WRONG Part 2 Property Rights?

The importance of identifying the rights to be appraised

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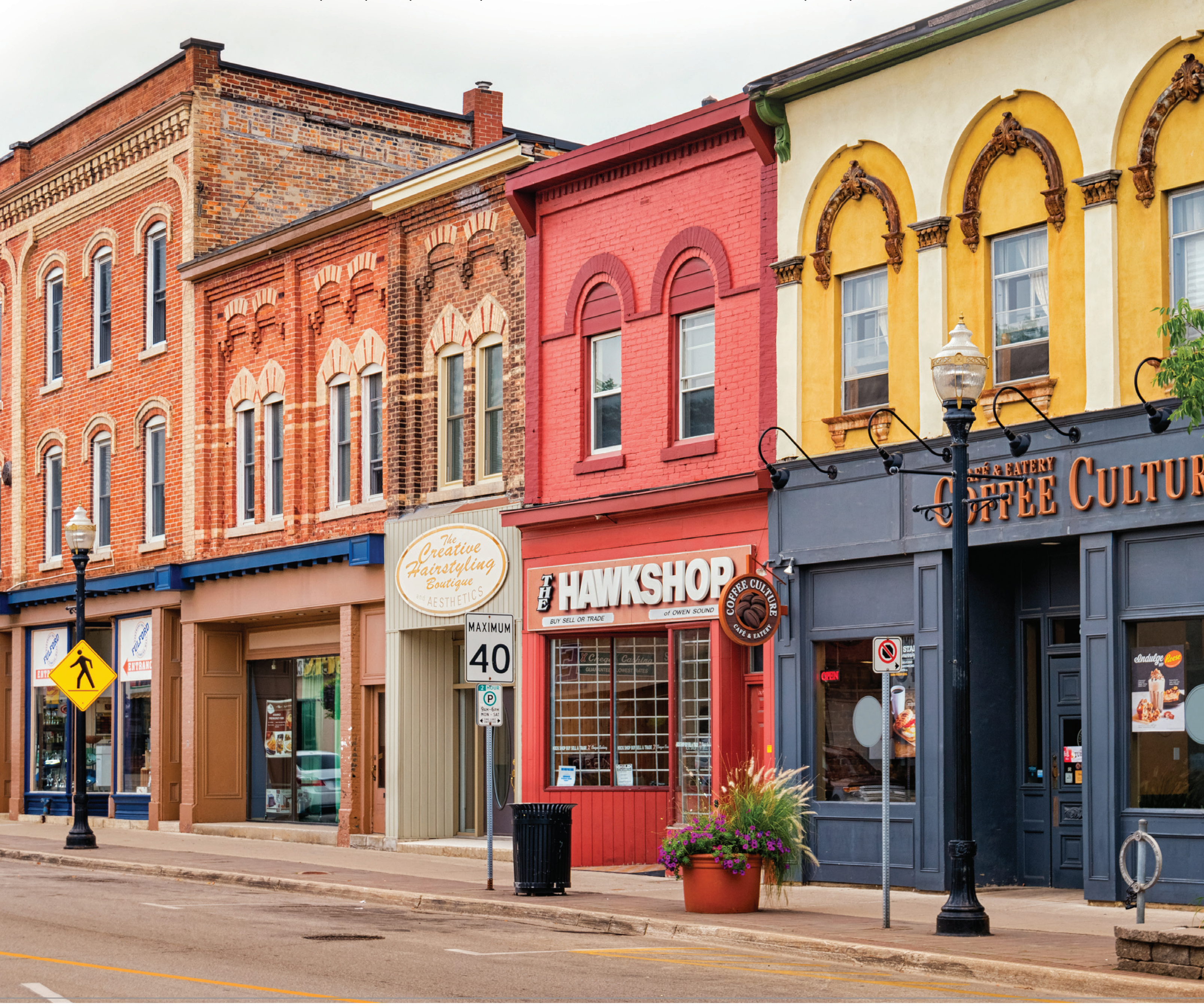


As touched on in Part 1 of this article (September/October 2024 issue), the various types of property characteristics (e.g., economic, legal and physical) can be held in any combination and by a variety of ownership types. Ownership types include co-tenancy/concurrent ownership, condominium, various holding entities (e.g., LLC, LP, GP, Corporation), co-op and timeshare. The distinction between property interests and ownership types is not inherently easy to discern other than property interests are tied directly to benefits derived from the real estate, or how the real property can be put to its highest and best use, while ownership types are the legal constructs by which property rights are held.

