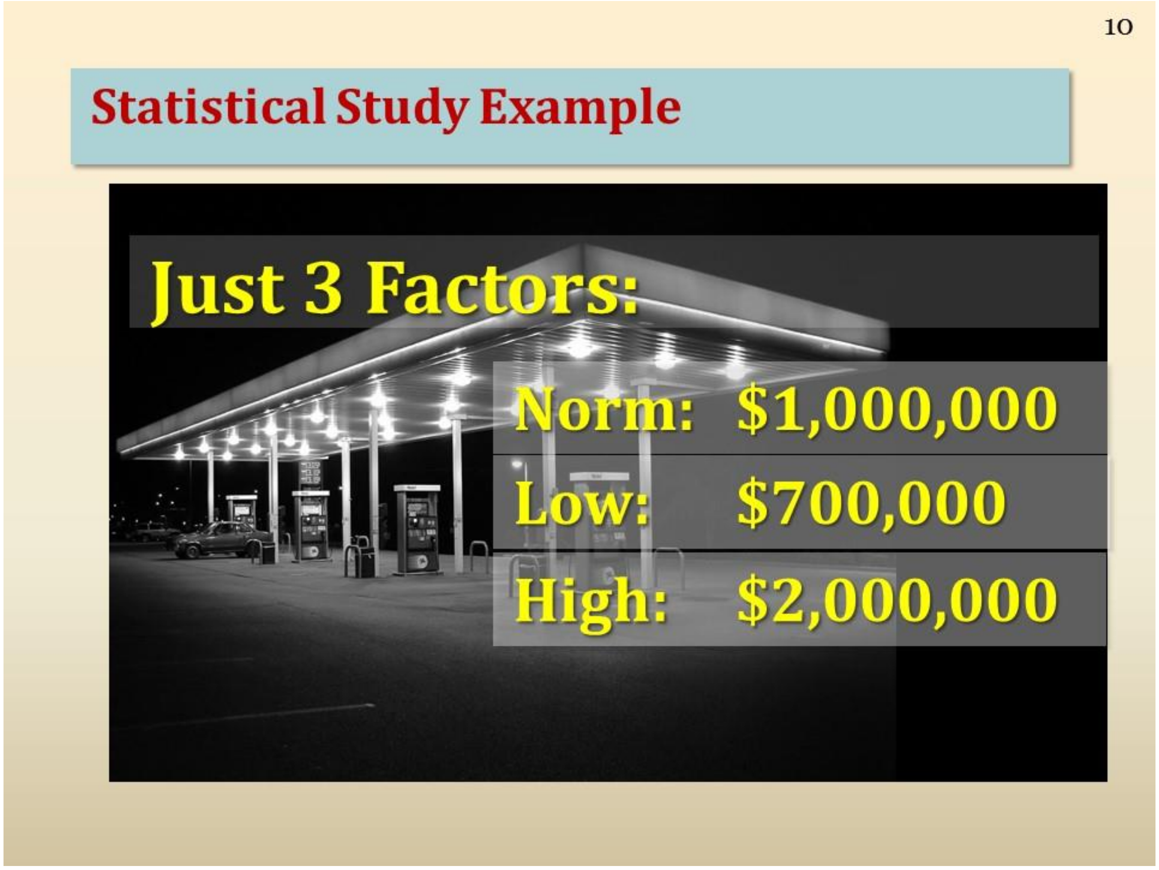

Just these three factors when we went from the low end to the high end of the range of these variables in our sample of 110 stores, caused a convenience store with a normal value of $1 million

To vary from a low of $700,000

To a high of $2 million.

Just on changing these three variables alone.

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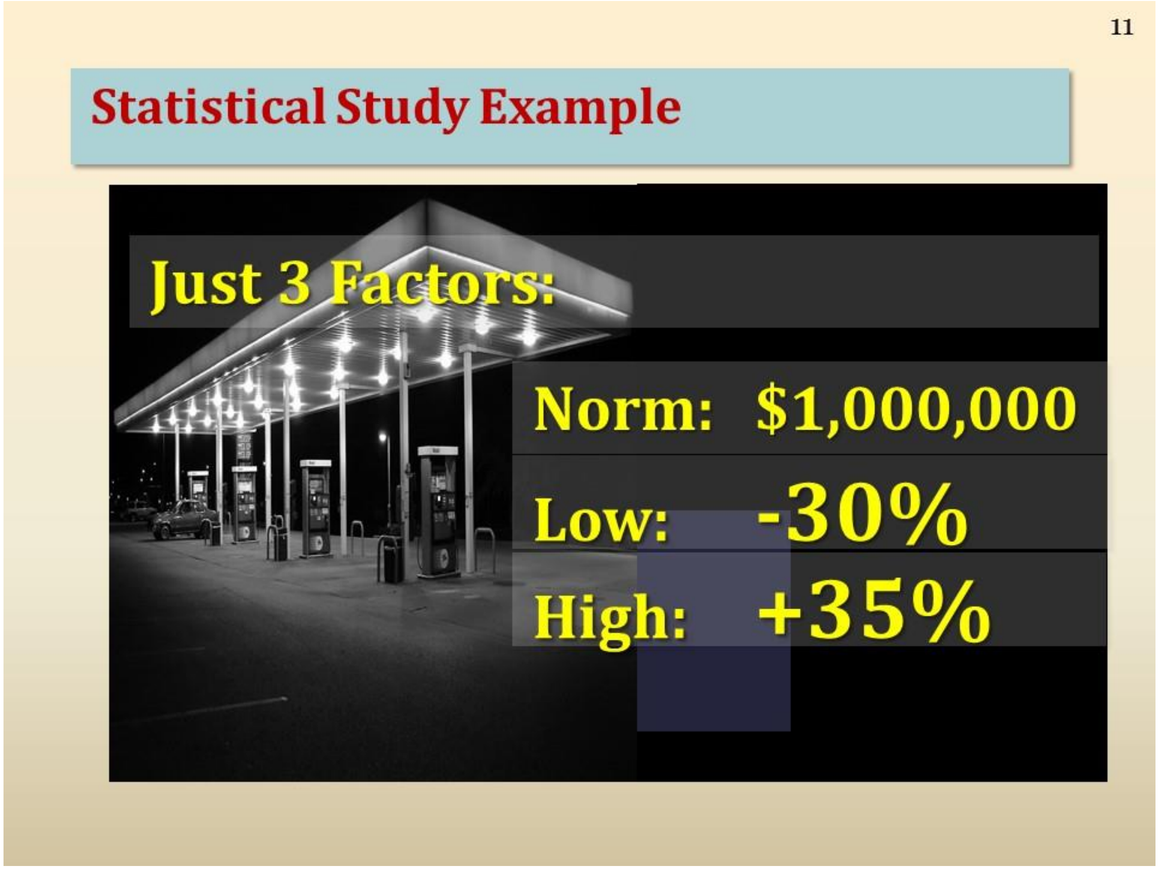

That is a difference in the estimated market value of the real estate of -30% to +35%!

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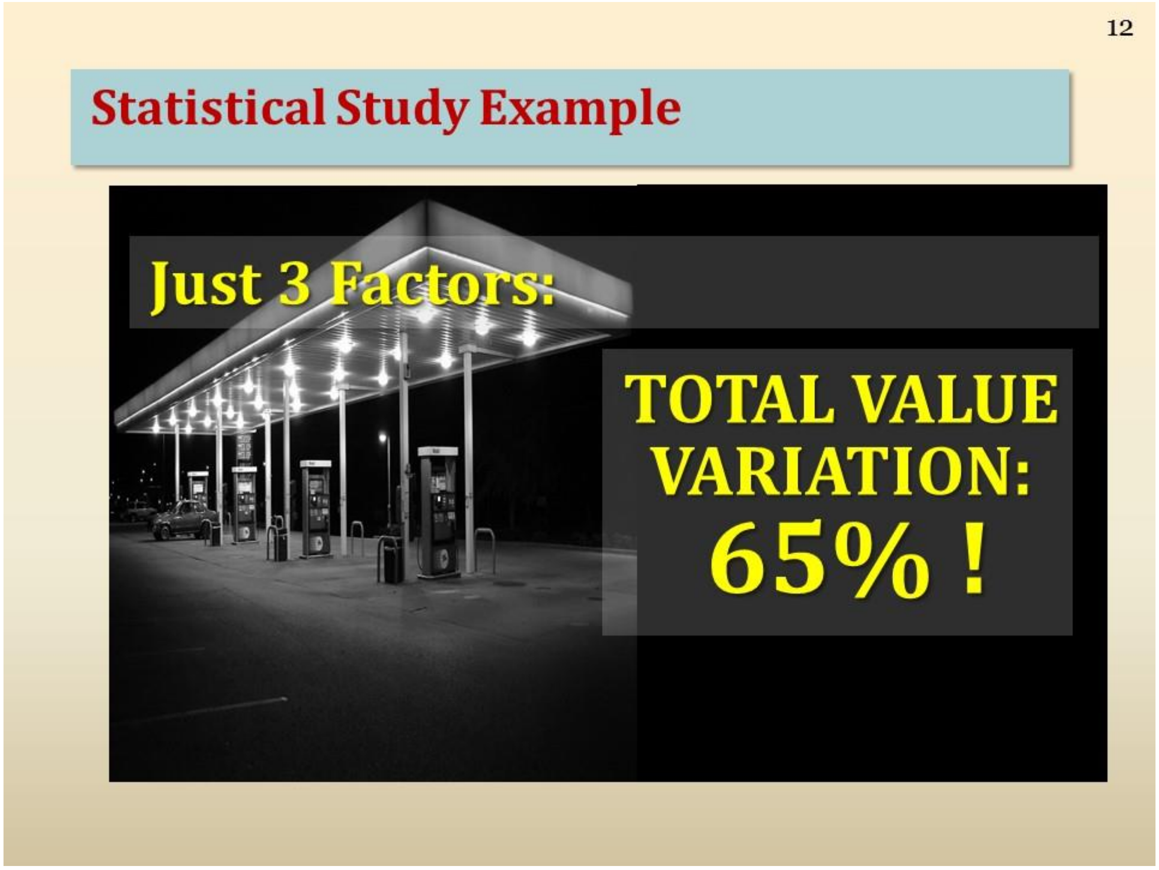

In other words, a total variation in market value of the real estate of 65%!

So, it is very important to include these factors in the appraisal. Furthermore, what we have seen here is true for almost all TRPs.

SLIDE 13:

Let’s look at some examples of how the appraiser can analyze these factors in the appraisal report.

On-line demographic services can help measure Supply and Demand. Supply is the number of competing stores within the trade area. Demand can be measured by the number of resident customers. The fundamental question concerning value is whether there are few competitors or many. Is the trade are over-supplied or under-supplied? The real estate value will be affected by this relationship.

SLIDE 14:

The on-line demographic programs even have the ability to tell us if the resident customers within the trade area have of higher or lower propensity to shop at a convenience store. This can be measured with published indexes.

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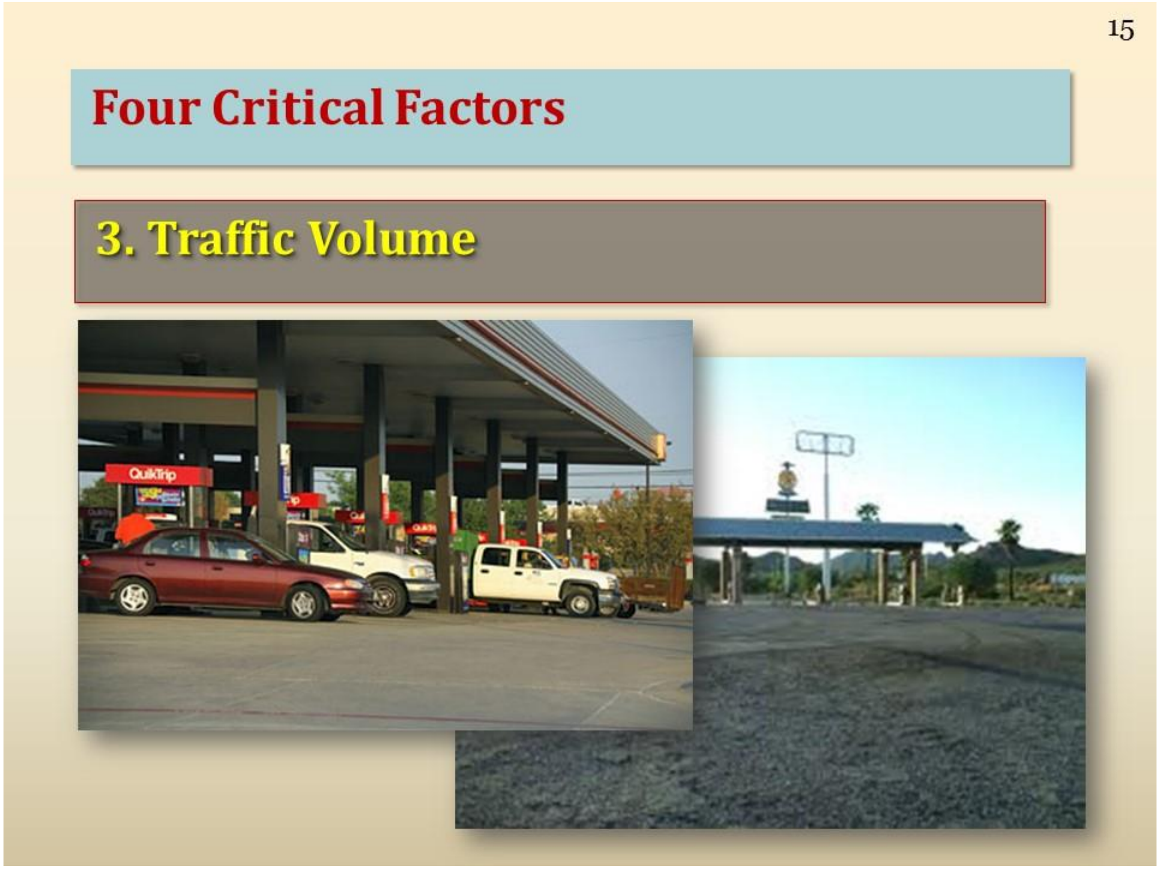

Obviously, for a convenience store, traffic volumes on the adjacent street play an important role in the value of the real estate.

SLIDE 16:

Our fourth location consideration for convenience stores is hypermarket competition. Hypermarkets typically sell gasoline below the average street price and this takes customers away from traditional convenience stores. Here, you see a drive-time of the trade area with the plotted location of a Costco store that is selling gasoline.

This close proximity of the Costco hypermarket will have a significant negative impact on the value of the subject store.