A condominium is a commonly encountered example that aids in understanding the difference between property rights and ownership type. The legal description of a condominium usually references the specific unit on the condominium plan, in which there is exclusive use, access and ownership (i.e., the fee simple bundle of rights). There is also the inclusion of a pro-rata percentage interest in the common areas, which includes an overview of explicitly spelled out rights.

This combination of property rights makes it clear that condominium is an ownership type, rather than a category of property rights, as it incorporates the fee simple interest in the specific unit along with a minority interest in the shared common areas. Lack of clarity about ownership types versus property rights can lead to confusion over the appropriate scope of work as well as highest and best use considerations.

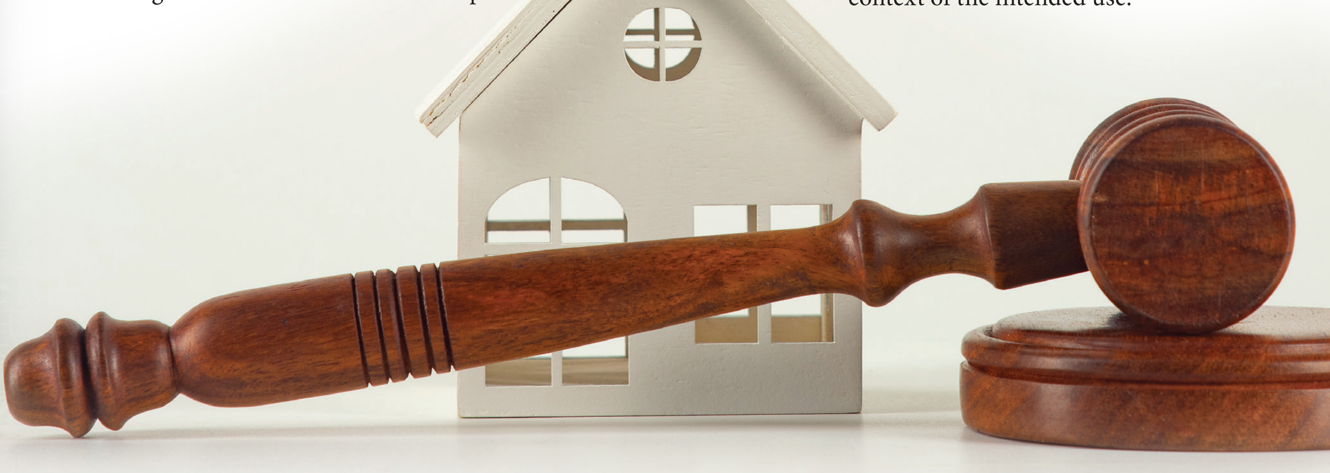
With the above discussion of terminology, coupled with the discussion in Part 1 of this article, one can further explore the foundational nature of property rights in the appraisal sphere. The obvious place to begin is with the fee simple estate in which the full bundle of rights is available to the ownership.

Consistent Use of Terminology

It is worth observing at this point that the term *fee simple* is also often inconsistently applied in the valuation sphere. For instance, it is commonly suggested in appraisals prepared for lending purposes that what is being appraised is "fee simple, subject to short-term leases." This is also seen in other assignments through the label of "fee simple, subject to existing encumbrances."

Once the right of occupancy and use is encumbered by a lease, the ownership no longer controls the full bundle of rights, as the right to occupy and use is now assigned to a third party. As a result, the ownership is bifurcated with the property owner possessing the leased fee interest and the tenant controlling the leasehold interest (appraisers should be wary of assuming the two partial interest values equal the fee simple). Additionally, attorneys regularly use the term "fee simple subject to leases." This is in part because some jurisdictions incorporate this terminology in statutes and regulations related to real estate. However, from the standpoint of valuation theory, once a lease is in place, it becomes a leased fee interest, regardless of duration or whether the lease rate is in line with market expectations at the time of valuation for the reasons described above.

This inaccurate use of terminology often stems from confusion over the fact it is possible (and permissible under USPAP) to appraise the fee simple interest even though the property is encumbered by a lease agreement. Of course, this does not absolve the appraiser from incorporating proper discussion to inform the reader of existing encumbrances and the appropriateness of valuing the fee simple estate within the context of the intended use.



Similarly, when a property has severed mineral rights, it is common for the fee simple estate to be identified as the appraised interest. In some instances, the separation of mineral rights functionally has little impact on the ownership's ability to enjoy the fee simple bundle of rights. This is especially true in instances where mineral deposits are not viably extractable or in instances when the mineral rights were severed on a speculative basis. As with the previous example, it is possible to value the fee simple estate with adequate discussion about existing encumbrances; however, it may be perceived as technically inaccurate to describe what is owned as the fee simple estate.

Fractional vs. Partial Interests

What is owned in the above example might be construed as a fractional interest or something less than the fee simple estate. Some may even refer to this as a partial interest. These two terms are regularly used interchangeably, a circumstance that is reflected by the cross reference of these terms in the "Dictionary of Real Estate Appraisal, 7th Edition." Despite this circumstance, each of these terms have distinct meanings that can be linked to the root words and usage within niche areas of appraisal practice.

Fractional interest suggests a percentage (consistent with the mathematical use of "fraction") of a whole interest. As an example, this term is regularly applied to describe co-tenancy ownership interests, along with percentage ownership in real estate partnerships (e.g., LLCs, LPs, general partnerships, etc.). From this, it becomes apparent the term is tied to ownership types rather than specific property rights as well as some division of an interest beyond a whole unit.

If this understanding of *fractional interest* is accepted, then understanding *partial interest* becomes readily apparent. Partial interest suggests a piece of a larger bundle (i.e., separating the right to occupy a property from the right to leverage it). This understanding, coupled with that of *fractional interest*, makes it clear the term *partial interest* references individual rights that are separated from the larger bundle.

Such an understanding also renders it clear why a 1-acre take in an eminent domain setting is called a "partial take." The 1 acre is one whole unit of the larger bundle of 5 acres, hence a "partial take," rather than a "fractional take." By extension, it is then clear that when dealing with individual property rights/interests they are more properly labeled partial interests, rather than fractional interests within a valuation theory context.

Advisory Opinion 23

Advisory Opinion 23 indicates that "Taken together, the definitions of *real property* and *real estate* provided in USPAP require that the subject of a real property appraisal is a specific ownership of a right (or rights) in identified real estate." There are often situations wherein an appraiser is tasked with analyzing the fee simple interest despite the encumbrance of a lease (i.e., leased fee interest). We often find these circumstances as a direct result of federal or state law such as is the case for eminent domain and ad valorem taxation purposes, but it can also be an assignment condition. Thus, when the intended use requires an appraiser to develop a value of the fee simple interest in a leased property, the appraisal premise should consider the property being available (i.e., owner-occupied, month-to-month tenancy, etc.) to be leased at market rates, as this type of assignment should be an examination of the property's full bundle of rights.

Too often, valuation professionals seem to believe that a property achieving a contract rent that is equal to market rent constitutes equality across the fee simple and leased fee property rights. Although this can be the case, it often is not. As previously highlighted within this discussion, and as offered within Advisory Opinion 23, the appraisal of real property involves an investigation of both a property's physical and legal attributes. The result of this investigation then informs the selection of relevant methodologies, data and analysis subject to the type and definition of value and intended use of the assignment results. Ultimately, the appraiser must recognize the varying characteristics of the subject of a real property appraisal, which is critical to identifying and communicating which characteristics of the property are relevant in the assignment.

Practical Example #1

Depending on the property rights being analyzed, the fee simple and leased fee scenarios may conclude to the same value, or they could be vastly different depending upon the circumstances. For example, imagine two identical properties on Main Street, Anytown USA. These properties consist of assets typically purchased for owner-occupancy. Property A is owner occupied, while the identical Property B is subject to a moderate-to-long-term lease equal to market rent. Depending on the intended use and intended user, which typically drive the property interest being examined, the value propositions could be wildly different.

If the intended use requires the value of Property A's fee simple interest, this will likely include examining Property A by employing the sales comparison approach and focusing on owner-occupied sales from within the competitive market area. It is generally accepted that this methodology most aptly emulates the actions of the most likely buyer in the purchase of such an asset. An income approach may be included for academic purposes or at the request of the client. In such circumstances, it is common for the income approach value to be well below the sales comparison approach value, as the former models different motivations and behaviors that are not necessarily consistent with those of an owner-occupant.

In contrast, in developing an appraisal for Property B, most appraisers would examine its income generating attributes and assess the quality, quantity and durability of the property's income stream through the use of the income approach as the primary driver of support for the value opinion. Such an analysis may yield a value opinion that is the same, significantly higher, or lower when compared with the development of an income approach used in the Property A analysis, depending on the property rights being examined as well as a variety of investment criteria, market conditions, interest rates, tenant quality or other market forces.