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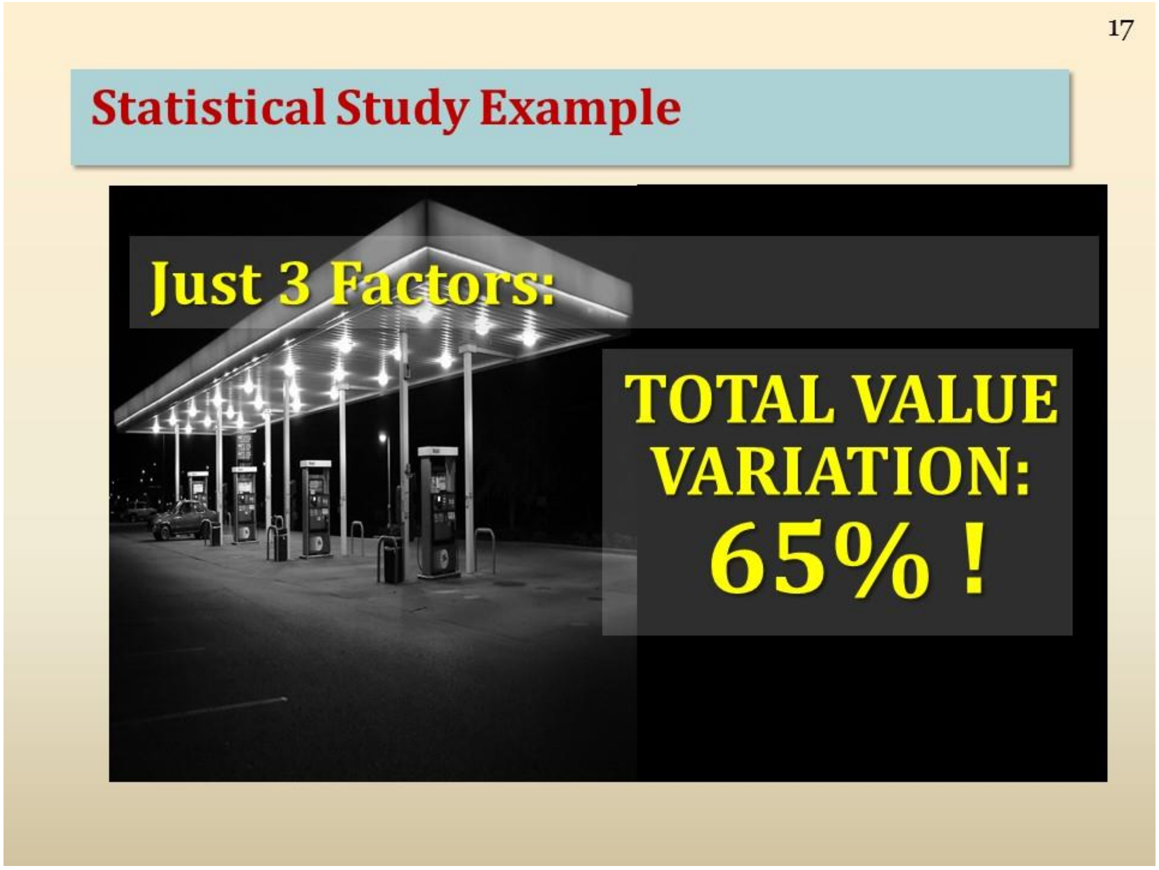

Remember, just three of the location factors we just looked at caused a total variation on the estimated value of the real estate of 65%.

We're not talking about intangibles or business profit.

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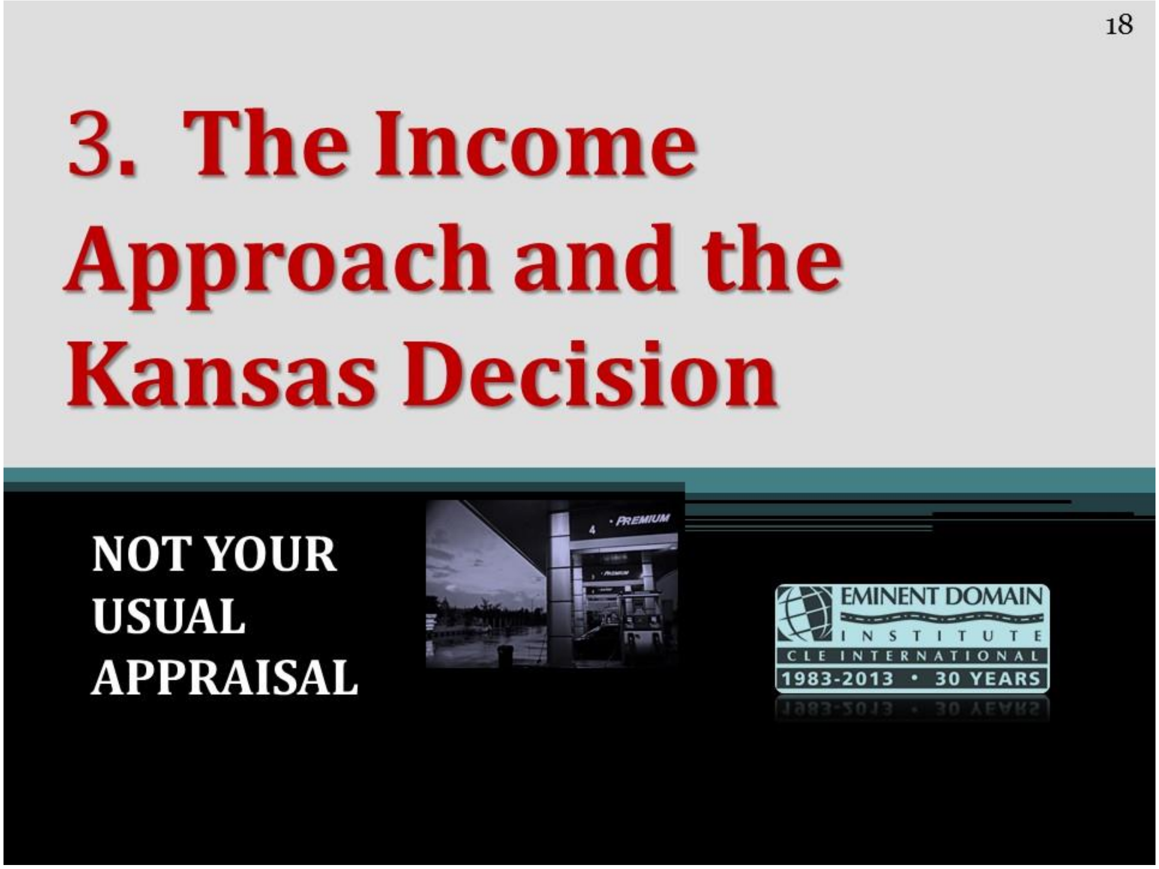

At this point we are going to shift gears and move into the current legal arguments over the income approach in condemnation cases in states where business profits are not compensable. The courts have long held that capitalizing rent to the real estate is acceptable as a valuation method for income-producing property.

Slide 19:

My thesis today is that an earnings allocation is appropriate for condemnation cases also. Indeed, for certain types of property, namely TRPs, it is a better method of estimating economic rent to the real estate.

SLIDE 20:

To help bring out the legal arguments, we are going to follow the Presta Oil decision, a 2013 case out of Kansas that involved a gas station in condemnation.

Again, the reason I have chosen the Presta case is that the ruling elucidates the arguments, and these arguments are very similar to those being made in other courts all across the country.

We can learn something from what the court said.

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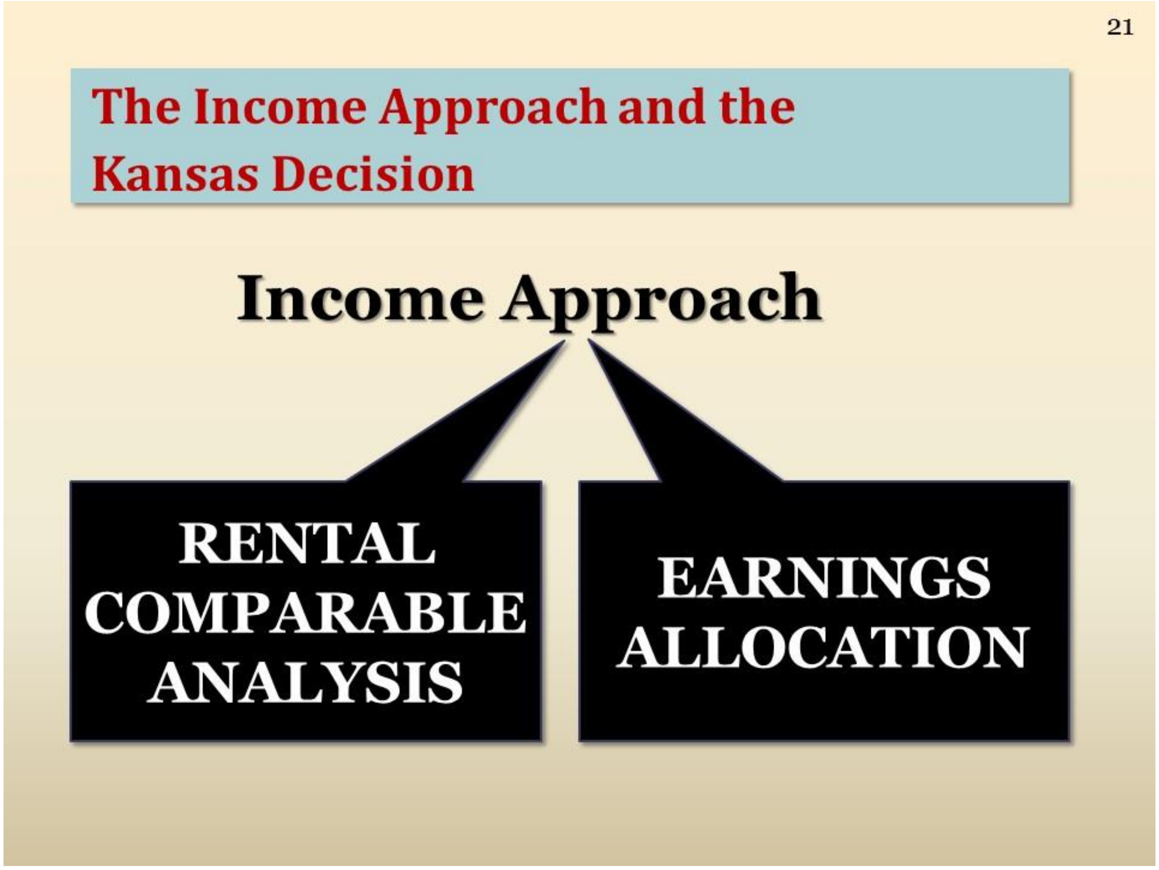

Keeping the discussion of TRPs and these special location factors in mind, we want to draw down our discussion to a focus on the Income Approach, as it is applied to these types of properties.

After talking about the two methods of performing an income approach, we will focus on the Kansas Decision in the *Presta* Case, and see what was good and what was bad about the ruling from an appraiser's perspective.

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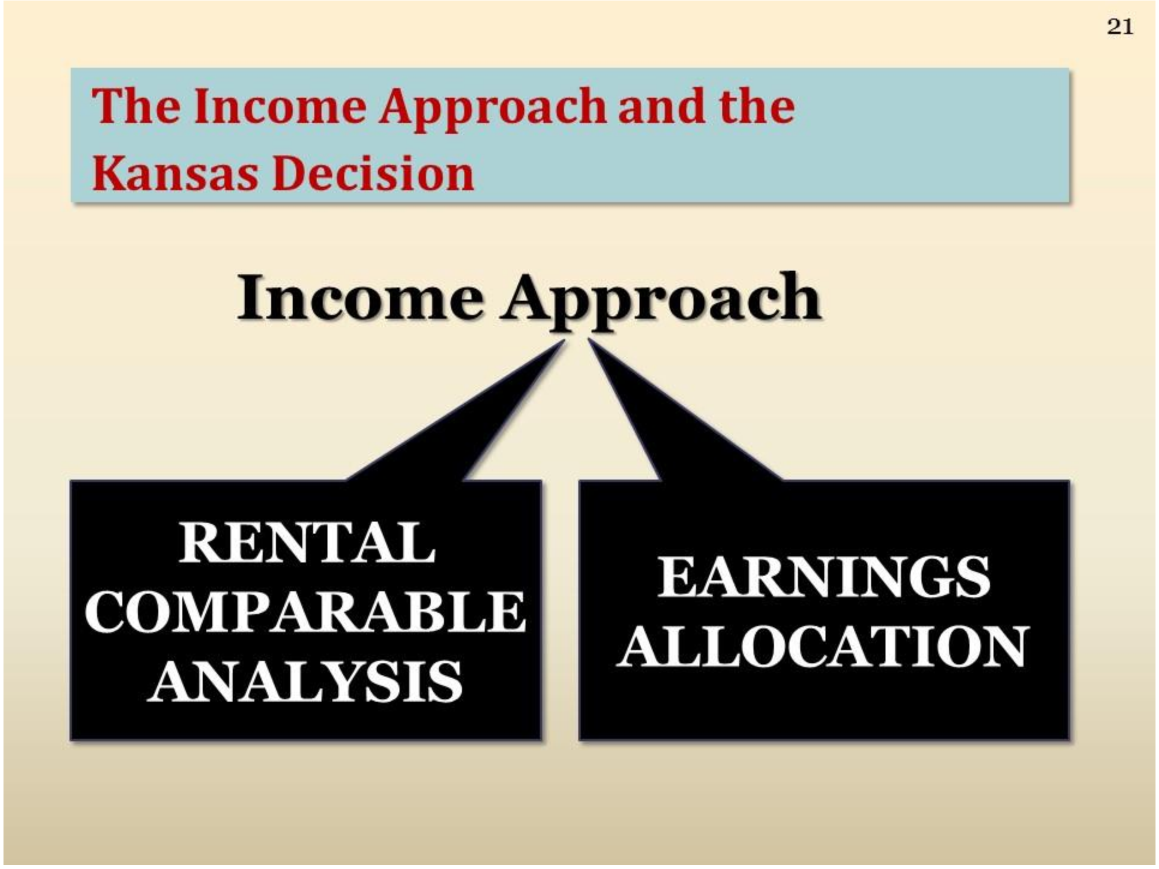

The appraiser has two choices in the income approach that are equally valid: the first is a rental comparable analysis, and the second is an earnings allocation.

Even though each is valid, neither is suitable to all income- producing property.

Remember, income-producing property is divided into those that are built for rental income and those that produce income because they are an integrated part of business enterprise.

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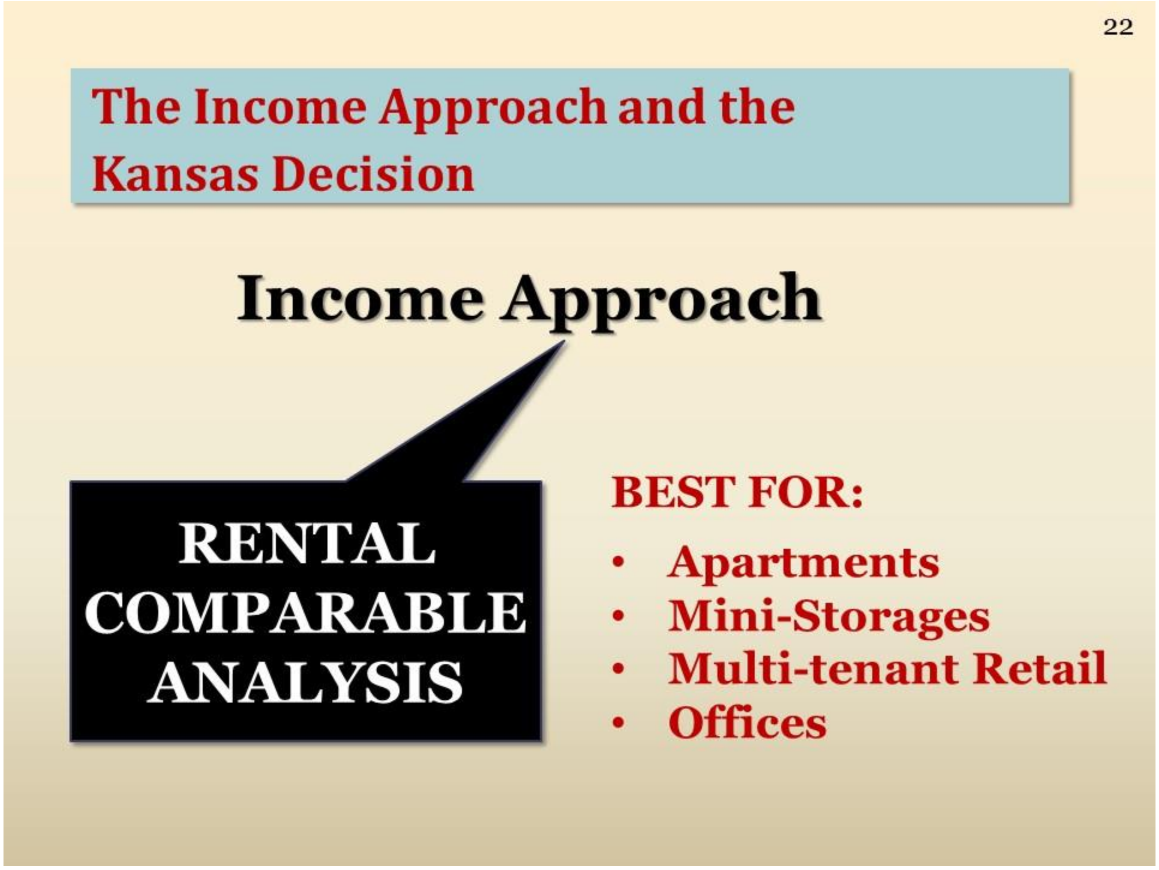

Keeping this distinction in mind, a rental comparable analysis, where the appraiser selects rental comparison properties to develop an estimate of market rent, is best for properties that are built for their rental income, such as apartments, mini-storages, multi-tenant retail, and offices.

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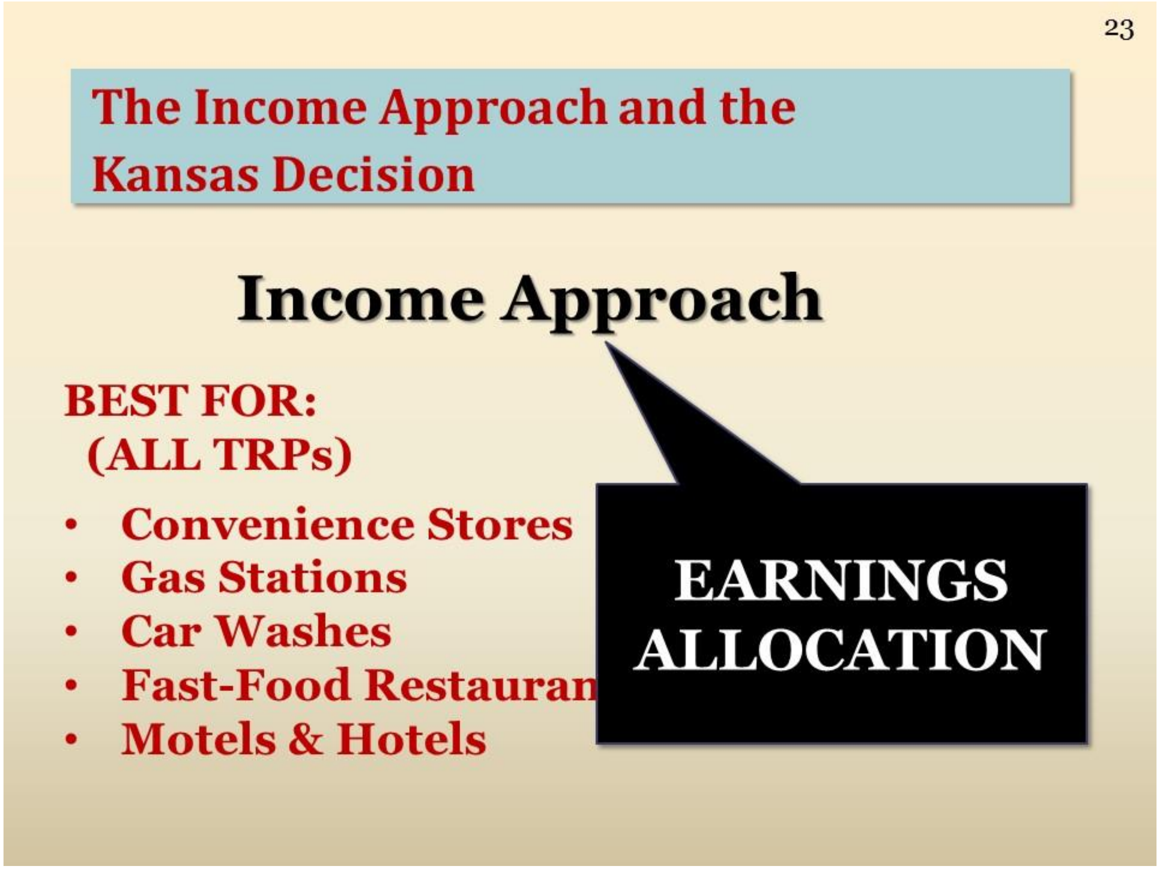

On the other hand, an earnings allocation is best for TRPs. These properties are not built for their rental income. They are built as part of a business enterprise and how successful they are at this determines their market value.

This includes convenience stores, gas stations, car washes, fast-food restaurants, and motels and hotels.

Because of their location requirements, TRPs are often involved in condemnation proceedings.

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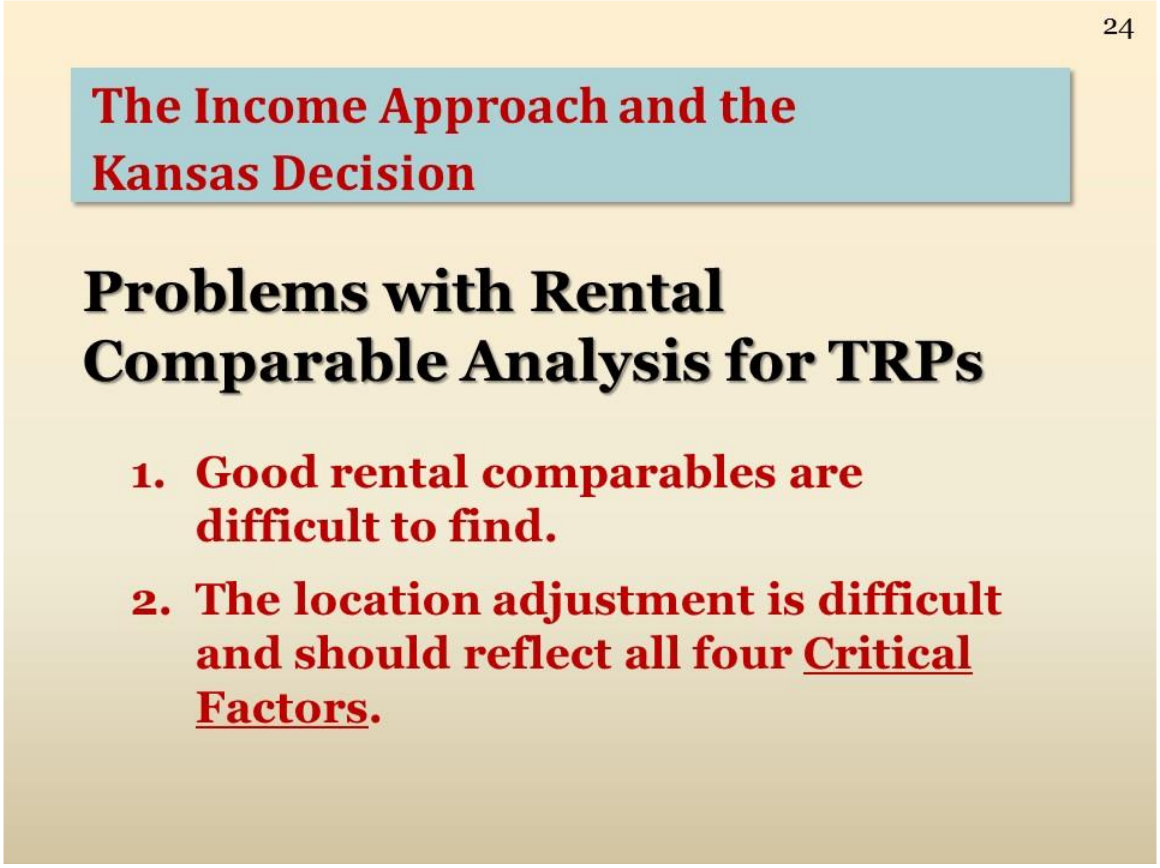

Well, why can't we use Rental Comparables with TRPs?

The first reason is:

1. Good rental comparables are difficult to find.

Remember, TRPs are not built to be rented out. It makes sense that we will not find good rental comparisons. Incidentally, sale/leasebacks are not rental comparisons, even though many appraiser try to use them with TRPs.

2. The location adjustment for TRPs is complex and prone to error when a rental comparable analysis is performed.

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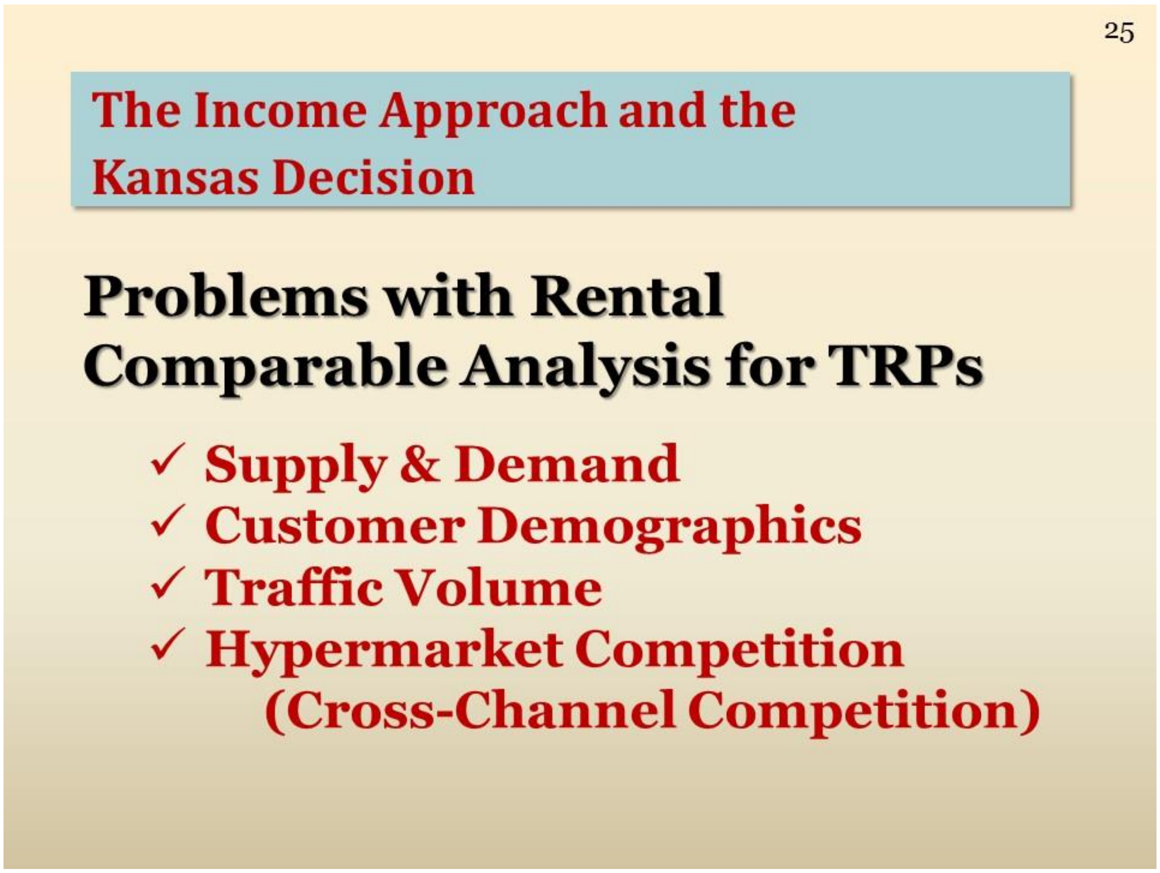

Remember from our earlier discussion, all four of these critical Location Factors should be considered.

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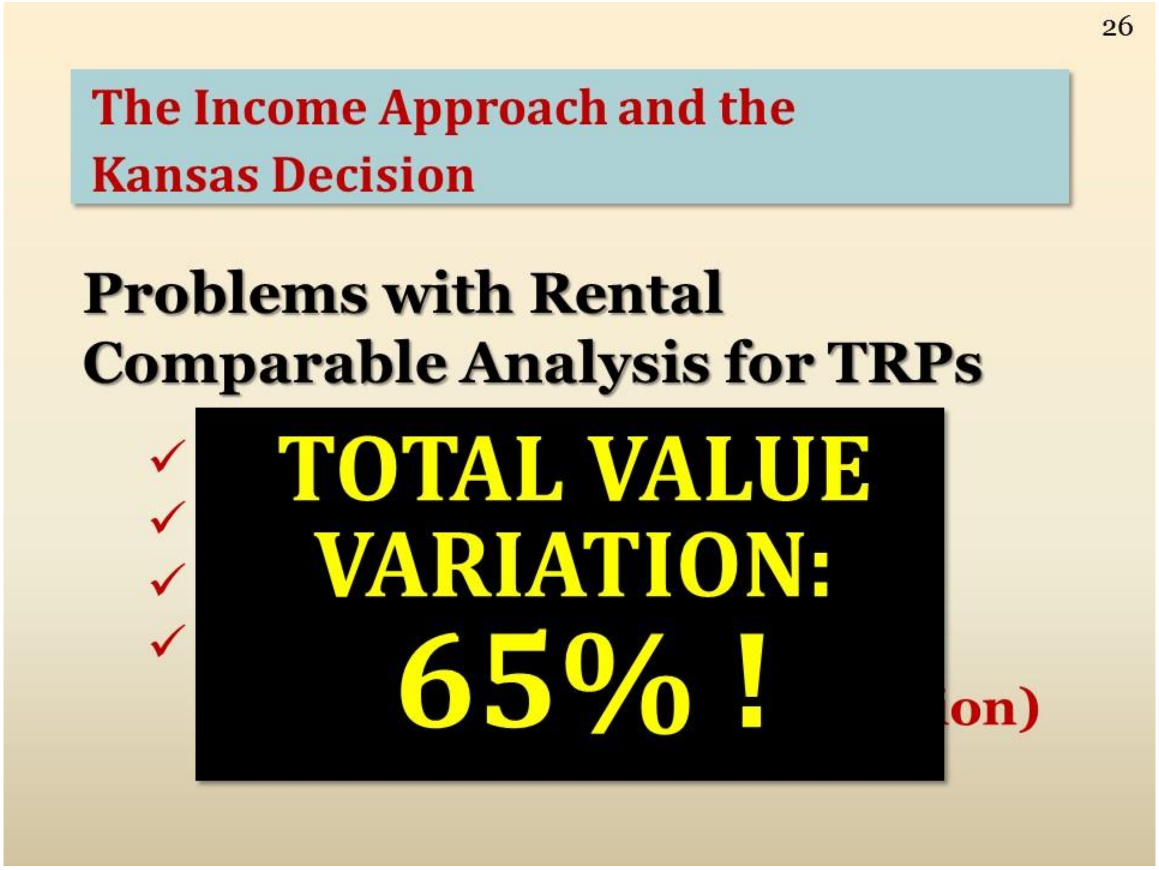

And, just three of those real estate –related location factors can cause a variation in estimated market value of 65%.