Practical Example #2

Another example of differentiating fee simple and leased fee property rights can be dependent on tenancy. Similar to the previous example, picture two identical properties on the same Main Street, Anytown USA. In this example, suppose these two properties are adjacent, leased coffee shops, with Property A housing a national brand chain as its tenant and Juan Doe Coffee Beans occupying Property B. Assume both properties are achieving lease rates that are consistent with market expectations. Ceteris paribus, would fee simple and leased fee be equal? Would the values be exactly the same for both properties? As every appraiser worth their salt will tell you, it depends.

High-quality tenants (typically characterized by businesses with strong financial histories) are likely to contribute to the financial stability of the property and crucially are more likely to meet lease obligations on time. Such circumstances help ensure a steady cash flow for property owners, as a high-quality tenant helps provide the property owner and potential buyers with confidence in timely rent payments and long-term lease commitments. In other words, this type of tenant can be viewed as having a lower risk profile relative to a single location operator.

On the other hand, a property with a low-quality tenant can lead to a lackluster environment with lower foot traffic and reduced business performance. This can negatively impact the revenue potential of surrounding tenants and decrease the overall attractiveness of the property. Ultimately, the quality of tenants plays a pivotal role in how buyers perceive a property and its relative risk profile. With appraisers attempting to emulate the actions of buyers and sellers in the market, it is important to consider such factors. For reasons noted above, a competent appraiser is likely to apply a very different capitalization rate

when valuing these coffee shops due to their differing income attributes and risk profiles, despite the fact that the two properties have identical income streams. The result is potentially different value opinions for the leased fee and fee simple scenarios.

Practical Example #3

The final example we present highlighting the importance of an appraiser's responsibility to identify the correct property rights involves the valuation of land. As appraisers, we are all aware that six valuation techniques exist for developing land value. However, three of the six can only be used when the land is generating income, such as is the case with a ground lease. In the world of income producing properties, the income or cash flow generated by a property is usually the primary determinant of its value.

The valuation of a leased fee interest in an income producing property hinges on three critical factors: the quantity, quality and durability of the property's income stream. Understanding these elements is essential for investors and appraisers to make informed decisions and accurately assess a property's value.

The quantity of income generally refers to the total amount of revenue a property generates (i.e., rent, royalties or other income streams). Meanwhile the quality of an income relates to the reliability and risk of the income stream. The durability of income refers to the expected duration and sustainability of the property's revenue stream (i.e., lease term, likelihood of renewal, etc.), which can have a significant impact on the valuation of a ground lease.

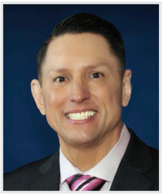
An unencumbered vacant site and a ground lease both require valuations using one of the six recognized land valuation techniques, yet depending on the income attributes, or lack thereof, can result in a significantly higher, or lower, leased fee ground lease value versus the fee simple valuation of the land using the sales comparison approach. In light of these points, it should become clear that comparing a fee simple interest to a leased fee interest in a site (even as a test of reasonableness) is arguably inappropriate without further context and consideration.

Closing Thoughts

This article has endeavored to scratch the surface of the complexities associated with identifying property rights and how a solid understanding of property rights is essential to the valuation process. Property rights are complex and require the skillful appraiser to begin with understanding the nature of the assignment and "problem" to be solved for their clients. The identification of the appropriate property rights to be valued begins with communication with the client. Valuation practitioners have a variety of tools and resources that can be called into action but can also be easily misapplied.

Whether analyzing the fee simple or leased fee interest, care must be taken to identify the most relevant methodologies, reflecting the motivations and behavior of market participants as they determine the most appropriate price to pay. Assignment conditions must also be taken into account. Furthermore, when developing an opinion of the value of a leased fee estate or a leasehold estate, an appraiser must analyze the effect on value, if any, of the terms and conditions of the lease(s) which may result in parts being worth more or less than the full bundle of rights when considered as a whole.

As has hopefully been illuminated throughout Part 1 and Part 2 of this article, the sum of the parts does not always equal the whole, as suggested in a comment associated with USPAP Standards Rule 1-2(e). While there are more nuances and concepts than can be covered within the scope of this two-part article, the hope is that readers walk away with a greater appreciation of the challenges faced by appraisers and valuation practitioners as they attempt to model the market's reaction to a specific real estate asset. ✪



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