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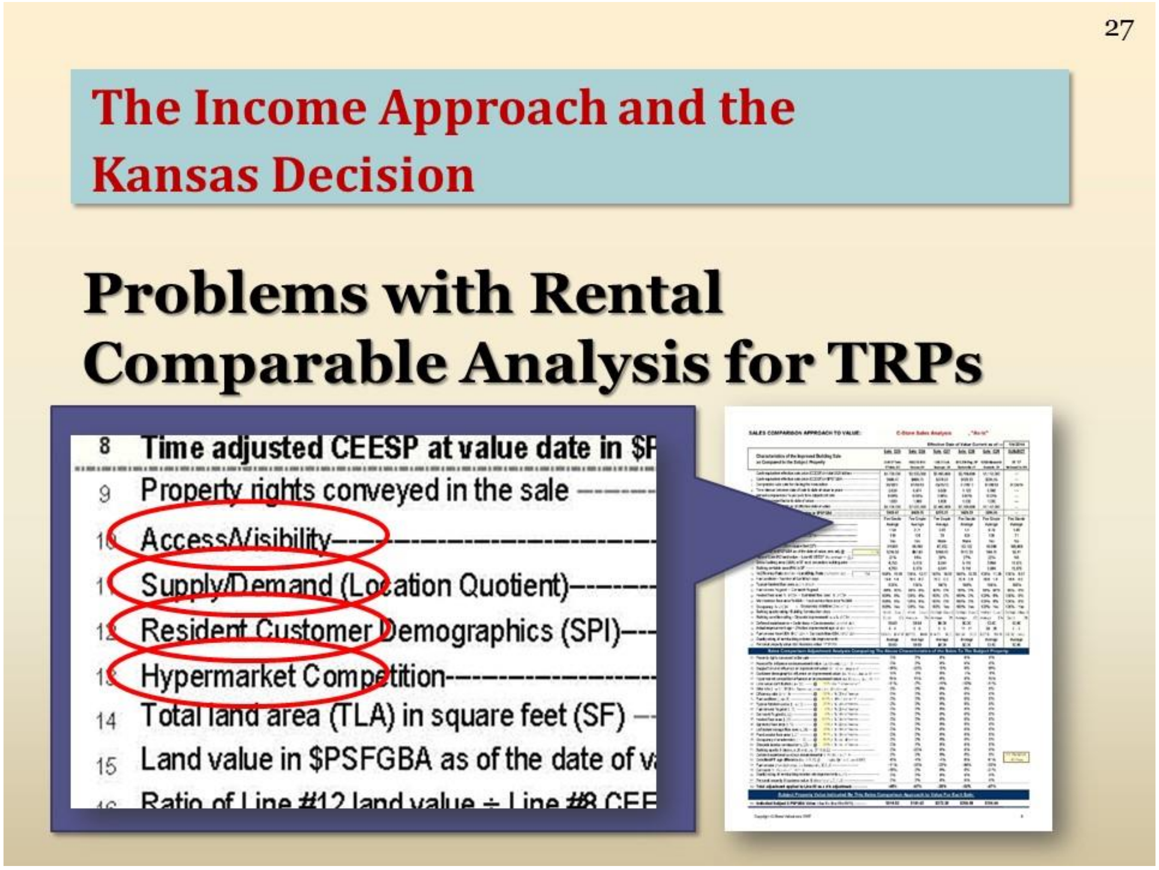

To show the weakness of a Rental Comparable Analysis, the appraiser should adjust each of the comparables for these four factors in addition to the other physical characteristics of the property. For example, if five rental comparables are used, that’s five adjustments for each location factor. This adjustment process can become subjective and prone to error, simply because of the large number of adjustments involved with a TRP.

Finally, a rental comparable analysis is still merely an indirect measure of value. What it will rent for on the open market is not as important as knowing how much it earns for that use for which it is designed.

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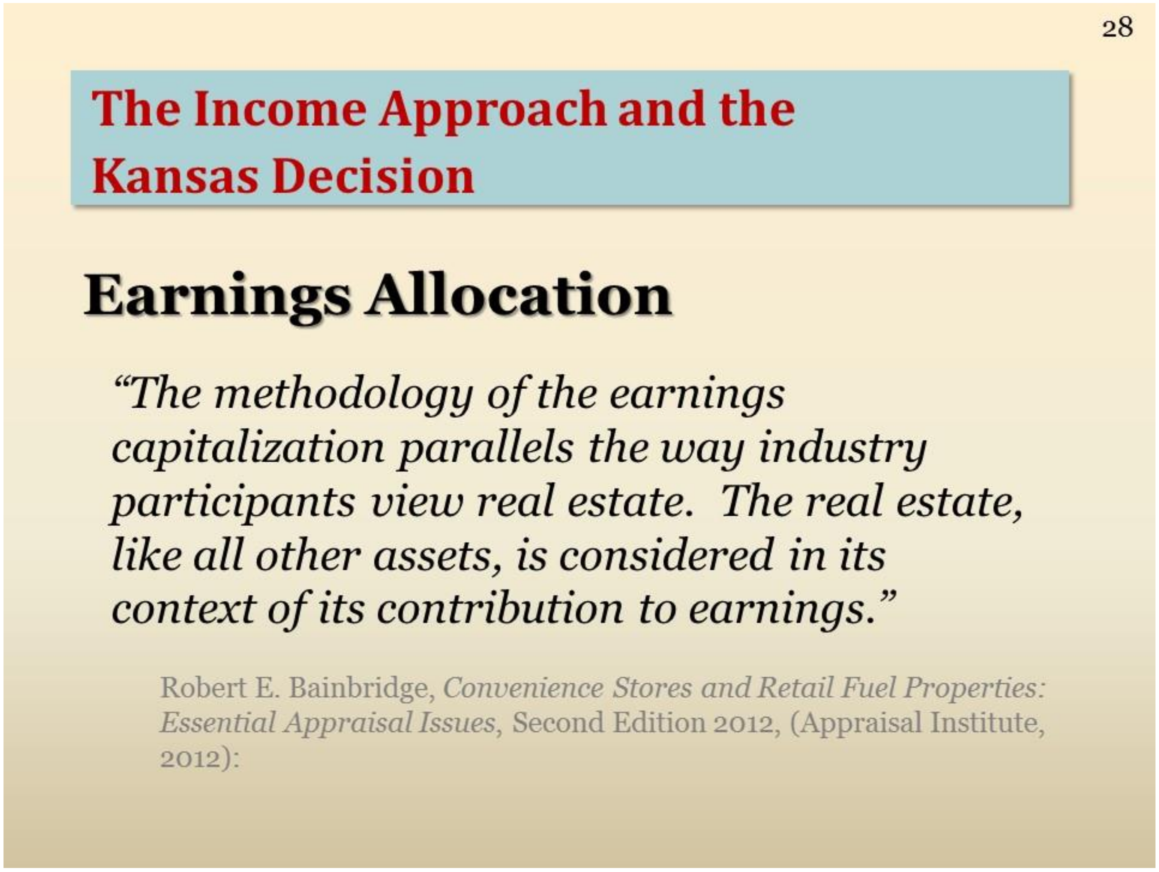

So, obviously, a Rental Comparable Analysis, even though it is familiar and comfortable to all commercial property appraisers, it is not the best method of applying the income approach to TRPs.

Let's look at what the appraisal industry says about this.

This statement is from my book on convenience stores:

Quote:

“The methodology of the earnings capitalization parallels the way industry participants view real estate. The real estate, like all other assets, is considered in its context of its contribution to earnings.”

Robert E. Bainbridge, *Convenience Stores and Retail Fuel Properties: Essential Appraisal Issues*, Second Edition 2012, (Appraisal Institute, 2012).

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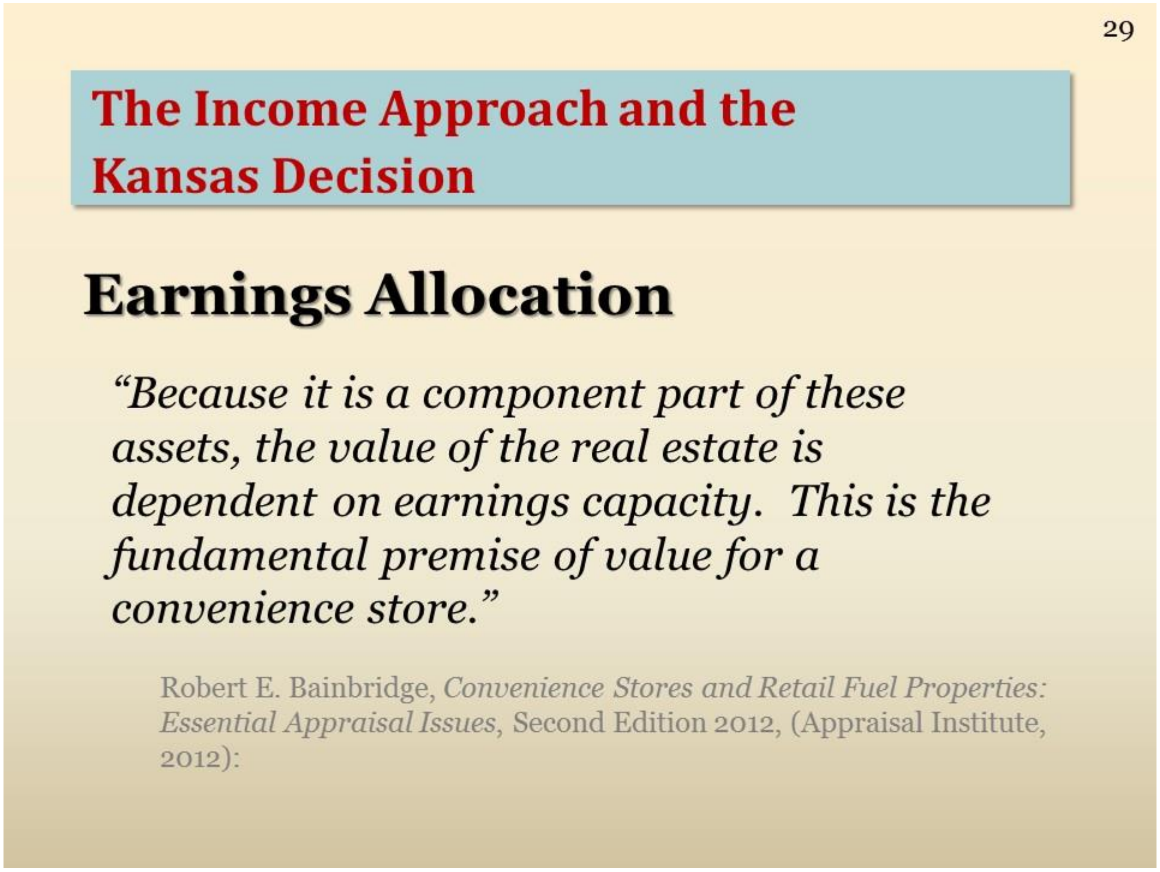

Here is another from the book:

"Because it is a component part of these assets, the value of the real estate is dependent on earnings capacity. This is the fundamental premise of value for a convenience store."

Robert E. Bainbridge, *Convenience Stores and Retail Fuel Properties: Essential Appraisal Issues*, Second Edition 2012, (Appraisal Institute, 2012.:

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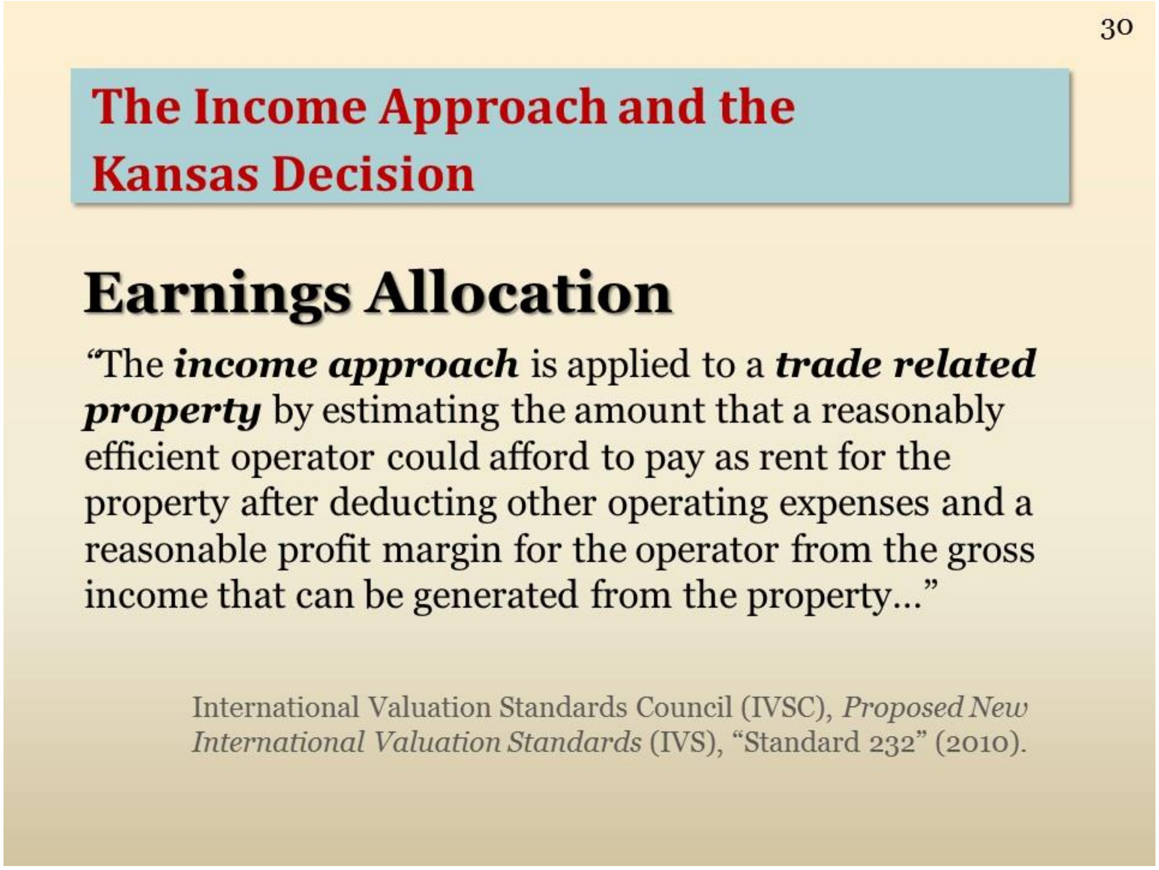

This statement is from International Valuation Standards:

Quote:

*"*The ***income approach*** is applied to a ***trade related property*** by estimating the amount that a reasonably efficient operator could afford to pay as rent for the property after deducting other operating expenses and a reasonable profit margin for the operator from the gross income that can be generated from the property…" (close quote).

International Valuation Standards Council (IVSC), *Proposed New International Valuation Standards* (IVS), “Standard 232” (2010).

This is the industry best-practices as stated in International Valuation Standards.

They are talking about an earnings allocation as being the best method of applying the income approach to TRPs.

Let’s note some important specifics in what they said.

IVS states that the earnings the appraiser starts the analysis with is the estimated earnings to a “TYPICAL OPERATOR”. We are NOT capitalizing the earnings of the current operator or owner of the property. This is important because this is the bridge to market value.

In the *Presta* decision, no one ever brought out this point. The court’s reasoning in the decision was skewed because the court only considered the earnings of the current operator – Presta Oil – and they rightly concluded that whatever the result was from an earnings analysis, it was not market value.

Note also IVS states here that the number that is developed in the earnings allocation method is, at the end of the procedure, “THE RENT FOR THE PROPERTY”. This is the estimated fair market rent for the real estate. That is what we capitalize in a condemnation case. IVS states that the operating expenses of the business and the profit are deducted BEFORE the allocation to the real estate.

So, earnings to business profit are not included in the final estimate of value. When done properly, it is a pure income stream to the real estate. It is the equivalent of economic rent.

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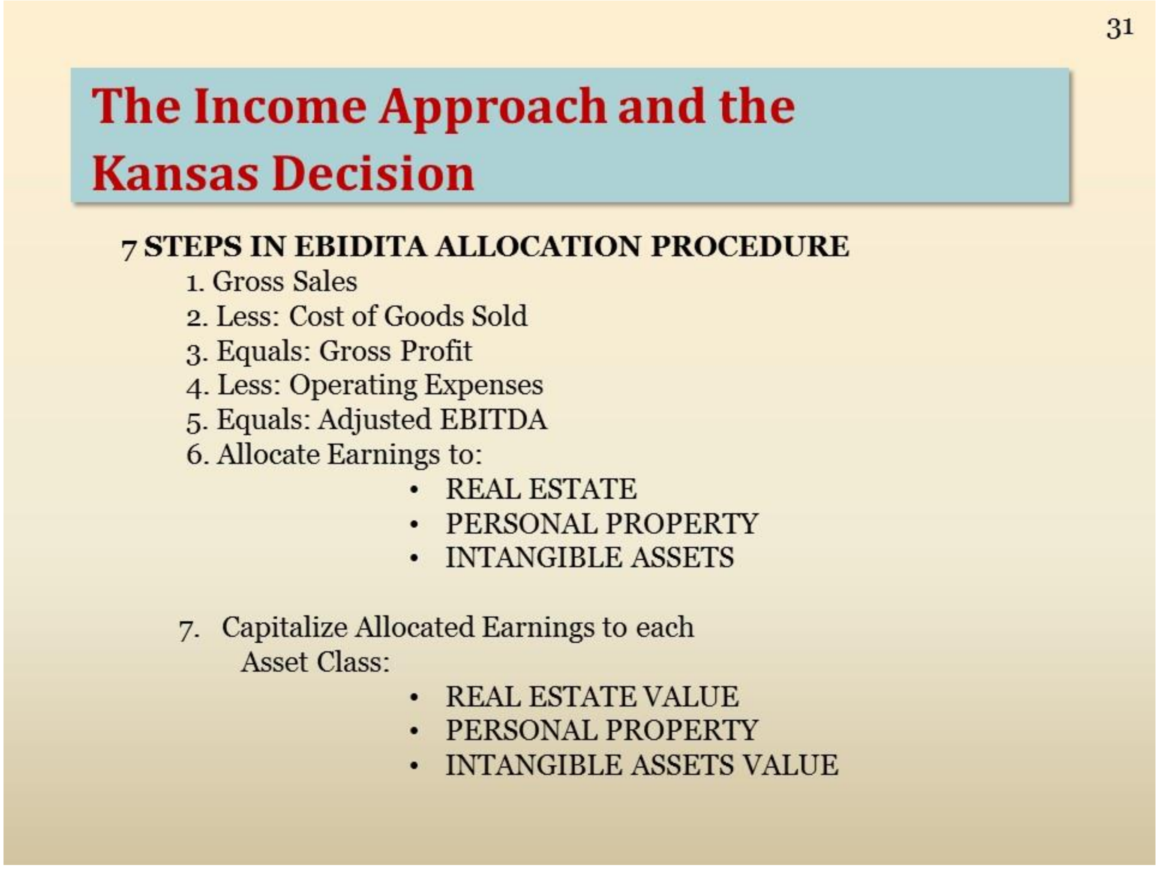

Here is the step-by-step procedure for processing an earnings allocation for a TRP.

We start by estimating the gross sales attainable by a typical operator, not the gross sales of the current business.

In the same way, we deduct the operating expenses of the business under typical management. This can be done with industry benchmarks.

This equals Adjusted EBITDA, which is the gross return to the assets of the business, including the real estate, FF&E and profit.

In the *Presta* case, this is where the appraiser for the property owner made a big mistake. He capitalized EBITDA and said that was the compensation due to the owner.

He should have gone to the next step and made the allocation to the three asset classes.

The court recognized this error and then threw out all testimony related to earnings.

If the appraiser had allocated the earnings to real estate below the EBITDA line, he would have had the estimated gross rent to the real estate, which the court, in their own reasoning was willing to accept. Conceptually, … the allocation to real estate below the EBITDA line is equivalent to the real estate rent estimated from a Comparable Rental Analysis. They are in fact the same number.

No court in a condemnation case should have any misgivings or reluctance to accept the estimate of real estate rent in an earnings allocation. It is just as valid and likely more accurate for a TRP than attempting to estimate rent from comparable rental properties.

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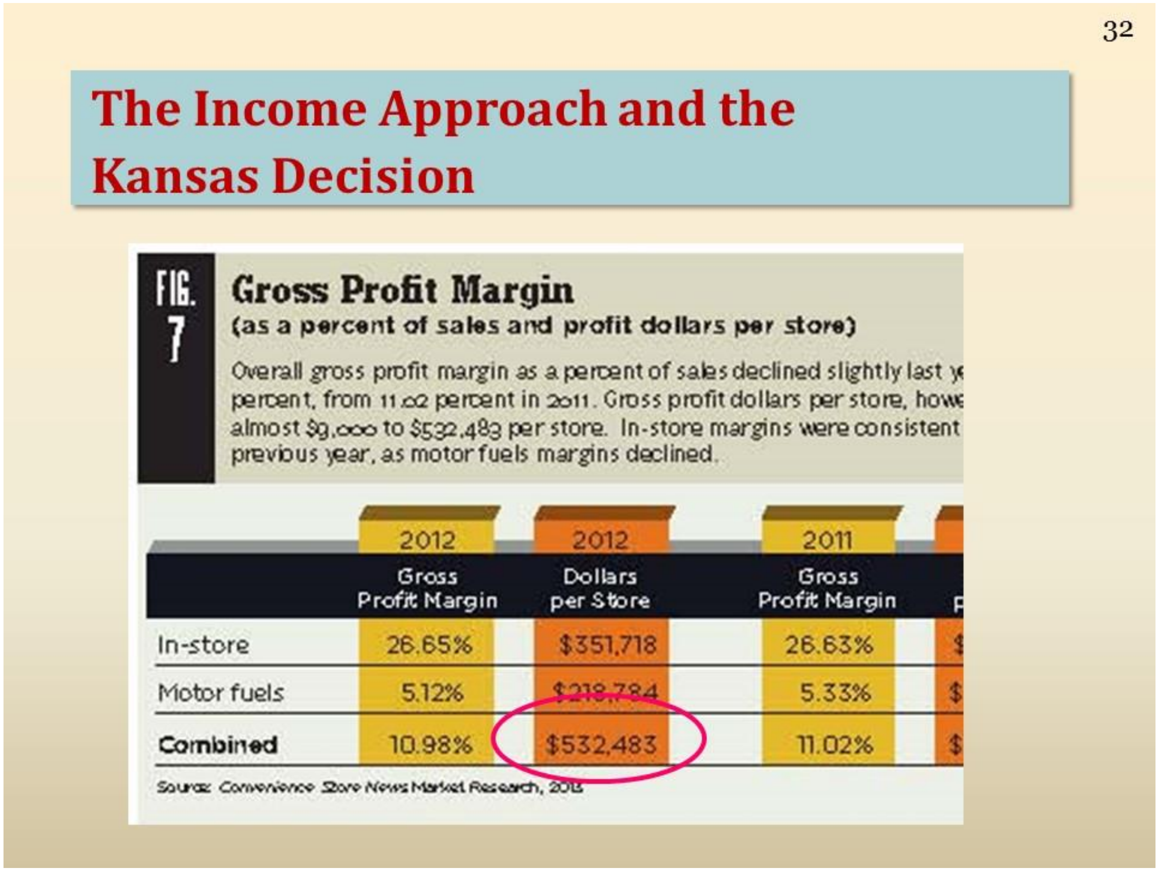

Some appraisers make the deduction or the allocation to business profit, or intangible assets more difficult than it needs to be.

The convenience industry publishes this number every year. Here is an example from Annual Industry Report.

When this number is treated as a percentage of gross profit, or a proportion of earnings, it is a reliable and defendable measure of business profit under typical management. So, what some believe is the most thorny issue in a condemnation case – deducting business profit - is really quite simple.

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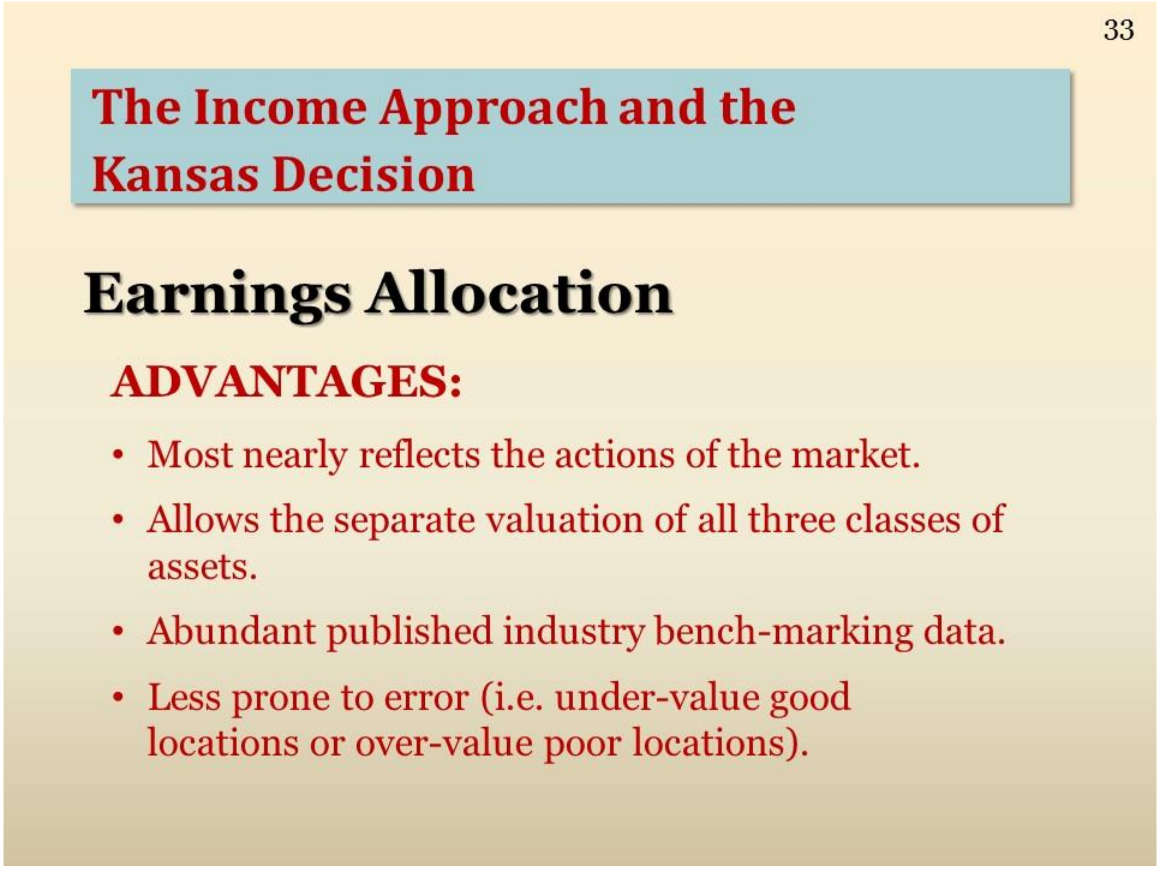

The advantages of using an earnings allocation income approach for TRPs are:

1. The method most nearly reflects the actions of the market, which is always the hallmark of good appraising. This is the way buyers and sellers think of the value of the real estate.

2. It is the only method that allows the separation and direct estimate of the value of the three asset classes.

3. We have abundant and better quality published data to process this method than we do for a rental comparable analysis.

4. It is less prone to error because the appraiser is making fewer adjustments.

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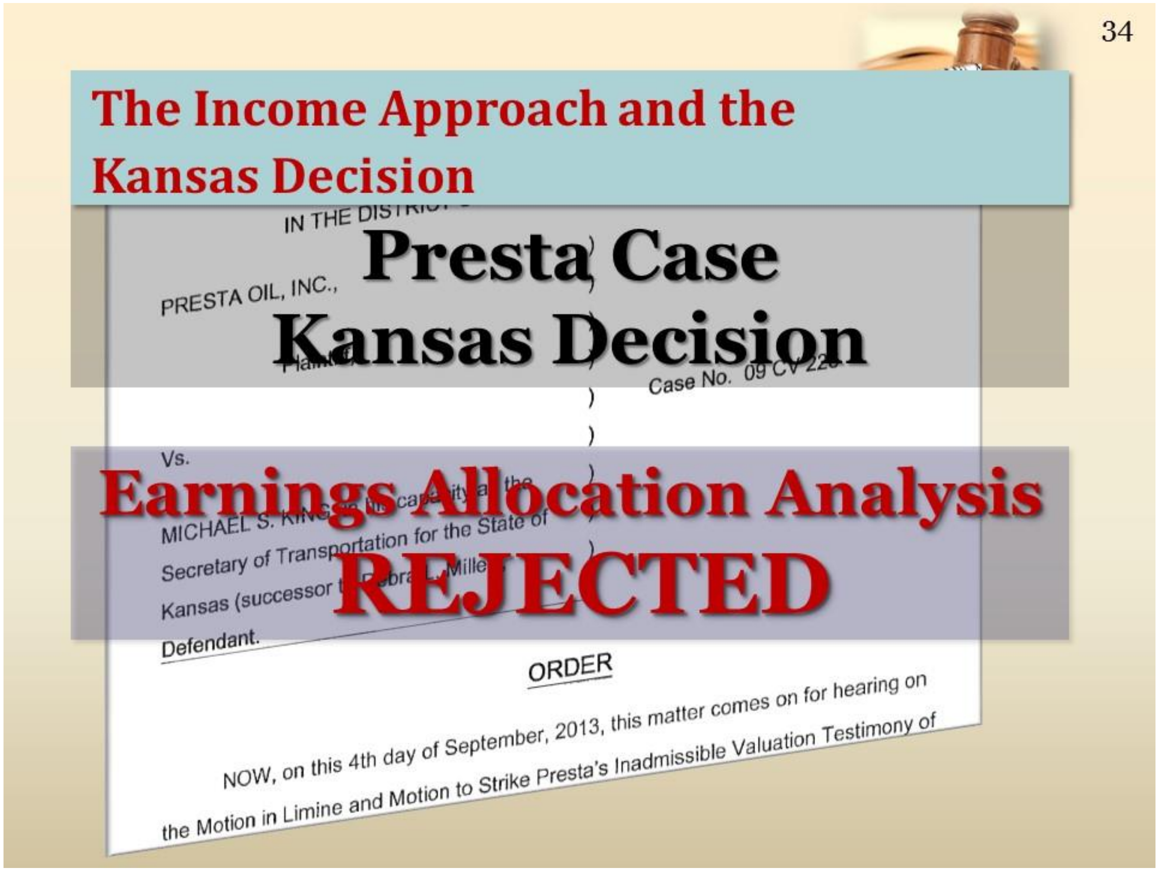

Let’s turn now to the *Presta* Decision.

Again, this was a Motion in Limine on a condemnation case concerning a gas station in Kansas. The owner wanted an appraisal based on earnings because he believed that this better reflected the value of his property.

The Kansas Department of Transportation wanted to exclude this testimony as irrelevant because they held that the appraiser’s analysis included business profit, which is not compensable in Kansas.

The court decided in favor of the State and rejected any testimony regarding the appraiser's earnings analysis.

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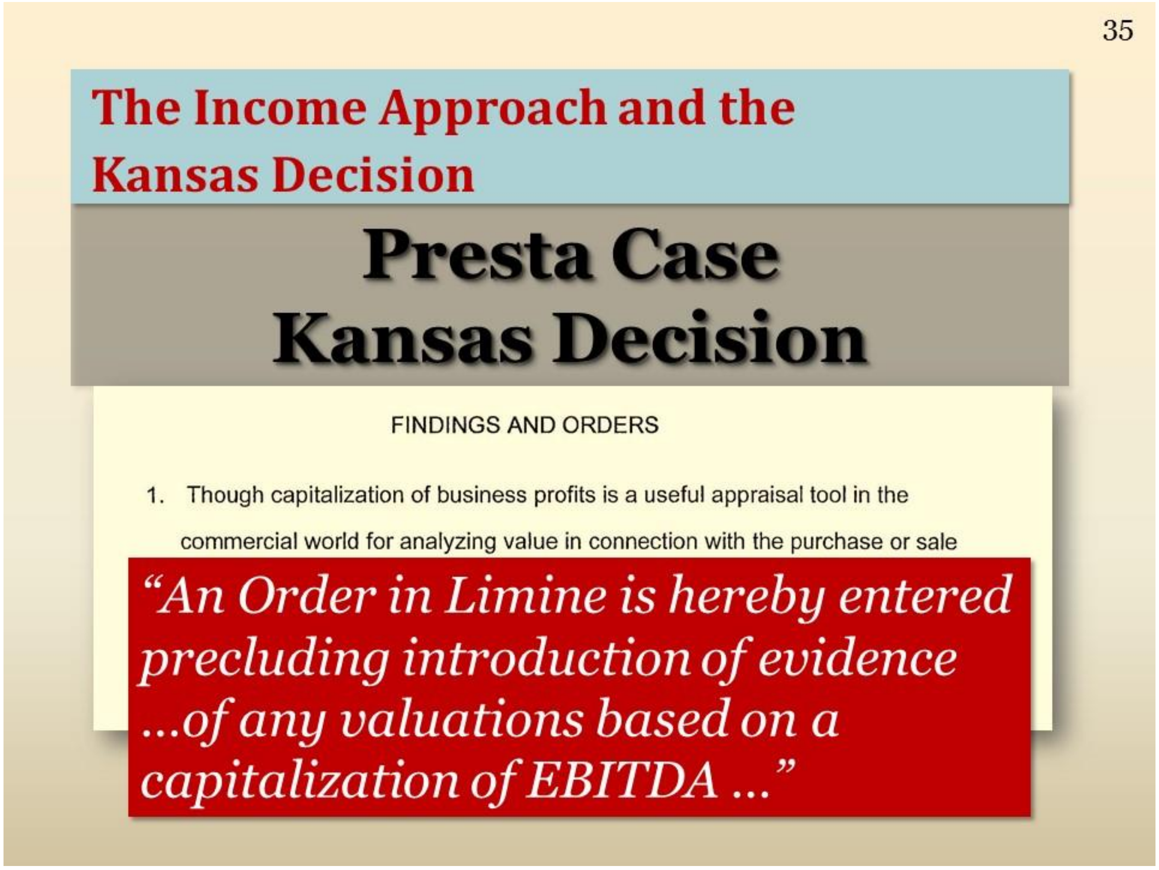

Specifically, the order stated:

"An Order in Limine is hereby entered precluding introduction of evidence …of any valuations based on a capitalization of EBITDA …"

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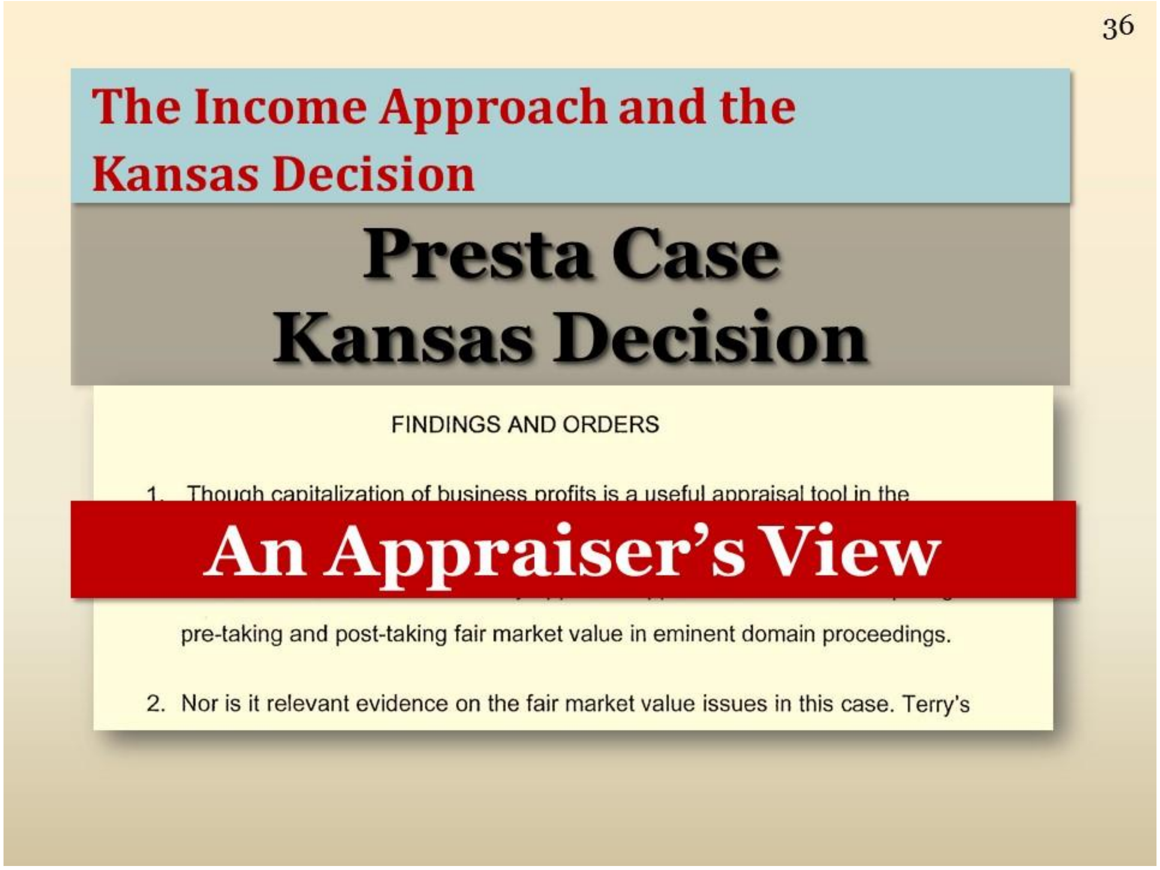

At this point I want to finish the presentation by giving you an appraiser's perspective on the decision. I really am not so concerned about the legal arguments or ramifications, as I am the reasoning and wording of the ruling in light of appraisal industry best-practices.

In other words, I am not trying to analyze this as a attorney would, but rather as an appraiser, because some good and bad things happened here.

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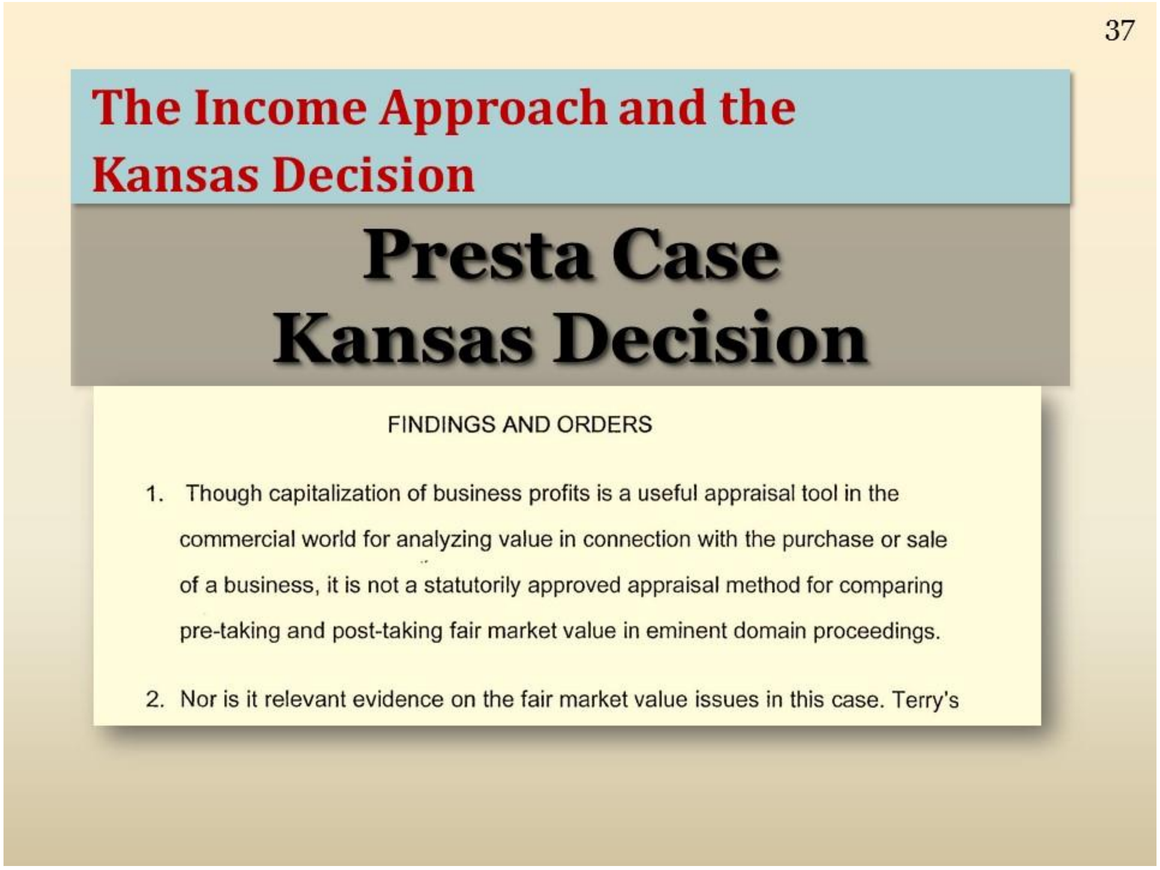

Notice in the language the court specifically stated " A CAPITALIZATION OF EBITDA."

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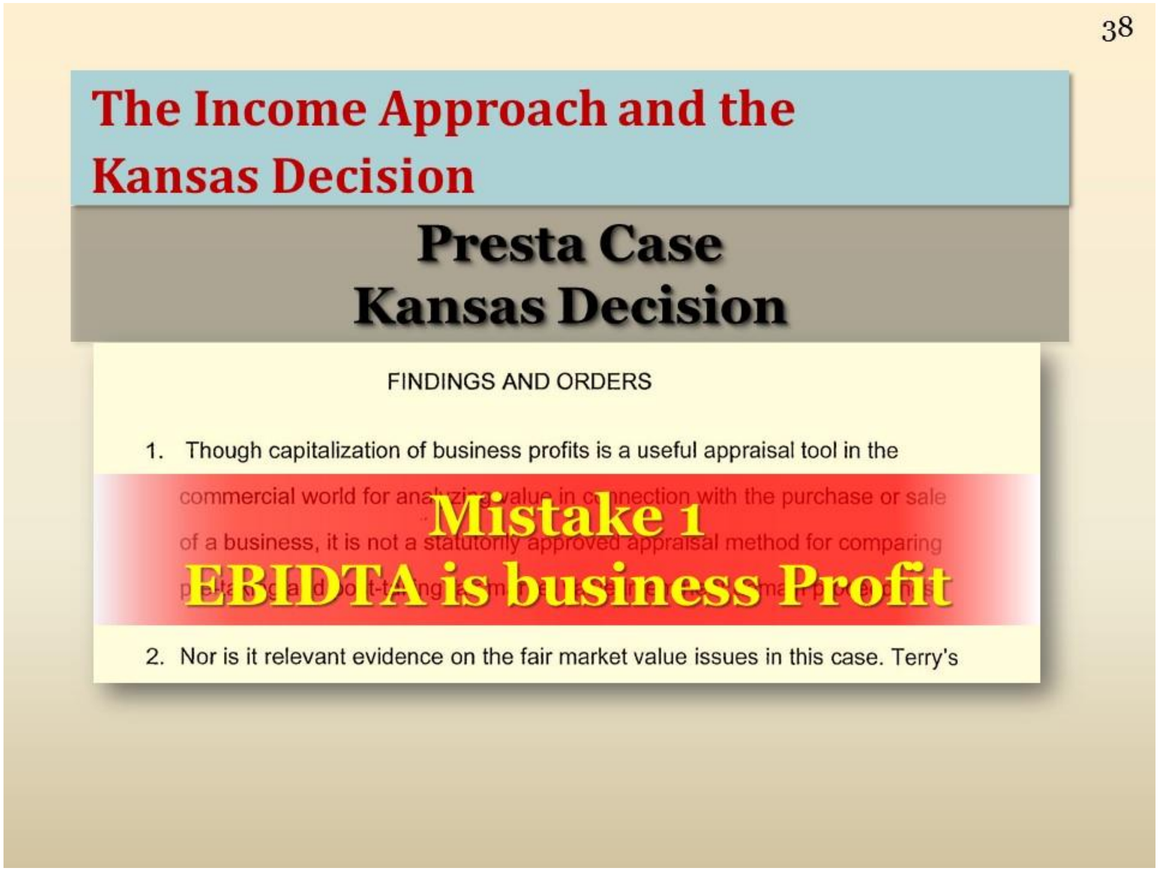

However, in the supporting statements, the court equated this to a CAPITALIZATION OF BUSINESS PROFITS.

This is the first mistake.

EBITDA is not business profits, and when the language used becomes vague and imprecise, the ruling leaves us wondering what is the court really saying? We as appraisers don't know.

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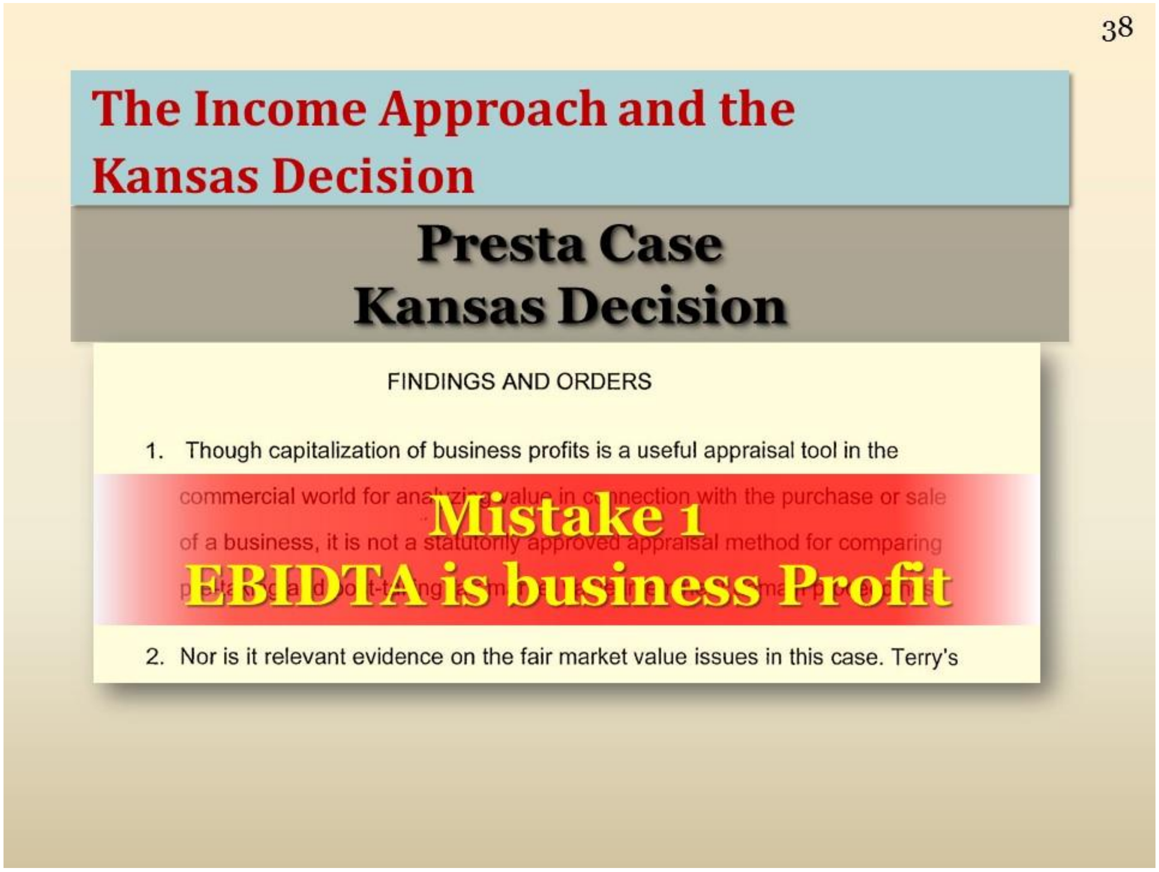

In the supporting statements to the ruling, the court used the terms:

- **Income**
- **EBIDTA**
- **Business income**
- **Profits**
- **Business Profit**

Almost interchangeably.

We really can't tell if they recognize that these are all distinctly different terms to an appraiser. These terms do not mean the same thing.

Examples:

(a) On Page 2 of the ruling, the court said *"EBIDTA or income derived from its retail operations…"*

This is very broad. It is too broad.

(b) On Page 2 they also said, *"…evidence of business profit is not relevant…"*

I agree with. But, what does business profit have to do with EBITDA?

(c) *"…lost income…"* is referred to on Page 2

Then the court went on to a different concept:

(d) *"…capitalization of business profits…"* on Page 5.

And then switched to:

(e) *"…lost business income…"* on Page 6.

The court then attempts to define their thinking:

(f) *"…To be sure, rental income from real estate is to some degree from a business, and the net income is actually the profit."*

This is not true.

(f) On Page 7, they state: *"…income produced by a retail business…"*

What income? Gross Sales?, Gross Profit? EBITDA?, Earnings to Real Estate?

The Court doesn't say?

We don't know what they are thinking.

And, what makes this worse, this is a case where the appraiser did not do it right. So, a bad appraisal led to a bad court decision.

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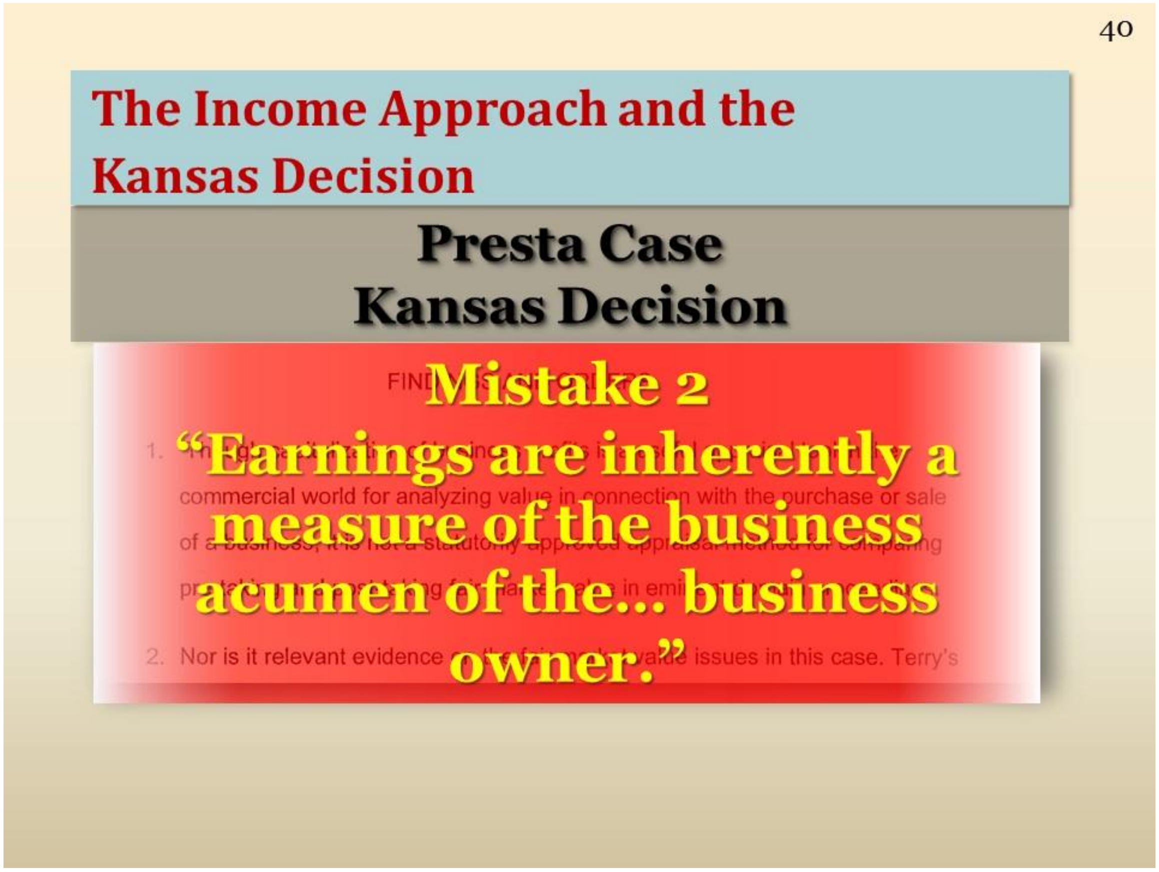


The court went on to say in the supporting statements that:

Quote:

> **“Earnings are inherently a measure of the business acumen of the… business owner.”**

The court borrowed this language from a previous decision in the Denton case, which incidentally, was an entirely different type of property. The Denton case did not involve a gas station. Here the court stated:

Quote:

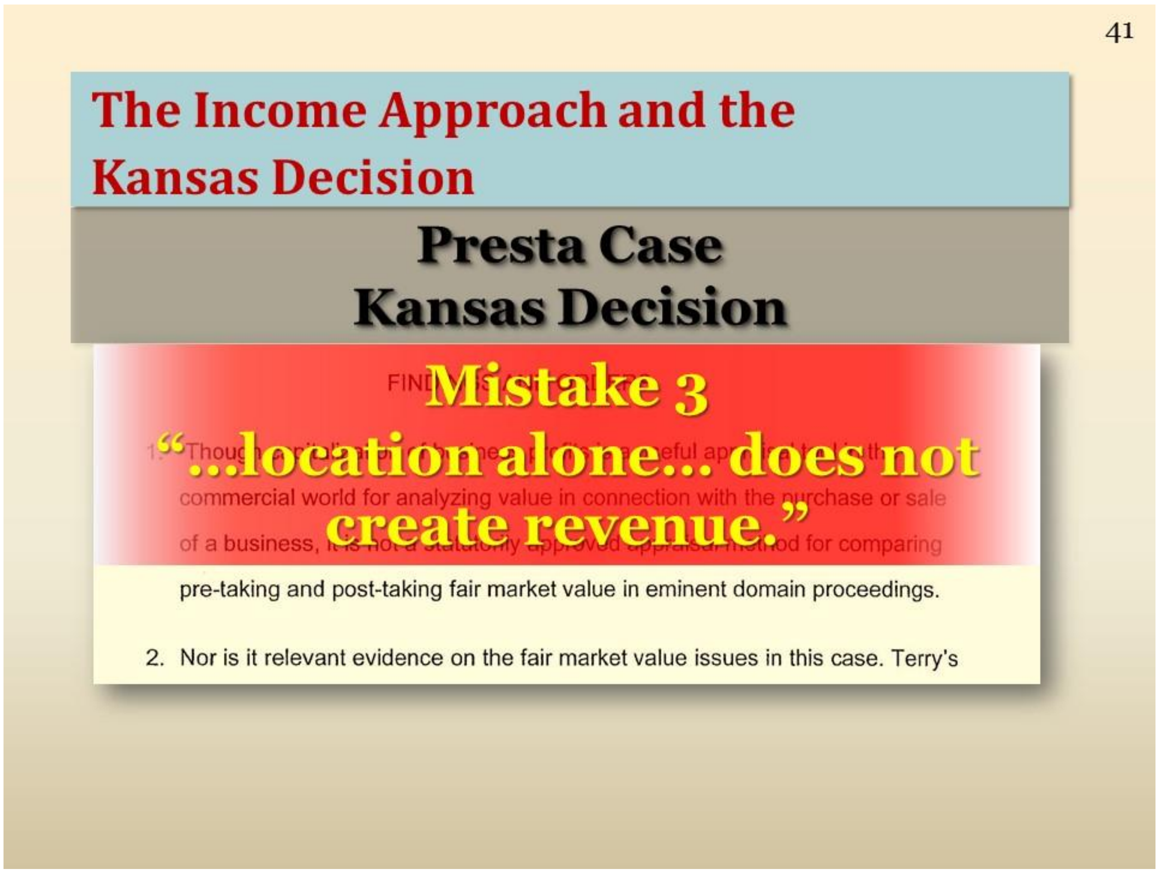
> (a) "…the amount of profits from the business conducted upon the property depends so much upon the capital employed and the fortune, skill and good management with which the business is conducted, that it furnishes no test of the value of the property (in other words, no test of the value of the real estate)." (close quote)

This is not true. Profit (or intangible earnings) should be rightly excluded. But, other measures of earnings are a significant measure of the value of the real estate. For a TRP, earnings under typical management is the single-most important factor in establishing the value of the real estate.

In perfectly competitive markets, the management skills of the owner actually play a very small part in creating value for the business enterprise. For convenience stores and gas stations it is usually less than 7% of the overall value.

This is quite a contrast to the unsupported statement made by the Kansas Court.

SLIDE 41:



Further, the court reasoned:

Quote:

> “To be sure, the location may play a role in the success of the business, but this is equally true for a convenience store or any number of other businesses. But location alone, no matter how unique, does not create revenue.” P.8

This is wrong. Location plays a major role in the creation of earnings. We have already seen how supply and demand, customer demographics and cross-channel competition in the trade area can cause the value of the real estate to rise or fall by as much as 30% or 40%.

These are all location factors.

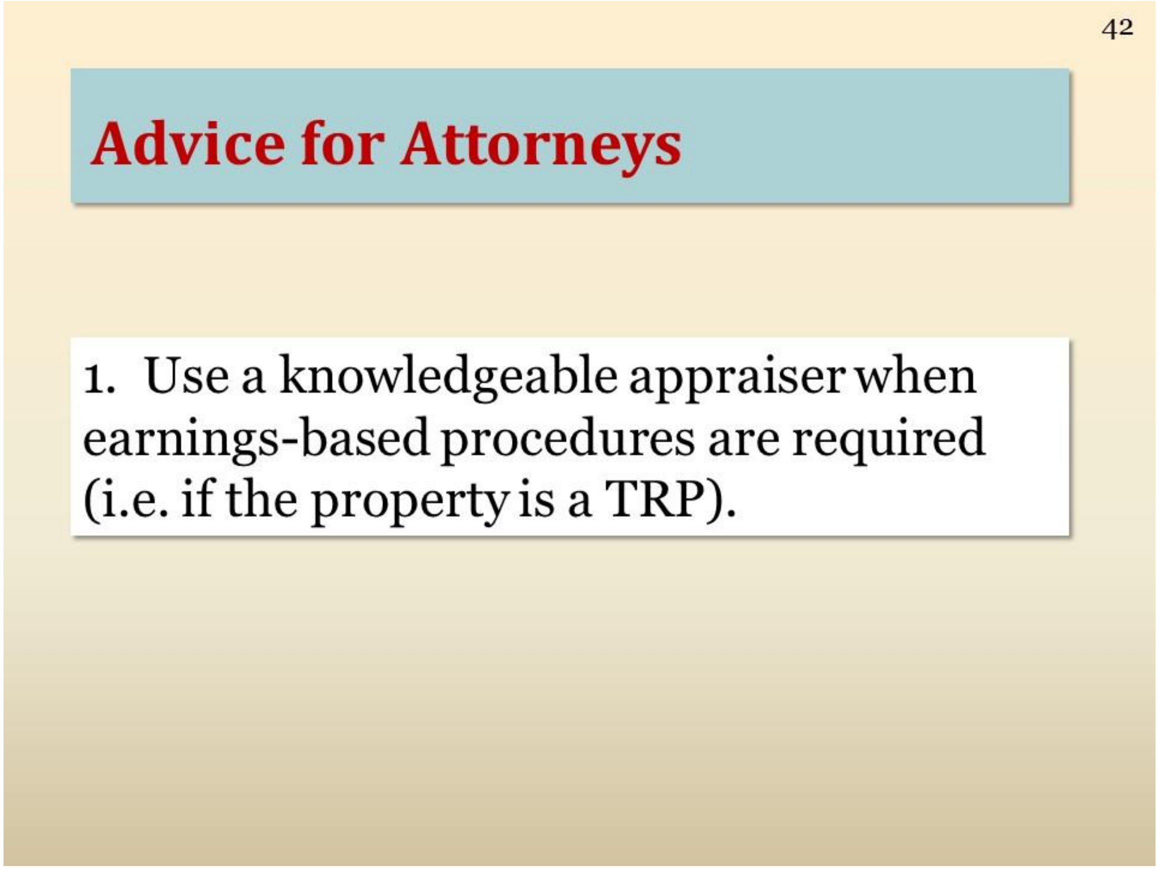
Location does create revenue for TRPs and it is revenue that creates real estate value.

To summarize my view on *Presta* Decision:

The court was correct to reject the property owner’s use of an earnings analysis. However, the court was correct because the appraiser did not do his job. The court is NOT CORRECT in rejecting an earnings allocation because of a belief that the method is unsuited to condemnation cases.

An earnings allocation is a perfectly acceptable, and indeed, a superior method of applying the income approach to Trade Related Property, even in states where business profits are not compensable.

SLIDE 42:



Here is my advice for attorneys:

1. Use a knowledgeable appraiser. One who is familiar with the type of property and one who is fluent in an earnings allocation.

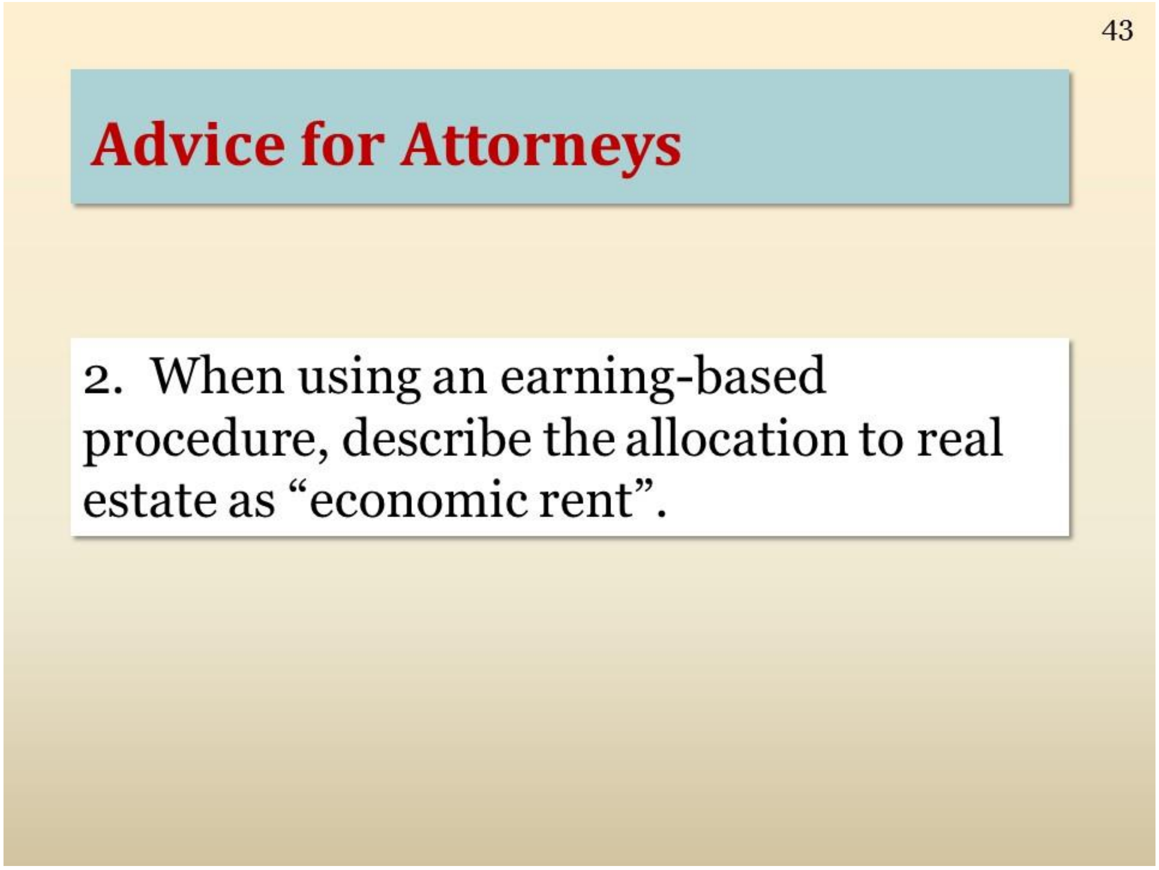
Appraisers, even MAIs, are not created equally.

Some are better at this than others.

For convenience stores and travel centers in high performance locations, the difference in compensation to the property owner can amount to millions of dollars.

So, get an appraiser that knows what they are doing.

SLIDE 43:

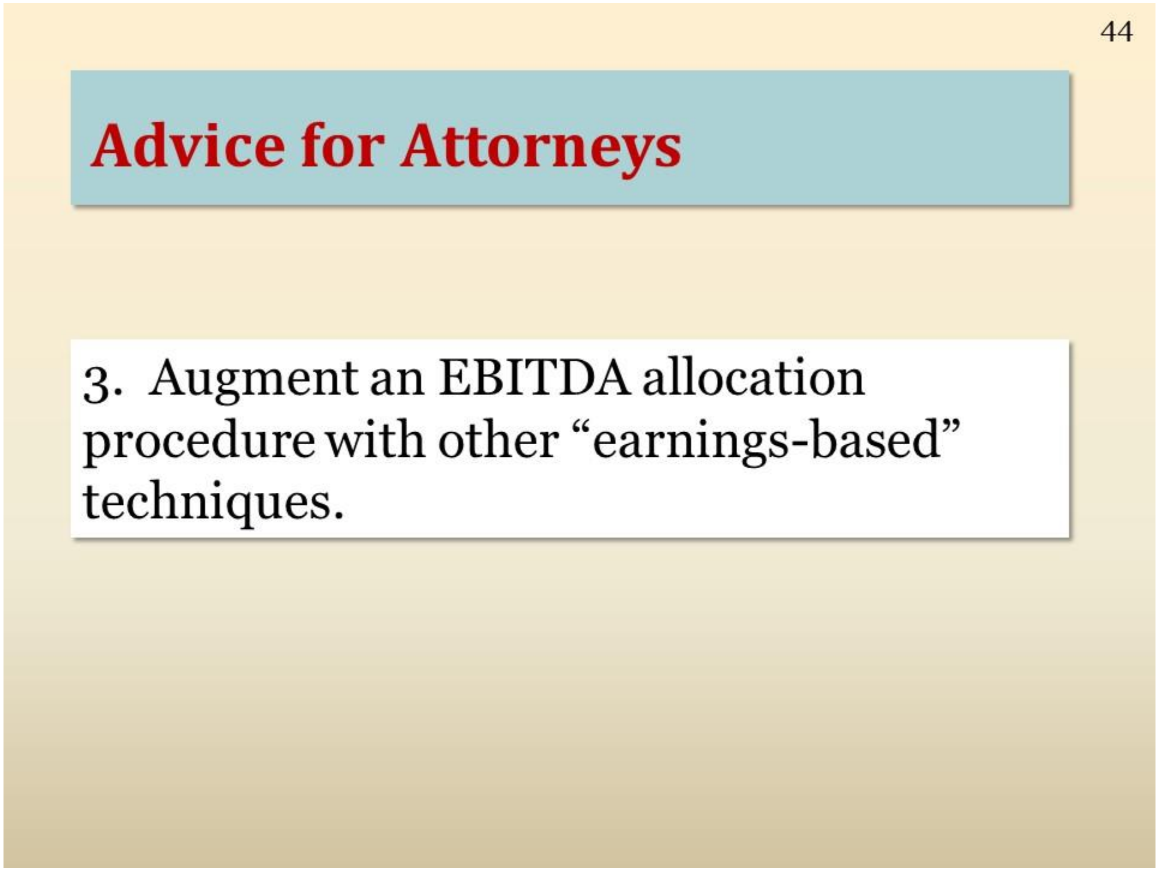


2. When using an earning-based procedure, describe the allocation to real estate as "economic rent".

Make it easy for the court to understand and connect the dots.

When using an earnings allocation the estimated income to real estate should be termed, "Economic Rent". The courts understand that term. The word "Rent" is not vague. It resonates with a judge or jury. It clears up the confusion.

SLIDE 44:



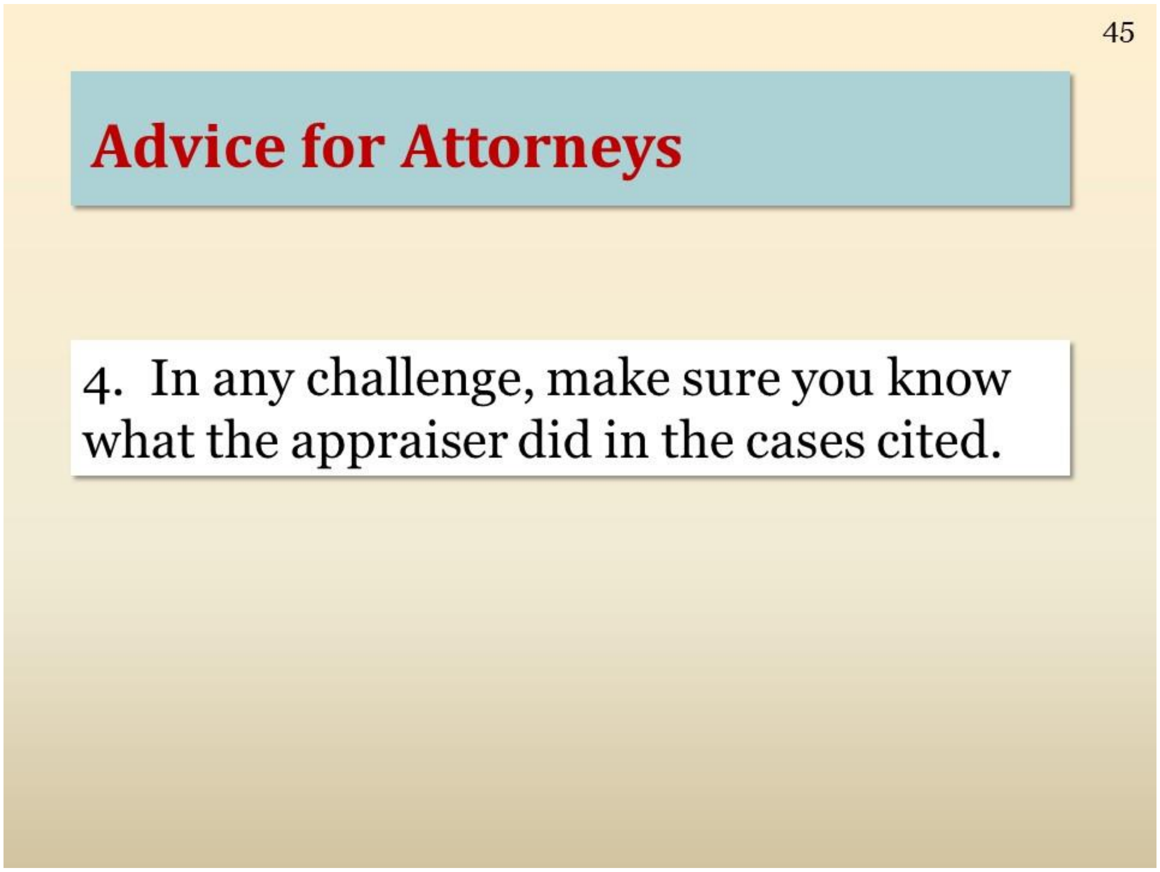
3. Augment an EBITDA allocation procedure with other "earnings-based" techniques.

This helps the trier of fact to see that even when looking at an earnings analysis from different perspectives the results are consistent, as they should be.

This helps instill confidence in the entire appraisal report.

In other words, don't put all of your eggs in one basket, or just one measure of earnings.

SLIDE 45:

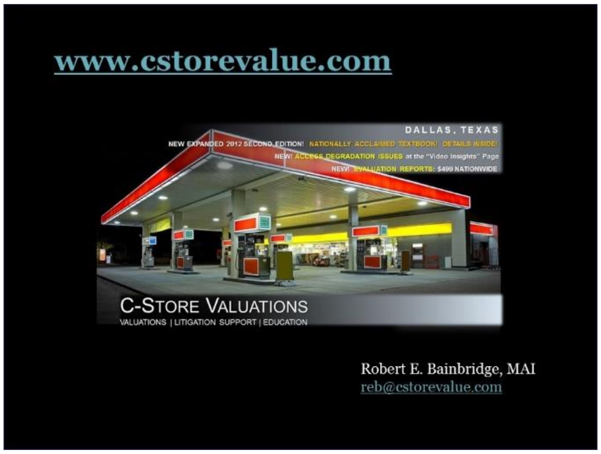


4. In any challenge, make sure you know what the appraiser did in the cases that are being cited.

If a cited case is important to yours, there is really no substitute for getting a copy of the original appraisal in that case and seeing what the appraiser did.

The appraiser may not have done the earnings allocation procedure correctly. It is often not possible to tell by simply reading a WestLaw summary.

SLIDE 46:



I would be happy to answer any questions, or take any comments, in the time remaining.

If you have a question after this session, or something comes up later in your work and you want to discuss it with me,

You can reach me through my website at www.cstorevalue.com

We have a Litigation Advisory page, which has some helpful information and published articles on eminent domain issues regarding convenience stores and gas stations.

Thank you for having me today.

QUESTIONS